EXPONENT INC
Form 10-Q
May 09, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended April 4, 2014

OR

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

For the transition period from _________________________ to _________________________

Commission File Number 0-18655

EXPONENT, INC.

(Exact name of registrant as specified in its charter)

DELAWARE	**77-0218904**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

149 COMMONWEALTH DRIVE, MENLO PARK, CALIFORNIA	**94025**
(Address of principal executive office)	(Zip Code)

(650) 326-9400

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No ¨

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

Large accelerated filer ¨	Accelerated filer x	Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

As of May 2, 2014, the latest practicable date, the registrant had 13,102,801 shares of Common Stock, $0.001 par value per share, outstanding.

EXPONENT, INC.

FORM 10-Q

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

EXPONENT, INC.

Condensed Consolidated Balance Sheets

April 4, 2014 and January 3, 2014

(in thousands, except par value)

(unaudited)

	April 4, 2014	January 3, 2014
Assets		
Current assets:		
Cash and cash equivalents	$105,621	$122,948
Short-term investments	31,831	33,171
Accounts receivable, net of allowance for doubtful accounts of $2,753 and $2,771 at April 4, 2014 and January 3, 2014, respectively	84,946	76,980
Prepaid expenses and other assets	16,835	10,450
Deferred income taxes	10,408	8,135
Total current assets	249,641	251,684
Property, equipment and leasehold improvements, net	28,314	28,721
Goodwill	8,607	8,607
Deferred income taxes	22,073	21,102
Deferred compensation plan assets	32,766	33,501
Other assets	593	551
Total assets	$341,994	$344,166
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	$12,862	$8,442
Accrued payroll and employee benefits	42,336	56,934
Deferred revenues	7,204	6,771
Total current liabilities	62,402	72,147

Other liabilities	1,250	1,181
Deferred compensation	34,516	33,447
Deferred rent	2,233	2,332
Total liabilities	100,401	109,107
Stockholders' equity:		
Common stock, $0.001 par value; 100,000 shares authorized;		
16,427 shares issued at April 4, 2014 and January 3, 2014	16	16
Additional paid-in capital	155,690	141,250
Accumulated other comprehensive income		
Investment securities, available for sale	24	10
Foreign currency translation adjustments	151	99
	175	109
Retained earnings	225,592	226,040
Treasury stock, at cost; 3,293 and 3,363 shares held at		
April 4, 2014 and January 3, 2014, respectively	(139,880)	(132,356)
Total stockholders' equity	241,593	235,059
Total liabilities and stockholders' equity	$341,994	$344,166

The accompanying notes are an integral part of these Unaudited Condensed Consolidated Financial Statements.

EXPONENT, INC.

Condensed Consolidated Statements of Income

For the Three Months Ended April 4, 2014 and March 29, 2013

(in thousands, except per share data)

(unaudited)

	Three Months Ended	
	April 4, 2014	March 29, 2013
Revenues:		
Revenues before reimbursements	$ 72,967	$ 68,992
Reimbursements	2,995	3,668
Revenues	75,962	72,660
Operating expenses:		
Compensation and related expenses	48,858	48,562
Other operating expenses	6,317	6,147
Reimbursable expenses	2,995	3,668
General and administrative expenses	3,698	3,432
Total operating expenses	61,868	61,809
Operating income	14,094	10,851
Other income, net:		
Interest income, net	44	45
Miscellaneous income, net	1,227	2,609
Total other income, net	1,271	2,654
Income before income taxes	15,365	13,505
Income taxes	6,211	5,529
Net income	$ 9,154	$ 7,976
Net income per share:		

Basic	$ 0.68	$ 0.58
Diluted	$ 0.66	$ 0.56
Shares used in per share computations:		
Basic	13,537	13,667
Diluted	13,940	14,125
Cash dividends declared per common share	$ 0.25	$ 0.15

The accompanying notes are an integral part of these Unaudited Condensed Consolidated Financial Statements

EXPONENT, INC.

Condensed Consolidated Statements of Comprehensive Income

For the Three Months Ended April 4, 2014 and March 29, 2013

(in thousands)

(unaudited)

	Three Months Ended	
	April 4, 2014	March 29, 2013
Net income	$ 9,154	$ 7,976
Other comprehensive income:		
Foreign currency translation adjustments, net of tax	52	(461)
Unrealized gains (losses) on available for sale investment securities arising during the period, net of tax	14	(12)
Comprehensive income	$ 9,220	$ 7,503

The accompanying notes are an integral part of these Unaudited Condensed Consolidated Financial Statements

EXPONENT, INC.

Condensed Consolidated Statements of Cash Flows

For the Three Months Ended April 4, 2014 and March 29, 2013

(in thousands)

(unaudited)

	Three Months Ended	
	April 4, 2014	March 29, 2013
Cash flows from operating activities:		
Net income	$9,154	$7,976
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization of property, equipment and leasehold improvements	1,322	1,149
Amortization of premiums and accretion of discounts on short-term investments	225	79
Deferred rent	(99)	61
Provision for doubtful accounts	249	135
Stock-based compensation	5,293	5,291
Deferred income tax provision	(3,324)	(1,254)
Excess tax benefit from equity awards	(4,499)	(3,774)
Changes in operating assets and liabilities:		
Accounts receivable	(8,215)	4,674
Prepaid expenses and other assets	(4,988)	(3,121)
Accounts payable and accrued liabilities	8,167	240
Accrued payroll and employee benefits	(9,838)	(15,401)
Deferred revenues	433	(1,237)
Net cash used in operating activities	(6,120)	(5,182)
Cash flows from investing activities:		
Capital expenditures	(915)	(1,959)
Maturity of short-term investments	1,140	11,240
Net cash provided by investing activities	225	9,281
Cash flows from financing activities:		
Excess tax benefit from equity awards	4,499	3,774
Payroll taxes for restricted stock units	(6,267)	(6,119)
Repurchase of common stock	(6,831)	(11,490)
Exercise of share-based payment awards	329	612

Dividends paid	(3,310)	(1,969)
Net cash used in financing activities	(11,580)	(15,192)
Effect of foreign currency exchange rates on cash and cash equivalents	148	(674)
Net decrease in cash and cash equivalents	(17,327)	(11,767)
Cash and cash equivalents at beginning of period	122,948	113,268
Cash and cash equivalents at end of period	$105,621	$101,501

The accompanying notes are an integral part of these Unaudited Condensed Consolidated Financial Statements.

EXPONENT, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1: Basis of Presentation

Exponent, Inc. (referred to as the “Company” or “Exponent”) is an engineering and scientific consulting firm that provides solutions to complex problems. The Company operates on a 52-53 week fiscal year ending on the Friday closest to the last day of December.

The accompanying unaudited condensed consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission. Accordingly, they do not contain all the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments which are necessary for the fair presentation of the condensed consolidated financial statements have been included and all such adjustments are of a normal and recurring nature. The operating results for the three months ended April 4, 2014 are not necessarily representative of the results of future quarterly or annual periods. The following information should be read in conjunction with the audited consolidated financial statements and accompanying notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended January 3, 2014 which was filed with the U.S. Securities and Exchange Commission on February 28, 2014.

The unaudited condensed consolidated financial statements include the accounts of Exponent, Inc. and its subsidiaries, which are all wholly owned. All intercompany accounts and transactions have been eliminated in consolidation.

Authorized Capital Stock. In a letter dated May 23, 2006, the Company committed to stockholders to limit its use of authorized capital stock to 40 million common shares, and 2 million preferred shares, unless the approval of the Company’s stockholders is subsequently obtained, such as through a further amendment to the Company’s authorized capital stock.

Dividend. The Company declared and paid cash dividends per common share during the periods presented as follows:

	Fiscal Year 2014	
	Dividends Per Share	Amount (in thousands)
First Quarter	$0.25	$ 3,262
		$ 3,262

	Fiscal Year 2013	
	Dividends Per Share	Amount (in thousands)
First Quarter	$0.15	$ 1,969
Second Quarter	$0.15	1,998
Third Quarter	$0.15	1,945
Fourth Quarter	$0.15	1,965
		$ 7,877

Prior to 2013 the Company had never paid cash dividends on its common stock. On April 23, 2014 the Company's Board of Directors announced a cash dividend of $0.25 per share of the Company's common stock, payable June 27, 2014, to stockholders of record as of June 6, 2014. The Company expects to continue paying quarterly dividends in the future, subject to declaration by the Company's Board of Directors.

Use of Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Significant items subject to such estimates and assumptions include accounting for revenue recognition and estimating the allowance for doubtful accounts. Actual results could differ from those estimates.

Note 2: Fair Value Measurements

The Company measures certain financial assets and liabilities at fair value on a recurring basis, including available-for-sale fixed income securities, trading fixed income and equity securities held in its deferred compensation plan and the liability associated with its deferred compensation plan. There have been no transfers between fair value measurement levels during the three months ended April 4, 2014 and March 29, 2013. Any transfers between fair value measurement levels would be recorded on the actual date of the event or change in circumstances that caused the transfer. The fair value of these certain financial assets and liabilities was determined using the following inputs at April 4, 2014:

	Fair Value Measurements at Reporting Date Using			
(In thousands)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Money market securities (1)	$ 38,347	$ 38,347	$ -	$ -
Fixed income available for sale securities (2)	31,831	-	31,831	-
Fixed income trading securities held in deferred compensation plan (3)	10,914	10,914	-	-
Equity trading securities held in deferred compensation plan (3)	32,251	32,251	-	-
Total	$ 113,343	$ 81,512	$ 31,831	$ -
Liabilities				
Deferred compensation plan (4)	44,874	44,874	-	-
Total	$ 44,874	$ 44,874	$ -	$ -

(1) Included in cash and cash equivalents on the Company’s unaudited condensed consolidated balance sheet.

(2) Included in short-term investments on the Company’s unaudited condensed consolidated balance sheet.

(3) Included in prepaid expenses and other assets and deferred compensation plan assets on the Company’s unaudited condensed consolidated balance sheet.

(4) Included in accrued payroll and employee benefits and deferred compensation on the Company’s unaudited condensed consolidated balance sheet.

The fair value of these certain financial assets and liabilities was determined using the following inputs at January 3, 2014:

	Fair Value Measurements at Reporting Date Using			
(In thousands)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Money market securities [1]	$ 37,099	$ 37,099	$ -	$ -
Fixed income available for sale securities [2]	33,171	-	33,171	-
Fixed income trading securities held in deferred compensation plan [3]	9,535	9,535	-	-
Equity trading securities held in deferred compensation plan [3]	28,444	28,444	-	-
Total	$ 108,249	$ 75,078	$ 33,171	$ -
Liabilities				
Deferred compensation plan [4]	37,926	37,926	-	-
Total	$ 37,926	$ 37,926	$ -	$ -

(1) Included in cash and cash equivalents on the Company's consolidated balance sheet.
(2) Included in short-term investments on the Company's consolidated balance sheet.
(3) Included in prepaid expenses and other assets and deferred compensation plan assets on the Company's consolidated balance sheet.
(4) Included in accrued payroll and employee benefits and deferred compensation on the Company's consolidated balance sheet.

Fixed income available-for-sale securities as of April 4, 2014 and January 3, 2014 represent primarily obligations of state and local government agencies. Fixed income and equity trading securities represent mutual funds held in the Company's deferred compensation plan. See Note 6 for additional information about the Company's deferred compensation plan.

Cash, cash equivalents and short-term investments consisted of the following as of April 4, 2014:

(In thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Classified as current assets:				
Cash	$ 67,274	$ -	$ -	$ 67,274
Cash equivalents:				
Money market securities	38,347	-	-	38,347
Total cash equivalents	38,347	-	-	38,347
Total cash and cash equivalents	105,621	-	-	105,621
Short-term investments:				
State and municipal bonds	31,791	43	(3)	31,831
Total short-term investments	31,791	43	(3)	31,831
Total cash, cash equivalents and short-term investments	$ 137,412	$ 43	$ (3)	$ 137,452

There were no securities in a continuous unrealized loss position for more than 12 months as of April 4, 2014.

Cash, cash equivalents and short-term investments consisted of the following as of January 3, 2014:

(In thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Classified as current assets:				
Cash	$ 85,849	$ -	$ -	$ 85,849
Cash equivalents:				
Money market securities	37,099	-	-	37,099
Total cash equivalents	37,099	-	-	37,099
Total cash and cash equivalents	122,948	-	-	122,948
Short-term investments:				
State and municipal bonds	33,155	25	(9)	33,171
Total short-term investments	33,155	25	(9)	33,171

Total cash, cash equivalents and short-term investments	$ 156,103	$ 25	$ (9)	$ 156,119

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The following table summarizes the cost and estimated fair value of short-term fixed income securities classified as short-term investments based on stated effective maturities as of April 4, 2014:

(In thousands)	Amortized Cost	Estimated Fair Value
Due within one year	$ 14,945	$ 14,956
Due between one and two years	16,846	16,875
Total	$ 31,791	$ 31,831

At April 4, 2014 and January 3, 2014, the Company did not have any assets or liabilities valued using significant unobservable inputs.

The following financial instruments are not measured at fair value on the Company's consolidated balance sheet at April 4, 2014 and January 3, 2014, but require disclosure of their fair values: accounts receivable, other assets and accounts payable. The estimated fair value of such instruments at April 4, 2014 and January 3, 2014 approximates their carrying value as reported on the consolidated balance sheet due to their generally short maturities. If measured at fair value in the financial statements, these instruments would be categorized as Level 2 of the fair value hierarchy.

There were no other-than-temporary impairments or credit losses related to available-for-sale securities during the three months ended April 4, 2014 and March 29, 2013.

Note 3: Net Income Per Share

Basic per share amounts are computed using the weighted-average number of common shares outstanding during the period. Diluted per share amounts are calculated using the weighted-average number of common shares outstanding during the period and, when dilutive, the weighted-average number of potential common shares from the issuance of common stock to satisfy outstanding restricted stock units and the exercise of outstanding options to purchase common stock using the treasury stock method.

The following schedule reconciles the shares used to calculate basic and diluted net income per share:

	Three Months Ended	
(In thousands)	April 4, 2014	March 29, 2013
Shares used in basic per share computation	13,537	13,667
Effect of dilutive common stock options outstanding	79	76
Effect of dilutive restricted stock units outstanding	324	382
Shares used in diluted per share computation	13,940	14,125

There were no options excluded from the diluted per share calculations for the three months ended April 4, 2014 and March 29, 2013.

Note 4: Stock-Based Compensation

Restricted Stock Units

Restricted stock unit grants are designed to attract and retain employees, and to better align employee interests with those of the Company’s stockholders. For a select group of employees, up to 40% of their annual bonus is settled with fully vested restricted stock unit awards. Under these fully vested restricted stock unit awards, the holder of each award has the right to receive one share of the Company’s common stock for each fully vested restricted stock unit four years from the date of grant. Each individual who receives a fully vested restricted stock unit award is also granted a matching number of unvested restricted stock unit awards. Unvested restricted stock unit awards are also granted for select new hires and promotions. These unvested restricted stock unit awards generally cliff vest four years from the date of grant, at which time the holder of each award will have the right to receive one share of the Company’s common stock for each restricted stock unit award provided the holder of each award has met certain employment conditions. In the case of retirement at 59½ years or older, all unvested restricted stock unit awards will continue to vest, provided that the holder of each award does all consulting work through the Company and does not become an employee for a past or present client, beneficial party or competitor of the Company.

The value of these restricted stock unit awards is determined based on the market price of the Company’s common stock on the date of grant. The value of fully vested restricted stock unit awards issued is recorded as a reduction to accrued bonuses. The portion of bonus expense that the Company expects to settle with fully vested restricted stock unit awards is recorded as stock-based compensation during the period the bonus is earned. The Company recorded stock-based compensation expense associated with accrued bonus awards of $1,586,000 and $1,513,000 during the three months ended April 4, 2014 and March 29, 2013, respectively. The value of the unvested restricted stock unit awards granted is recognized on a straight-line basis over the shorter of the four-year vesting period or the period between the grant date and the date the award recipient turns 59½. If the award recipient is 59½ years or older on the date of grant, the value of the entire award is expensed upon grant. The Company recorded stock-based compensation expense associated with the unvested restricted stock unit awards of $3,227,000 and $3,158,000 during the three months ended April 4, 2014 and March 29, 2013, respectively.

Stock Options

Stock options are granted for terms of ten years and generally vest 25% per year over a four-year period from the grant date. For options granted on or after January 1, 2012, all unvested stock option awards will continue to vest in the case of retirement at 59½ or older, provided that the holder of each award does all consulting work through the Company and does not become an employee for a past or present client, beneficial party or competitor of the Company. The Company grants options at exercise prices equal to the fair value of the Company’s common stock on the date of grant. The Company recorded stock-based compensation expense of $480,000 and $620,000 during the three months ended April 4, 2014 and March 29, 2013, respectively, associated with stock option grants.

The Company uses the Black-Scholes option-pricing model to determine the fair value of options granted. The determination of the fair value of stock-based awards on the date of grant using an option-pricing model is affected by the Company's stock price as well as assumptions regarding a number of complex and subjective variables. These variables include expected stock price volatility over the term of the award, actual and projected employee stock option exercise behaviors, the risk-free interest rate and expected dividends.

The Company used historical exercise and post-vesting forfeiture and expiration data to estimate the expected term of options granted. The historical volatility of the Company's common stock over a period of time equal to the expected term of the options granted was used to estimate expected volatility. The risk-free interest rate used in the option-pricing model was based on United States Treasury zero-coupon issues with remaining terms similar to the expected term on the options. The Company is required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. Historical data was used to estimate pre-vesting option forfeitures and stock-based compensation expense was recorded only for those awards that are expected to vest. All share-based payment awards are recognized on a straight-line basis over the requisite service periods of the awards.

Note 5: Treasury Stock

On February 9, 2012, the Company's Board of Directors authorized $35,000,000 for the repurchase of the Company's common stock. On February 15, 2013, the Company's Board of Directors authorized an additional $35,000,000 for the repurchase of the Company's common stock.

The Company repurchased 102,719 shares of its common stock for $7,631,000 during the three months ended April 4, 2014. The Company repurchased 229,433 shares of its common stock for $11,676,000 during the three months ended March 29, 2013. As of April 4, 2014, the Company had remaining authorization under its stock repurchase plans of $23,369,000 to repurchase shares of common stock.

Net losses related to the re-issuance of treasury stock to settle restricted stock unit and stock option awards of $6,050,000 and $10,025,000 were recorded as a reduction to retained earnings during the three months ended April 4, 2014 and March 29, 2013, respectively.

Note 6: Deferred Compensation Plan

The Company maintains a nonqualified deferred compensation plan for the benefit of a select group of highly compensated employees. Under this plan, participants may elect to defer up to 100% of their compensation. Company assets that are earmarked to pay benefits under the plan are held in a rabbi trust and are subject to the claims of the Company's creditors. As of April 4, 2014 and January 3, 2014, the invested amounts under the plan totaled $43,165,000 and $37,979,000, respectively. These assets are classified as trading securities and are recorded at fair value with changes recorded as adjustments to other income and expense.

As of April 4, 2014 and January 3, 2014, vested amounts due under the plan totaled $44,874,000 and $37,926,000, respectively. Changes in the liability are recorded as adjustments to compensation expense. During the three months ended April 4, 2014 and March 29, 2013, the Company recognized compensation expense of $731,000 and $2,066,000, respectively, as a result of increases in the fair value of the trust assets with the same amount being recorded as income in other income, net.

Note 7: Supplemental Cash Flow Information

The following is supplemental disclosure of cash flow information:

	Three Months Ended	
(In thousands)	April 4, 2014	March 29, 2013
Cash paid during period:		
Income taxes	$ 428	$ 623
Non-cash investing and financing activities:		
Unrealized gain (loss) on short-term investments	$ 14	$ (12)

Vested stock unit awards issued to settle accrued bonuses	$ 6,008	$ 5,807
Stock repurchases payable to broker	$ 800	$ 694

Note 8: Accounts Receivable, Net

At April 4, 2014 and January 3, 2014, accounts receivable, net, was comprised of the following:

(In thousands)	April 4, 2014	January 3, 2014
Billed accounts receivable	$55,774	$ 52,674
Unbilled accounts receivable	31,925	27,077
Allowance for doubtful accounts	(2,753)	(2,771)
Total accounts receivable, net	$84,946	$ 76,980

Note 9: Segment Reporting

The Company has two operating segments based on two primary areas of service. The Engineering and Other Scientific operating segment is a broad service group providing technical consulting in different practices primarily in the areas of engineering and technology development. The Environmental and Health operating segment provides services in the area of environmental, epidemiology and health risk analysis. This operating segment provides a wide range of consulting services relating to environmental hazards and risks and the impact on both human health and the environment.

Segment information for the three months ended April 4, 2014 and March 29, 2013 follows:

Revenues

	Three Months Ended	
(In thousands)	April 4, 2014	March 29, 2013
Engineering and Other Scientific	$55,827	$53,323
Environmental and Health	20,135	19,337
Total revenues	$75,962	$72,660

Operating income

	Three Months Ended	
(In thousands)	April 4, 2014	March 29, 2013
Engineering and Other Scientific	$18,818	$16,874
Environmental and Health	5,973	5,580
Total segment operating income	24,791	22,454
Corporate operating expense	(10,697)	(11,603)
Total operating income	$14,094	$10,851

Capital Expenditures

	Three Months Ended	
(In thousands)	April 4, 2014	March 29, 2013
Engineering and Other Scientific	$530	$1,361
Environmental and Health	55	38
Total segment capital expenditures	585	1,399
Corporate capital expenditures	330	560

Total capital expenditures	$915	$1,959

Depreciation and Amortization

(In thousands)	Three Months Ended April 4, 2014	March 29, 2013
Engineering and Other Scientific	$873	$699
Environmental and Health	47	74
Total segment depreciation and amortization	920	773
Corporate depreciation and amortization	402	376
Total depreciation and amortization	$1,322	$1,149

No single customer comprised more than 10% of the Company's revenues during the three months ended April 4, 2014 and March 29, 2013. No single customer comprised more than 10% of the Company's accounts receivable at April 4, 2014 and January 3, 2014.

Note 10: Goodwill

Below is a breakdown of goodwill reported by segment as of April 4, 2014:

(In thousands)	Environmental and Health	Engineering and Other Scientific	Total
Goodwill	$ 8,099	$ 508	$8,607

There were no acquisitions, dispositions, impairments or other changes in the carrying amount of goodwill, nor any changes in the composition of the Company's reporting units, during the three months ended April 4, 2014.

Note 11: Contingencies

The Company is party to a lawsuit arising from the Company's hiring of employees from another consulting firm. Their former employer alleges that the Company aided and abetted the employees' breach of duties owed to their former employer, wrongfully interfered with the former employer's economic relationships, and breached a software license agreement. The lawsuit also alleges that the Company misappropriated the former employer's trade secrets and violated unfair trade practice laws. The case is currently in discovery and no trial date has been set. The Company intends to vigorously defend itself. Although the Company's ultimate liability in this matter cannot be determined based on the information currently available, the Company, after consultation with legal counsel, has accrued an immaterial amount. The Company believes, after consultation with legal counsel, the ultimate resolution of this claim will not have a material adverse effect on its financial condition or results of operations. However, due to the risks and uncertainties inherent in legal proceedings, actual results could differ from current expected results.

In addition to the above matter, the Company is a party to various other legal actions from time to time and may be contingently liable in connection with claims and contracts arising in the normal course of business, the outcome of which the Company believes, after consultation with legal counsel, will not have a material adverse effect on its financial condition, results of operations or liquidity. However, due to the risks and uncertainties inherent in legal proceedings, actual results could differ from current expected results. All legal costs associated with litigation are expensed as incurred.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with the unaudited condensed consolidated financial statements and notes thereto included herein and with our audited consolidated financial statements and notes thereto for the fiscal year ended January 3, 2014, which are contained in our fiscal 2013 Annual Report on Form 10-K which was filed with the U.S. Securities and Exchange Commission on February 28, 2014.

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains certain “forward-looking” statements (as such term is defined in the Private Securities Litigation Reform Act of 1995, and the rules promulgated pursuant to the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended thereto) that are based on the beliefs of the Company’s management, as well as assumptions made by and information currently available to the Company’s management. Such forward-looking statements are subject to the safe harbor created by the Private Securities Litigation Reform Act of 1995. When used in this document the words “anticipate,” “believe,” “estimate,” “expect” and similar expressions, as they relate to the Company or its management, identify such forward-looking statements. Such statements reflect the current views of the Company or its management with respect to future events and are subject to certain risks, uncertainties and assumptions. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, the Company’s actual results, performance, or achievements could differ materially from those expressed in, or implied by, any such forward-looking statements. Factors that could cause or contribute to such material differences include the possibility that the demand for our services may decline as a result of changes in general and industry specific economic conditions, the timing of engagements for our services, the effects of competitive services and pricing, the absence of backlog related to our business, our ability to attract and retain key employees, the effect of tort reform and government regulation on our business and liabilities resulting from claims made against us. Additional risks and uncertainties are discussed in our fiscal 2013 Annual Report on Form 10-K under the heading “Risk Factors” and elsewhere in the report. The inclusion of such forward-looking information should not be regarded as a representation by the Company or any other person that the future events, plans, or expectations contemplated by the Company will be achieved. Due to such uncertainties and risks, you are warned not to place undue reliance on such forward-looking statements, which speak only as of the date hereof. The Company does not intend to release publicly any updates or revisions to any such forward-looking statements.

Business Overview

Exponent, Inc. is an engineering and scientific consulting firm that provides solutions to complex problems. Our multidisciplinary team of scientists, physicians, engineers and business consultants brings together more than 90 different technical disciplines to solve complicated issues facing industry and business today. Our services include analysis of product development, product recall, regulatory compliance, and discovery of potential problems related to products, people or property and impending litigation, as well as the development of technical new products.

CRITICAL ACCOUNTING ESTIMATES

In preparing our unaudited condensed consolidated financial statements, we make assumptions, judgments and estimates that can have a significant impact on our revenue, operating income and net income, as well as on the value of certain assets and liabilities on our consolidated balance sheet. We base our assumptions, judgments and estimates on historical experience and various other factors that we believe to be reasonable under the circumstances. Actual results could differ materially from these estimates under different assumptions or conditions. On a regular basis we evaluate our assumptions, judgments and estimates and make changes accordingly. We believe that the assumptions, judgments and estimates involved in the accounting for revenue recognition and estimating the allowance for doubtful accounts have the greatest potential impact on our consolidated financial statements, so we consider these to be our critical accounting policies. Historically, our assumptions, judgments and estimates relative to our critical accounting policies have not differed materially from actual results. Policies covering revenue recognition and estimating the allowance for doubtful accounts are described in our fiscal 2013 Annual Report on Form 10-K under “Critical Accounting Estimates” and Note 1 (Summary of Significant Accounting Policies) of the Notes to Consolidated Financial Statements.

RESULTS OF CONSOLIDATED OPERATIONS

Executive Summary

Revenues for the first quarter of 2014 increased 5% and revenues before reimbursements increased 6% as compared to the same period last year. The increase in revenues before reimbursements was due to an increase in billable hours and an increase in billing rates. We experienced strong demand for our consulting services from a diverse set of clients for both reactive and proactive projects and received some follow-on activities related to several major investigations. This was partially offset by the expected decline in the level of activity for some of these major investigations. For the quarter, we had notable performances in several practices. In our polymer sciences practice, we evaluated materials for medical devices, consumer electronics and textiles. In our biomedical engineering practice, we assisted clients with addressing issues of compatibility between their devices and magnetic resonance imaging and radio frequency equipment. In our environmental practice, we continued our work on assessing the impact of an oil spill; and in our construction consulting practice, we helped clients manage significant capital projects.

The increase in revenues before reimbursements resulted in a 15% increase in net income during the first quarter of 2014 as compared to the same period last year. Net income increased to $9,154,000 during the first quarter of 2014 as compared to $7,976,000 during the same period last year. Diluted earnings per share increased to $0.66 per share as compared to $0.56 in the same period last year due to the increase in net income and our ongoing share repurchase program.

We remain focused on selectively adding top talent and developing the skills necessary to expand our market position, providing clients with in-depth scientific research and analysis to determine what happened and how to prevent failures or exposures in the future, capitalizing on emerging growth areas, managing other operating expenses, generating cash from operations, maintaining a strong balance sheet and undertaking activities such as share repurchases and dividends to enhance shareholder value. We continue to expect some of our major investigations to step down from their elevated levels of activity as they move through their project life cycle. We also continue to expect a step down in the level of activity in our defense technology development practice due to the constraints on defense spending and reduction of forces in Afghanistan by the United States federal government.

Overview of the Three Months Ended April 4, 2014

During the first quarter of 2014, billable hours increased 3% to 274,000 as compared to 265,000 during the same period last year. The increase in billable hours was due to follow-on activities related to major investigations and continued demand for our proactive and reactive consulting services. Our utilization was 72% during the first quarter of 2014 and 2013. Technical full-time equivalent employees increased 3% to 732 during the first quarter of 2014 as compared to 708 during the same period last year due to our recruiting and retention efforts. We continue to selectively hire key talent to expand our capabilities.

three months ended March 31, 2016 are approximately $6 million for Applied Water, including $2 million incurred during the three months ended March 31, 2016. These costs primarily consist of severance charges. We currently expect activity related to these actions to continue through the end of 2017. Total expected costs associated with actions that commenced during the three months ended March 31, 2016 are approximately $3 million for Corporate, including $2 million incurred during the three months ended March 31, 2016. These costs primarily consist of severance charges. We currently expect activity related to these actions to continue through the end of 2017.

Total expected costs associated with actions that commenced during 2015 are approximately $5 million for Water Infrastructure. Approximately $4 million of the expected cost was incurred in 2015 and no additional costs were incurred during the three months ended March 31, 2016. We currently expect activity related to these actions to continue through the second quarter of 2016. Total expected costs associated with actions that commenced during 2015 are approximately $1 million for Applied Water. These costs primarily consist of severance charges and substantially all of the costs associated with these actions have been incurred in 2015.

Note 5. Income Taxes

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

The income tax provision for the three months ended March 31, 2016 was a benefit of $1 million resulting in an effective tax rate of negative 1.6%, compared to an expense of $13 million resulting in an effective tax rate of 17.3% for the same period in 2015. The effective tax rate was lower than the United States federal statutory rate primarily due to geographic mix of earnings in both periods as well as a reduction in the amount of unrecognized tax benefits recorded as a result of the effective settlement of a tax examination in the current period.

Unrecognized Tax Benefits

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

The amount of unrecognized tax benefits at March 31, 2016 was $27 million which, if ultimately recognized, will reduce our annual effective tax rate. We do not believe that the unrecognized tax benefits will significantly change within the next twelve months.

We classify interest expense relating to unrecognized tax benefits as a component of other non-operating expense, net, and tax penalties as a component of income tax expense in our Condensed Consolidated Income Statements. As of March 31, 2016, we had $1 million of interest accrued for unrecognized tax benefits.

Note 6. Earnings Per Share

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

	Three Months Ended March 31,	
	2016	2015
Net income (in millions)	$66	$ 64
Shares (in thousands):		
Weighted average common shares outstanding	178,560	182,049
Add: Participating securities (a)	30	46
Weighted average common shares outstanding — Basic	178,590	182,095
Plus incremental shares from assumed conversions: (b)		
Dilutive effect of stock options	333	532
Dilutive effect of restricted stock units and performance shares	390	437
Weighted average common shares outstanding — Diluted	179,313	183,064
Basic earnings per share	$0.37	$ 0.35
Diluted earnings per share	$0.37	$ 0.35

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

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

(in thousands)	Three Months Ended March 31, 2016	2015
Stock options	2,254	2,634
Restricted stock units	600	590
Performance shares	258	158

Note 7. Inventories

The components of total inventories are summarized as follows:

(in millions)	March 31, 2016	December 31, 2015
Finished goods	$ 215	$ 213
Work in process	41	32
Raw materials	226	188
Total inventories	$ 482	$ 433

Note 8. Property, Plant and Equipment

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

(in millions)	March 31, 2016	December 31, 2015
Land, buildings and improvements	$ 250	$ 240
Machinery and equipment	658	650
Equipment held for lease or rental	214	205
Furniture and fixtures	82	79
Construction work in progress	52	46
Other	19	19
Total property, plant and equipment, gross	1,275	1,239
Less accumulated depreciation	829	800
Total property, plant and equipment, net	$ 446	$ 439

Depreciation expense of $20 million and $24 million was recognized in the three months ended March 31, 2016 and 2015, respectively.

Note 9. Goodwill and Other Intangible Assets

Goodwill

Changes in the carrying value of goodwill by reportable segment for the three months ended March 31, 2016 are as follows:

(in millions)	Water Infrastructure	Applied Water	Total
Balance as of January 1, 2016	$ 1,066	$ 518	$1,584
Activity in 2016			
Acquired (a)	36	—	36
Foreign currency and other	8	4	12
Balance as of March 31, 2016	$ 1,110	$ 522	$1,632

(a) On February 1, 2016, we acquired Tideland and recorded $36 million of goodwill. Refer to Note 3, "Acquisitions and Divestitures" for additional information.

Other Intangible Assets

Information regarding our other intangible assets is as follows:

(in millions)	March 31, 2016 Carrying Amount	March 31, 2016 Accumulated Amortization	March 31, 2016 Net Intangibles	December 31, 2015 Carrying Amount	December 31, 2015 Accumulated Amortization	December 31, 2015 Net Intangibles
Customer and distributor relationships	$345	$ (148)	$ 197	$320	$ (140)	$ 180
Proprietary technology and patents	120	(57)	63	116	(54)	62
Trademarks	43	(20)	23	35	(19)	16
Software	163	(115)	48	155	(110)	45
Other	8	(8)	—	8	(8)	—
Indefinite-lived intangibles	133	—	133	132	—	132
	$812	$ (348)	$ 464	$766	$ (331)	$ 435

Amortization expense related to finite-lived intangible assets was $12 million and $11 million for the three months ended March 31, 2016 and 2015, respectively.

Note 10. Derivative Financial Instruments

Risk Management Objective of Using Derivatives

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

Cash Flow Hedges of Foreign Exchange Risk

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

Certain business units with exposure to foreign currency exchange risks have designated certain currency forward agreements as cash flow hedges of forecasted intercompany inventory purchases and sales. Our principal currency exposures relate to the Euro, Swedish Krona, British Pound, Canadian Dollar, Polish Zloty and Australian Dollar. We held forward foreign exchange contracts with purchase notional amounts totaling $240 million and $94 million as of March 31, 2016 and December 31, 2015, respectively. As of March 31, 2016, our most significant foreign currency derivatives include contracts to purchase Swedish Krona and sell Euro, sell US Dollar and purchase Euro, sell Canadian Dollar and purchase US Dollar, sell Canadian Dollar and purchase Euro, and purchase Polish Zloty and sell Euro. The purchased notional amounts associated with these currency derivatives are $99 million, $89 million, $14 million, $14 million, and $13 million, respectively. As of December 31, 2015, our most significant foreign currency derivatives included contracts to purchase Swedish Krona and sell Euro, sell U.S. Dollar and purchase Euro, and to sell British Pound and purchase Euro. The purchased notional amounts associated with these currency derivatives are $51 million, $24 million and $12 million, respectively.

Hedges of Net Investments in Foreign Operations

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

Cross Currency Swaps

Beginning in 2015, we entered into cross currency swaps to manage our exposure to fluctuations in the Euro-U.S. Dollar exchange rate. The total notional amount of derivative instruments designated as net investment hedges was $423 million and $411 million as of March 31, 2016 and December 31, 2015, respectively.

Foreign Currency Denominated Debt

On March 11, 2016, we issued 2.250% Senior Notes of €500 million aggregate principal amount due March 2023. We designated the entirety of the outstanding balance or $560 million, net of unamortized discount, as a hedge of a net investment in certain foreign subsidiaries.

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

(in millions)	Three Months Ended March 31, 2016	2015
Cash Flow Hedges		
Foreign Exchange Contracts		
Amount of gain (loss) recognized in OCI (a)	$4	$(5)
Amount of loss reclassified from OCI into revenue (a)	1	4
Amount of (gain) loss reclassified from OCI into cost of revenue (a)	(1)	1
Net Investment Hedges		
Cross Currency Swaps		
Amount of (loss) recognized in OCI (a)	$(11)	$—
Foreign Currency Denominated Debt		
Amount of (loss) recognized in OCI (a)	$(15)	$—

(a) Effective portion

As of March 31, 2016, $5 million of the net unrealized gains on cash flow hedges is expected to be reclassified into earnings in the next 12 months. The ineffective portion of a cash flow hedge is recognized immediately in selling, general and administrative expenses in the Condensed Consolidated Income Statements and was not material for the three months ended March 31, 2016 and 2015.

As of March 31, 2016, no gains or losses on the net investment hedges are expected to be reclassified into earnings over their duration. The net investment hedges did not experience any ineffectiveness for the three months ended March 31, 2016.

The fair values of our derivative assets and liabilities are measured on a recurring basis using Level 2 inputs and are determined through the use of models that consider various assumptions including yield curves, time value and other measurements.

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

(in millions)	March 31, 2016	December 31, 2015
Derivatives designated as hedging instruments		
Assets		
Cash Flow Hedges		
Other current assets	$ 5	$ 2
Liabilities		
Cash Flow Hedges		
Other current liabilities	$ (1)	$ —
Net Investment Hedges		
Other non-current liabilities	$ (31)	$ (18)

The fair value of our long-term debt, due in 2023, designated as a net investment hedge was $588 million as of March 31, 2016.

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Note 11. Accrued and Other Current Liabilities

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

(in millions)	March 31, 2016	December 31, 2015
Compensation and other employee benefits	$ 149	$ 156
Customer-related liabilities	60	64
Accrued warranty costs	33	33
Accrued taxes	60	64
Other accrued liabilities	78	90
Total accrued and other current liabilities	$ 380	$ 407

Note 12. Credit Facilities and Debt

Total debt outstanding is summarized as follows:

(in millions)	March 31, 2016	December 31, 2015
3.550% Senior Notes due 2016 (a)	$ 600	$ 600
4.875% Senior Notes due 2021 (a)	600	600
2.250% Senior Notes due 2023 (a)	566	—
Research and development facility agreement	120	76
Other	1	2
Debt issuance costs and unamortized discount (b)	(14)	(4)
Total debt	1,873	1,274
Less: short-term borrowings and current maturities of long-term debt	720	78
Total long-term debt	$ 1,153	$ 1,196

(a) The fair value of our Senior Notes (as defined below) was determined using quoted prices in active markets for identical securities, which are considered Level 1 inputs. Our Senior Notes due 2016 are recorded at amortized cost basis which approximates fair value. The fair value of our Senior Notes due 2021 was $648 million and $640 million as of March 31, 2016 and December 31, 2015, respectively. The fair value of our Senior Notes due 2023 was $588 million as of March 31, 2016.

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

Senior Notes

On September 20, 2011, we issued 3.550% Senior Notes of $600 million aggregate principal amount due September 2016 (the "Senior Notes due 2016") and 4.875% Senior Notes of $600 million aggregate principal amount due October 2021 (the "Senior Notes due 2021"). On March 11, 2016, we issued 2.250% Senior Notes of €500 million aggregate principal amount due March 2023 (the "Senior Notes due 2023" and together with the Senior Notes due 2016 and 2021, the "Senior Notes").

The Senior Notes include covenants which restrict our ability, subject to exceptions, to incur debt secured by liens and engage in sale and leaseback transactions, as well as provide for customary events of default (subject, in certain cases, to receipt of notice of default and/or customary grace and cure periods). We may redeem the Senior Notes, as applicable, in whole or in part, at any time at a redemption price equal to the principal amount of the Senior Notes to be redeemed, plus a make-whole premium. We may redeem all or a portion of the Senior Notes due 2023 at our option at any time on or after December 11, 2022 (three months prior to their maturity), at a redemption price equal to 100% of the principal amount, plus accrued and unpaid interest to the redemption date. We may also redeem all, but not part, of the Senior Notes due 2023 in the event of specified tax events as described in the applicable Senior Notes indenture. If a change of control triggering event (as defined in the applicable Senior Notes indenture) occurs, we will be required to make an offer to purchase the Senior Notes at a price equal to 101% of their principal amount plus accrued and unpaid interest to the date of repurchase. As of

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March 31, 2016, we were in compliance with all covenants for the Senior Notes.

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. Interest on the Senior Notes due 2023 is payable on March 11 of each year.

On April 11, 2016, our Senior Notes due 2016 were settled for a total of $607 million which included make-whole interest expense of $7 million. The Company will record this loss on extinguishment of the debt in the second quarter of 2016 as interest expense.

Five-Year Revolving Credit Facility

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

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

In accordance with the terms, we may not exceed a maximum leverage ratio of 3.50 to 1.00 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. The Credit Facility also contains limitations on, among other things, incurring secured debt, granting liens, entering into sale and leaseback transactions, mergers, consolidations, liquidations, dissolutions and sales of assets. In addition, the Credit Facility contains other terms and conditions such as customary representations and warranties, additional covenants and customary events of default. As of March 31, 2016, we were in compliance with all covenants.

As of March 31, 2016, the Credit Facility was undrawn.

Research and Development Facility Agreement

On December 3, 2015, the Company amended and restated its Risk Sharing Finance Facility Agreement (the "R&D Facility Agreement") with The European Investment Bank (the "EIB") to amend the maturity date. The facility provides an aggregate principal amount of up to €120 million (approximately $136 million) to finance research projects and infrastructure development in the European Union. The Company's wholly owned subsidiaries in Luxembourg, Xylem Holdings S.á r.l. and Xylem International S.á r.l., are the borrowers under the R&D Facility Agreement. The obligations of the borrowers under the R&D Facility Agreement are guaranteed by the Company under an Amended and Restated Deed of Guarantee, dated as of December 4, 2013, in favor of the EIB. The funds are available during the period from 2013 through 2016 at the Company's facilities in Sweden, Germany, Italy, the United Kingdom, Austria, Norway and Hungary.

Under the R&D Facility Agreement, the borrower was able to draw loans on or before March 31, 2016 with a maturity of no longer than 12 years. The R&D Facility Agreement provides for Fixed Rate loans and Floating Rate loans. The interest rate per annum applicable to Fixed Rate loans is at a fixed percentage rate per annum specified by the EIB which includes the applicable margin. The interest rate per annum applicable to Floating Rate loans is at the rate determined by reference to EURIBOR for loans drawn in Euros and LIBOR for loans drawn in Pounds Sterling or U.S. Dollars, plus an applicable spread specified by the EIB which includes the applicable margin. The applicable margin for both Fixed Rate loans and Floating Rate loans is determined by reference to the credit rating of the Company.

In accordance with the terms of the R&D Facility Agreement, we may not exceed a maximum leverage ratio of 3.50 to 1.00 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. The R&D Facility Agreement also contains limitations on, among other things, incurring debt, granting liens, and entering into sale and leaseback transactions. In addition, the R&D Facility Agreement contains other terms and conditions, such as customary representations and warranties, additional covenants and customary events of default. As of March 31, 2016, we were in compliance with all covenants.

As of March 31, 2016 and December 31, 2015, $120 million and $76 million was outstanding, respectively, under the R&D Facility Agreement. Although the borrowing term for this arrangement is up to five years, we have classified it as short-term debt on our Condensed Consolidated Balance Sheet since we intend to repay this obligation in less than a year.

Note 13. Postretirement Benefit Plans

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

	Three Months Ended March 31,					
(in millions)	2016			2015		
Domestic defined benefit pension plans:						
Interest cost	$	1		$	1	
Expected return on plan assets	(1		)	(1		)
Amortization of net actuarial loss	1			1		
Net periodic benefit cost	$	1		$	1	
International defined benefit pension plans:						
Service cost	$	3		$	3	
Interest cost	6			6		
Expected return on plan assets	(9		)	(8		)
Amortization of net actuarial loss	2			3		
Net periodic benefit cost	$	2		$	4	
Total net periodic benefit cost	$	3		$	5	

The total net periodic benefit cost for other postretirement employee benefit plans was $1 million including amounts recognized in other comprehensive income ("OCI") of less than $1 million for the three months ended March 31, 2016 and 2015, respectively.

We contributed $8 million and $6 million to our defined benefit plans during the three months ended March 31, 2016 and 2015, respectively. Additional contributions ranging between approximately $18 million and $28 million are expected during the remainder of 2016.

Note 14. Share-Based Compensation Plans

Share-based compensation expense was $5 million and $4 million during the three months ended March 31, 2016 and 2015, respectively. The unrecognized compensation expense related to our stock options, restricted stock units and performance based shares was $8 million, $24 million and $11 million, respectively, at March 31, 2016 and is expected to be recognized over a weighted average period of 2.2, 2.1 and 2.6 years, respectively. The amount of cash received from the exercise of stock options was $8 million and $6 million for the three months ended March 31, 2016 and 2015, respectively.

Stock Option Grants

The following is a summary of the changes in outstanding stock options for the three months ended March 31, 2016.

	Shares (in thousands)	Weighted Average Exercise Price / Share	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (in millions)
Outstanding at January 1, 2016	2,561	$ 31.16	6.8	
Granted	420	37.47		
Exercised	(322)	26.42		
Forfeited and expired	(20)	37.00		
Outstanding at March 31, 2016	2,639	$ 32.70	7.3	$ 23
Options exercisable at March 31, 2016	1,695	$ 30.38	6.3	$ 18
Vested and expected to vest as of March 31, 2016	2,523	$ 32.50	7.2	$ 22

The total intrinsic value of options exercised (which is the amount by which the stock price exceeded the exercise price of the options on the date of exercise) during the three months ended March 31, 2016 was $3 million.

Stock Option Fair Value

The fair value of each option grant was estimated on the date of grant using the binomial lattice pricing model which incorporates multiple and variable assumptions over time, including assumptions such as employee exercise patterns, stock price volatility and changes in dividends. The following are weighted-average assumptions for 2016 grants.

Volatility	29.1 %
Risk-free interest rate	1.42 %
Dividend yield	1.65 %
Expected term (in years)	5.6
Weighted-average fair value / share	$9.02

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

Restricted Stock Unit Grants

The following is a summary of restricted stock units activity for the three months ended March 31, 2016. The fair value of the restricted stock units is equal to the closing share price on the date of the grant.

(shares in thousands)	Shares	Weighted Average Grant Date Fair Value /Share
Outstanding at January 1, 2016	1,013	$ 34.52
Granted	240	37.47
Vested	(252)	28.54
Forfeited	(31)	36.25
Outstanding at March 31, 2016	970	$ 36.75

Performance-Based Share Grants

The following is a summary of Return on Invested Capital ("ROIC") performance-based share grants for the three months ended March 31, 2016. The fair value of the ROIC performance-based shares is equal to the closing share price on the date of the grant.

(shares in thousands)	Shares	Weighted Average Grant Date Fair Value /Share
Outstanding at January 1, 2016	160	$ 35.48
Granted	101	37.47
Vested	—	—
Forfeited	(18)	27.49
Outstanding at March 31, 2016	243	$ 36.90

The following is a summary of our Total Shareholder Return ("TSR") performance-based share grants for the three months ended March 31, 2016.

(shares in thousands)	Shares	Weighted Average Grant Date Fair Value /Share
Outstanding at January 1, 2016	—	$ —
Granted	101	45.34
Vested	—	—
Forfeited	—	—
Outstanding at March 31, 2016	101	$ 45.34

TSR Performance-based Share Fair Value

The fair value of TSR performance-based shares was calculated on the date of grant using a Monte Carlo simulation model utilizing several key assumptions, including expected Company and peer company share price volatility, correlation coefficients between peers, the risk-free rate of return, the expected dividend yield and other award design features. Assumptions used in the 2016 Monte Carlo simulation were as follows:

Volatility	31.7 %
Risk-free interest rate	0.88 %
Dividend yield	1.65 %

Note 15. Capital Stock

On August 24, 2015, our Board of Directors authorized the repurchase of up to $500 million in shares with no expiration date. The program's objective is to deploy our capital in a manner that benefits our shareholders and maintains our focus on growth. There were no shares repurchased under this program during the three months ended March 31, 2016. There are up to $420 million in shares that may still be purchased under this plan as of March 31, 2016.

On August 20, 2013, the Board of Directors authorized the repurchase of up to $250 million in shares with no expiration date. The program's objective was to deploy our capital in a manner that benefited our shareholders and maintained our focus on growth. During the three months ended March 31, 2015, we repurchased 1.4 million shares for $50 million under this program. As of December 31, 2015, we have exhausted the authorized amount to repurchase shares under this plan.

On August 18, 2012, our Board of Directors authorized the repurchase of up to 2.0 million shares of common stock with no expiration date. The program's objective is to offset dilution associated with various Xylem employee stock plans by acquiring shares in the open market from time to time. There were no shares repurchased under this program during the three months ended March 31, 2016 and 2015. There are up to 0.3 million shares (approximately $10 million in value) that may still be purchased under this plan as of March 31, 2016.
Aside from the aforementioned repurchase programs, we repurchased 0.1 million shares for $3 million for the three months ended March 31, 2016 and 2015, respectively, in relation to settlement of employee tax withholding obligations due as a result of the vesting of restricted stock units.
Note 16. Accumulated Other Comprehensive Income (Loss)
The following table provides the components of accumulated other comprehensive income (loss) for the three months ended March 31, 2016:

(in millions)	Foreign Currency Translation	Postretirement Benefit Plans	Derivative Instruments	Total
Balance at January 1, 2016	$ (43)	$ (185)	$ (10)	$(238)
Foreign currency translation adjustment	12	—	—	12
Tax on foreign currency translation adjustment	10	—	—	10
Amortization of net actuarial loss on postretirement benefit plans into:				
Cost of revenue	—	1	—	1
Selling, general and administrative expenses	—	2	—	2
Income tax impact on amortization of postretirement benefit plan items	—	(3)	—	(3)
Unrealized gain on derivative hedge agreements	—	—	4	4
Reclassification of unrealized loss on derivative hedge agreements into revenue	—	—	1	1
Reclassification of unrealized gain on derivative hedge agreements into cost of revenue	—	—	(1)	(1)
Reclassification of unrealized loss on net investment hedge	(11)	—	11	—
Balance at March 31, 2016	$ (32)	$ (185)	$ 5	$(212)

Note 17. Commitments and Contingencies
Legal Proceedings
From time to time, we are involved in legal proceedings that are incidental to the operation of our businesses, including acquisitions and divestitures, intellectual property matters, product liability and personal injury claims, employment and pension matters, government and commercial contract disputes.
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 2.4 million 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 in March 2013, the High Court upheld the determination of the CNC and the fine previously assessed. In June 2013, the Company appealed the decision to the Tribunal Supremo, the Supreme Court of Spain, and in November 2015

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the Tribunal Supremo upheld the determination and the fine previously assessed. The Company petitioned the Spanish Constitutional Court and the Council of the CNC in December 2015 and January 2016, respectively, for review of certain aspects relevant to the fine determination. In March 2016, the Council of the CNC informed the Company that it had rejected its appeal and in April 2016 the Spanish Constitutional Court informed the Company that it had rejected its appeal. The fine was paid in March 2016 and this matter is now closed.

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

Although the ultimate outcome of any legal matter cannot be predicted with certainty, based on present information, including our assessment of the merits of the particular claims, we do not expect that any asserted or unasserted legal claims or proceedings, individually or in aggregate, will have a material adverse effect on our results of operations, or financial condition.

Indemnifications

As part of our 2011 spin-off from our former parent, ITT, Exelis Inc. and Xylem will indemnify, defend and hold harmless each of the other parties with respect to such parties' assumed or retained liabilities under the Distribution Agreement and breaches of the Distribution Agreement or related spin agreements. The former parent's indemnification obligations include asserted and unasserted asbestos and silica liability claims that relate to the presence or alleged presence of asbestos or silica in products manufactured, repaired or sold prior to October 31, 2011, the Distribution Date, subject to limited exceptions with respect to certain employee claims, or in the structure or material of any building or facility, subject to exceptions with respect to employee claims relating to Xylem buildings or facilities. The indemnification associated with pending and future asbestos claims does not expire. Xylem has not recorded a liability for material matters for which we expect to be indemnified by the former parent or Exelis Inc. through the Distribution Agreement and we are not aware of any claims or other circumstances that would give rise to material payments from us under such indemnifications. On May 29, 2015, Harris Inc. acquired Exelis. As the parent of Exelis, Harris Inc. is responsible for Exelis's indemnification obligations under the Distribution Agreement.

Guarantees

We obtain certain stand-by letters of credit, bank guarantees and surety bonds from third-party financial institutions in the ordinary course of business when required under contracts or to satisfy insurance related requirements. As of March 31, 2016 and December 31, 2015, the amount of stand-by letters of credit, bank guarantees and surety bonds was $174 million and $161 million, respectively.

Environmental

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

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

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environmental expenditures are recorded on an undiscounted basis. We have estimated and accrued $4 million as of both March 31, 2016 and December 31, 2015 for environmental matters.

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

Warranties

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

(in millions)	2016	2015
Warranty accrual – January 1	$33	$31
Net changes for product warranties in the period	6	6
Settlement of warranty claims	(7)	(6)
Foreign currency and other	1	(1)
Warranty accrual - March 31	$33	$30

Note 18. Segment Information

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

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

The accounting policies of each segment are the same as those described in the summary of significant accounting policies (see Note 1 in the 2015 Annual Report). The following tables contain financial information for each reportable segment:

	Three Months Ended March 31,	
(in millions)	2016	2015
Revenue:		
Water Infrastructure	$514	$500
Applied Water	333	337
Total	$847	$837
Operating Income:		
Water Infrastructure	$54	$47
Applied Water	39	46
Corporate and other	(14)	(10)
Total	$79	$83
Depreciation and Amortization:		
Water Infrastructure	$22	$25
Applied Water	6	6
Regional selling locations (a)	2	2
Corporate and other	2	2
Total	$32	$35
Capital Expenditures:		
Water Infrastructure	$19	$25
Applied Water	8	7
Regional selling locations (b)	9	2
Corporate and other	1	3
Total	$37	$37

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

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

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

(in millions)	March 31, 2016	December 31, 2015
Water Infrastructure	$ 2,147	$ 2,024
Applied Water	1,055	1,054
Regional selling location (a)	916	905
Corporate and other (b)	1,186	674
Total	$ 5,304	$ 4,657

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

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

Note 19. Subsequent Events

On April 11, 2016, we settled our Senior Notes due 2016. See Note 12, "Credit Facilities and Debt" for further information.

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

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

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

Factors that could cause results to differ materially from those anticipated include: overall economic and business conditions, political and other risks associated with our international operations, including military actions, economic sanctions or trade embargoes that could affect customer markets, and non-compliance with laws, including foreign corrupt practice laws, export and import laws and competition laws; potential for unexpected cancellations or delays of customer orders in our reported backlog; our exposure to fluctuations in foreign currency exchange rates; competition and pricing pressures in the markets we serve; the strength of housing and related markets; weather conditions; ability to retain and attract key members of management; our relationship with and the performance of our channel partners; our ability to successfully identify, complete and integrate acquisitions; our ability to borrow or to refinance our existing indebtedness and availability of liquidity sufficient to meet our needs; changes in the value of goodwill or intangible assets; risks relating to product defects, product liability and recalls; governmental investigations; security breaches or other disruptions of our information technology systems; litigation and contingent liabilities; and other factors set forth under “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2015 ("2015 Annual Report") and with subsequent filings we make with the Securities and Exchange Commission ("SEC").

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

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

Overview

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

- Water Infrastructure serves the water infrastructure sector with pump systems that transport water from aquifers, lakes, rivers and seas; with filtration, ultraviolet and ozone systems that provide treatment, making the water fit to use; and pumping solutions that move the wastewater to treatment facilities where our mixers, biological treatment, monitoring and control systems provide the primary functions in the treatment process. We provide analytical instrumentation used to measure water quality, flow and level in wastewater, surface water and coastal environments. In the Water Infrastructure segment, we provide the

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majority of our sales directly to customers with strong application expertise, while the remaining amount is through distribution partners.

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

We sell our equipment and services through direct and indirect channels that serve the needs of each customer type. In the Water Infrastructure segment, we provide the majority of our sales direct to customers with strong application expertise, while the remaining amount is through distribution partners. In the Applied Water segment, we provide the majority of our sales through long-standing relationships with the world's leading distributors, with the remainder going direct to customers.

Executive Summary

Xylem reported revenue for the first quarter of 2016 of $847 million, an increase of 1.2% compared to $837 million during the first quarter of 2015. Revenue increased 4.4% on a constant currency basis due to strong organic growth in the public utility and commercial markets as well as our recent acquisition within our Water Infrastructure segment, partially offset by declines in the residential market. Operating income for the first quarter of 2016 was $79 million, reflecting a decrease of 4.8% compared to $83 million in the first quarter of 2015. Operating margin was 9.3% for 2016 versus 9.9% for 2015, a decrease of 60 basis points. Excluding restructuring and realignment charges as well as special charges, primarily initial acquisition related costs, operating income was $92 million with an operating margin of 10.9% in 2016 as compared to operating income of $90 million with an operating margin of 10.8%. This increase in adjusted operating margin was due to cost reductions and increased volume, partially offset by cost inflation, strategic investments and the impacts from acquisitions.

Additional financial highlights for the quarter ended March 31, 2016 include the following:

- Orders of $888 million, or 3.0% decline from $915 million in the prior year, though flat on an organic basis
- Earnings per share of $0.37, up 5.7% from the prior year ($0.35 on an adjusted basis, up 6.1%)
- Cash flow from operating activities of $41 million for the three months ended March 31, 2016, up 5.1% from prior year, and free cash flow of $4 million as compared to $2 million in the prior year

Key Performance Indicators and Non-GAAP Measures

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

- "organic revenue" and "organic orders" defined as revenue and orders, respectively, excluding the impact of fluctuations in foreign currency translation, intercompany transactions and contributions from acquisitions and divestitures. Divestitures include sales of insignificant portions of our business that did not meet the criteria for classification as a discontinued operation. The period-over-period change resulting from foreign currency translation assumes no change in exchange rates from the prior period.
- "constant currency" defined as financial results adjusted for foreign currency translation impacts by translating current period and prior period activity using the same currency conversion rate. This approach is used for countries whose functional currency is not the U.S. Dollar.

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

(In millions, except for per share data)	Three Months Ended March 31, 2016	2015
Net income	$66	$64
Restructuring and realignment, net of tax benefit of $2 and $2	7	4
Special charges, net of tax benefit of $1 and $0	3	2
Tax-related special items	(14)	(1)
Gain from sale of businesses, net of $0 tax	—	(9)
Adjusted net income	$62	$60
Weighted average number of shares - Diluted	179.3	183.1
Adjusted earnings per share	$0.35	$0.33

- "operating expenses excluding restructuring and realignment costs and special charges" defined as operating expenses, adjusted to exclude restructuring and realignment costs, and special charges.
- "adjusted operating income (loss)" defined as operating income (loss), adjusted to exclude restructuring and realignment costs and special charges, and "adjusted operating margin" defined as adjusted operating income divided by total revenue.
- “realignment costs” defined as costs not included in restructuring costs that are incurred as part of actions taken to reposition our business, including items such as professional fees, severance, relocation, travel, facility set-up and other costs.
- “special charges” defined as costs incurred by the Company, such as initial acquisition related costs, costs incurred for the contractual indemnification of tax obligations to ITT and other special non-operating items.
- "tax-related special items" defined as tax items, such as tax return versus tax provision adjustments, tax exam impacts, tax law change impacts, significant reserves for cash repatriation and other discrete tax adjustments.
- "free cash flow" defined as net cash from operating activities, as reported in the Statement of Cash Flow, less capital expenditures, as well as adjustments for other significant items that impact current results that management believes are not related to our ongoing operations and performance. Our definition of free cash flow does not consider certain non-discretionary cash payments, such as debt. The following table provides a reconciliation of free cash flow.

(In millions)	Three Months Ended March 31, 2016	2015
Net cash provided by operating activities	$41	$39
Capital expenditures	(37)	(37)
Free cash flow	$4	$2

2016 Outlook

We continue to anticipate organic revenue growth in the low-to-mid single digits in 2016. The following is a summary of our outlook by market.

- Industrial market performance was flat due to continued decreases in dewatering applications in the oil and gas market as well as weakness in the mining market which offset increases in the general industrial market. We expect growth to be flat to up in the low-single-digits for 2016. This projection assumes low-single-digit growth in light industrial applications, and double-digit declines in oil and gas, and mining applications.

- Through the first quarter, public utilities increased 12%. We expect growth in mid to high-single-digits for 2016 due in part to tougher comparisons in the second half of the year. We anticipate continued growth in the United States and continued growth across emerging markets. We also anticipate that market conditions in Europe will remain stable.
- In the commercial markets, growth was 5% through the first quarter driven by strong Europe and U.S. market performance. We expect continued growth in the mid-single-digit range for 2016. Our expectation is that growth in the U.S. institutional building market will continue through the year, urbanization will continue to drive growth in most emerging markets and that conditions in Europe will remain stable.
- Residential markets declined 5% through the first quarter. For 2016, we expect revenue to be flat as we anticipate growth in the U.S. and Europe to be partially offset by headwinds in emerging markets.
- Our agriculture markets, which is our smallest end market, declined 1% through the first quarter. We expect 2016 to grow low-single-digits as we will likely see a modest recovery from the significant weather events in 2015.

We will continue to execute restructuring and realignment actions to reposition our European and North American businesses in an effort to optimize our cost structure and improve our operational efficiency and effectiveness. During 2016, we expect to incur approximately $25 million in restructuring and realignment costs. We expect to realize approximately $1 million of incremental net savings in 2016 from actions initiated in 2015, and an additional $8 million of net savings from our 2016 actions.

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

Results of Operations

	Three Months Ended March 31,		
(In millions)	2016	2015	Change
Revenue	$847	$837	1.2 %
Gross profit	329	315	4.4 %
Gross margin	38.8 %	37.6 %	120 bp
Operating expenses excluding restructuring and realignment costs and special charges	237	225	5.3 %
Expense to revenue ratio	28.0 %	26.9 %	110 bp
Restructuring and realignment costs	9	6	50.0 %
Special charges	4	1	300.0 %
Total operating expenses	250	232	7.8 %
Operating income	79	83	(4.8)%
Operating margin	9.3 %	9.9 %	(60)bp
Interest and other non-operating expense, net	14	15	(6.7)%
Gain on sale of businesses	—	9	NM
Income tax (benefit) expense	(1)	13	(107.7)%
Tax rate	(1.6)%	17.3 %	(1,890)bp
Net income	$66	$64	3.1 %

NM - Not meaningful percentage change

Revenue

Revenue generated during the three months ended March 31, 2016 was $847 million, reflecting an increase of $10 million or 1.2%, compared to the same prior year period. On a constant currency basis, revenue grew 4.4% for the three months ended March 31, 2016. This increase was primarily driven by strong organic growth within the United States and western Europe, particularly in the United Kingdom and Germany. Emerging markets also contributed to the organic growth in the quarter, particularly in India and the Middle East region.

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The following table illustrates the impact from organic growth, recent acquisitions, and foreign currency translation in relation to revenue during the three months ended March 31, 2016:

(In millions)	Three Months Ended March 31, Change	% Change
2015 Revenue	$837	
Organic growth	31	3.7 %
Acquisitions	6	0.7 %
Constant currency	37	4.4 %
Foreign currency translation (a)	(27)	(3.2)%
Total change in revenue	10	1.2 %
2016 Revenue	$847	

(a) Foreign currency translation impact primarily due to fluctuations in the value of the British Pound, Euro, Argentine Peso, Canadian Dollar, South African Rand and Australian Dollar against the U.S. Dollar.

The following table summarizes revenue by segment:

(In millions)	Three Months Ended March 31, 2016	2015	As Reported Change	Constant Currency Change
Water Infrastructure	$514	$500	2.8 %	7.0 %
Applied Water	333	337	(1.2)%	0.6 %
Total	$847	$837	1.2 %	4.4 %

Water Infrastructure

Water Infrastructure revenue increased $14 million, or 2.8% for the first quarter of 2016 (7.0% increase at constant currency) compared to the respective 2015 period. The change at constant currency was driven by organic growth of $29 million or 5.8% due to continued strength in the public utility end market. The industrial market performance was flat due to continued decreases in dewatering applications in the oil and gas market as well as weakness in the mining market which offset increases in the balance of the industrial market.

From an application perspective for the first quarter of 2016, organic revenue grew in transport and treatment applications while test applications was flat. Organic revenue performance from transport applications was driven by public utility strength in the United States, due to strength in the water and wastewater pump market, share gains and favorable weather conditions, and in India from a large water circulation project. Revenue from treatment applications was also driven by public utility strength primarily in the United Kingdom and Germany, the Middle East and the United States mainly due to strong backlog execution and large project deliveries. Revenue from test applications remained flat mainly due to increased demand for industrial lab instruments in Germany which was offset by a slow start in the United States.

Applied Water

Applied Water revenue declined $4 million or 1.2% during the first quarter of 2016 (0.6% increase at constant currency) compared to the respective 2015 period. The increase at constant currency was driven by organic growth of $2 million or 0.6%. From an end market prospective, growth in commercial was partially offset by weakness in residential, while industrial water was flat.

From an application perspective for the first quarter of 2016, organic revenue grew in the building services applications while the industrial water application was flat. Building services growth was driven by strong commercial building services revenue due to market share gains from new products in western Europe as well as increased project work across all major regions of the United States. This increase was partially offset by declines within residential building services primarily in Europe and Asia Pacific due industry softness and a decline in China. Revenue from industrial water was flat as strength in general industrial applications was offset by weakness in the U.S. food and beverage, marine and mining sectors.

Orders / Backlog

Orders received during the first quarter of 2016 of $888 million decreased $27 million, or 3.0% over the first quarter of the prior year (0.4% increase at constant currency). Organic order growth was flat for the three months ended March 31, 2016.

Water Infrastructure segment orders decreased $28 million, or 5.0%, to $534 million (0.7% decrease at constant currency) for the first quarter of 2016 as compared to the same prior year period. Organic orders decreased 1.6% during the first quarter of 2016, predominately due to decreases in the treatment and transport applications as a result of the lapping of large orders in the first quarter of 2015 in the North American region. These decreases were partially offset by order strength in the Nordics, western Europe and India.

Applied Water segment orders increased $1 million, or 0.3% to $354 million (2.3% increase at constant currency) as compared to the same prior year period. Organic orders increased 2.3% as a result of similar market dynamics impacting revenue in addition to indirect channel growth.

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 $776 million at March 31, 2016, a decrease of $17 million or 2.1% as compared to March 31, 2015 and an increase of $60 million or 8.4%, as compared to December 31, 2015. We anticipate that 78% of the backlog at March 31, 2016 will be recognized as revenue in the remainder of 2016.

Gross Margin

Gross margin as a percentage of revenue increased to 38.8% for the three months ended March 31, 2016 as compared to 37.6% for 2015. The gross margin increase was primarily due to benefits realized from cost saving initiatives through global sourcing and continuous improvement initiatives, as well as increased volume which more than offset cost inflation and currency translation headwinds.

Operating Expenses

The following table presents operating expenses for the three months ended March 31, 2016 and 2015:

	March 31,		
(In millions)	2016	2015	Change
Selling, general and administrative expenses ("SG&A")	$219	$206	6.3 %
SG&A as a % of revenue	25.9 %	24.6 %	130 bp
Research and development expenses ("R&D")	25	23	8.7 %
R&D as a % of revenue	3.0 %	2.7 %	30 bp
Restructuring charges	6	3	100.0%
Operating expenses	$250	$232	7.8 %
Expense to revenue ratio	29.5 %	27.7 %	180 bp

Selling, General and Administrative Expenses

SG&A increased by $13 million to $219 million or 25.9% of revenue in the first quarter of 2016, as compared to $206 million or 24.6% of revenue in the comparable period of 2015. The increase in SG&A expenses as a percentage of revenue was primarily due to investments in regional sales channels and operational capabilities, initial acquisition related costs and inflation, partially offset by currency translation impacts and savings from restructuring actions.

Research and Development Expenses

R&D spending was $25 million or 3.0% of revenue in the first quarter of 2016 as compared to $23 million or 2.7% of revenue in the comparable period of 2015 primarily due to investments in new products and technology within both segments.

Restructuring Charges

During the three months ended March 31, 2016, we recognized restructuring charges of $6 million. We incurred these charges related to actions taken in 2016 primarily in an effort to reposition our European and North American businesses to optimize our cost structure and improve our operational efficiency and effectiveness. The charges included the elimination of headcount and consolidation of facilities within our Applied Water segment, the elimination of headcount in our Water Infrastructure segment, as well as Corporate headcount reductions. No additional costs related to actions commenced in prior years were included in the charges recorded during the three months ended March 31, 2016.

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

Total expected costs associated with actions that commenced during the three months ended March 31, 2016 are approximately $7 million for Water Infrastructure, approximately $6 million for Applied Water, and approximately $3 million for Corporate. Related to these actions Water Infrastructure, Applied Water, and Corporate each incurred $2 million during the three months ended March 31, 2016. These costs primarily consist of severance charges. We currently expect activity related to these actions to continue through the end of 2017. As a result of actions initiated during the three months ended March 31, 2016, we estimate net savings of approximately $2 million in 2016 and annual future net savings beginning in 2017 of approximately $10 million.

We expect to incur approximately $15 million in restructuring costs for the full year, which contemplates additional actions beyond those discussed above. As a result of all of the actions taken and expected to be taken in 2016, we anticipate approximately $5 million of total net savings to be realized during 2016.

Operating Income

We generated operating income of $79 million during the first quarter of 2016, a $4 million decrease compared to $83 million in the first quarter of 2015. Operating income as a percentage of revenue was 9.3% for 2016 versus 9.9% for 2015, a decrease of 60 basis points. Excluding restructuring and realignment charges as well as special charges, primarily initial acquisition related costs, operating income was $92 million with an operating margin of 10.9% in 2016 as compared to operating income of $90 million with an operating margin of 10.8%. This increase in adjusted operating margin was due to increased volume and cost reductions, partially offset by cost inflation, strategic investments and the impacts of purchase accounting for acquisitions.

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

	Three Months Ended March 31,		
(In millions)	2016	2015	Change
Water Infrastructure	$54	$47	14.9 %
Applied Water	39	46	(15.2)%
Segment operating income	93	93	— %
Corporate and other	(14)	(10)	40.0 %
Total operating income	$79	$83	(4.8)%
Operating margin			
Water Infrastructure	10.5%	9.4 %	110 bp
Applied Water	11.7%	13.6%	(190)bp
Total Xylem	9.3 %	9.9 %	(60)bp

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

	Three Months Ended March 31,		
(In millions)	2016	2015	Change
Water Infrastructure			
Operating income	$54	$47	14.9 %
Restructuring and realignment costs	4	5	(20.0)%
Special charges	4	1	300.0 %
Adjusted operating income	$62	$53	17.0 %
Adjusted operating margin	12.1 %	10.6 %	150 bp
Applied Water			
Operating income	$39	$46	(15.2)%
Restructuring and realignment costs	3	1	200.0 %
Adjusted operating income	$42	$47	(10.6)%
Adjusted operating margin	12.6 %	13.9 %	(130)bp
Corporate and other			
Operating loss	$(14)	$(10)	40.0 %
Restructuring and realignment costs	2	—	NM
Adjusted operating loss	$(12)	$(10)	20.0 %
Total Xylem			
Operating income	$79	$83	(4.8)%
Restructuring and realignment costs	9	6	50.0 %
Special charges	4	1	300.0 %
Adjusted operating income	$92	$90	2.2 %
Adjusted operating margin	10.9 %	10.8 %	10 bp

NM - Not meaningful percentage change

Water Infrastructure

Operating income for our Water Infrastructure segment increased $7 million, or 14.9%, (increased $9 million or 17.0% on an adjusted basis) for the first quarter of 2016 compared with the same respective prior year period. On an adjusted basis the operating margin increased from 10.6% to 12.1%. The increase in adjusted operating margin was due to cost savings from global procurement and continuous improvement initiatives as well as favorable mix and volume, partially offset by cost inflation and increased investment spending in growth initiatives, including new product development.

Applied Water

Operating income for our Applied Water segment decreased $7 million, or 15.2%, (decreased $5 million or 10.6% on an adjusted basis) for the first quarter of 2016 compared with the same respective prior year period. On an adjusted basis the operating margin decreased from 13.9% to 12.6%. The decrease in adjusted operating margin was due to the timing of strategic investments and unfavorable mix, which more than offset cost savings from global procurement and productivity gains, net of inflation. Strategic investments included building emerging market product localization capabilities, sales channel development and new product development.

Corporate and other

Operating loss for corporate and other increased $4 million, (increased $2 million on an adjusted basis) compared with the same respective prior year period. The increase in the adjusted operating loss was primarily due to increased compensation cost.

Interest Expense

Interest expense was $14 million for the three months ended March 31, 2016 and 2015, primarily related to the interest on the $1.2 billion long-term debt issued in September 2011. See "Liquidity and Capital Resources" for further details.

Income Tax Expense

The income tax provision for the three months ended March 31, 2016 was a benefit of $1 million resulting in an effective tax rate of negative 1.6%, compared to an expense of $13 million resulting in an effective tax rate of 17.3% for the same period in 2015. The variance in the effective tax rates resulted from the recognition of unrecognized tax benefits recorded in the current period.

Other Comprehensive Income (Loss)

Other comprehensive income was $26 million for the three months ended March 31, 2016 compared to a loss of $134 million for the same period in 2015. The change was driven almost entirely from favorable foreign currency translation impacts due primarily to the strengthening of the Euro against the U.S. Dollar in 2016 as compared to the weakening of the Euro against the U.S. Dollar during the same period in 2015.

Liquidity and Capital Resources

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

	Three Months Ended March 31,		
(In millions)	2016	2015	Change
Operating activities	$41	$39	$ 2
Investing activities	(105)	(36)	(69)
Financing activities	559	(71)	630
Foreign exchange (a)	18	(41)	59
Total	$513	$(109)	$ 622

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

Sources and Uses of Liquidity

Operating Activities

During the three months ended March 31, 2016, net cash provided by operating activities increased by $2 million as compared to the prior year. The year-over-year increase was primarily driven by a decrease in the use of working capital from increased customer collections offset by increases for cash paid for interest and income taxes as compared to the prior year due to the timing of our fiscal quarter-end.

Investing Activities

Cash used in investing activities was $105 million for the three months ended March 31, 2016 as compared to $36 million in the comparable prior year period. This increase was due to $70 million spent on our acquisition of Tideland Signal Corporation.

Financing Activities

Cash provided by financing activities was $559 million for the three months ended March 31, 2016 as compared to a use of $71 million in the comparable prior year period. This change was primarily driven by the issuance of long-term and short-term debt of $580 million as part of our refinancing of debt that matures later this year (see "Senior Notes" for further information) and a decrease in share repurchase activity of $50 million.

Funding and Liquidity Strategy
Our ability to fund our capital needs depends on our ongoing ability to generate cash from operations, and access to bank financing and the capital markets. Historically, we have generated operating cash flow sufficient to fund our primary cash needs centered on operating activities, working capital, capital expenditures, and strategic investments. If our cash flows from operations are less than we expect, we may need to incur debt or issue equity. From time to time, we may need to access the long-term and short-term capital markets to obtain financing. Our access to, and the availability of, financing on acceptable terms and conditions in the future will be impacted by many factors, including: (i) our credit ratings or absence of a credit rating, (ii) the liquidity of the overall capital markets, and (iii) the current state of the economy. There can be no assurance that such financing will be available to us on acceptable terms or that such financing will be available at all.
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 from operations and access to the commercial paper markets, we believe there is sufficient liquidity to meet our funding requirements. In addition, our existing committed credit facilities and access to the public debt markets would provide further liquidity if required.
We anticipate that our present sources of funds, including funds from operations and additional borrowings, will provide us with sufficient liquidity and capital resources to meet our liquidity and capital needs in both the United States and outside of the United States over the next twelve months.
Senior Notes
On September 20, 2011, we issued 3.550% Senior Notes of $600 million aggregate principal amount due September 2016 and 4.875% Senior Notes of $600 million aggregate principal amount due October 2021. On March 11, 2016, we issued 2.250% Senior Notes of €500 million aggregate principal amount due 2023.
The Senior Notes include covenants which restrict our ability, subject to exceptions, to incur debt secured by liens and engage in sale and leaseback transactions, as well as provide for customary events of default (subject, in certain cases, to receipt of notice of default and/or customary grace and cure periods). We may redeem the Senior Notes, as applicable, in whole or in part, at any time at a redemption price equal to the principal amount of the Senior Notes to be redeemed, plus a make-whole premium. We may redeem all or a portion of the Senior Notes due 2023 at our option at any time on or after December 11, 2022 (three months prior to their maturity), at a redemption price equal to 100% of the principal amount, plus accrued and unpaid interest to the redemption date. We may also redeem all, but not part, of the Senior Notes due 2023 in the event of specified tax events as described in the applicable Senior Notes indenture. If a change of control triggering event (as defined in the applicable Senior Notes indenture) occurs, we will be required to make an offer to purchase the Senior Notes at a price equal to 101% of their principal amount plus accrued and unpaid interest to the date of repurchase. As of March 31, 2016, we were in compliance with all covenants for the Senior Notes.
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. Interest on the Senior Notes due 2023 is payable on March 11 of each year.
On April 11, 2016, our Senior Notes due 2016 were settled for a total of $607 million which included make-whole interest expense of $7 million. The Company will record this loss on extinguishment of the debt in the second quarter of 2016 as interest expense.
Credit Facility
Effective March 27, 2015, Xylem entered into a Five-Year Revolving Credit Facility with Citibank, N.A., as administrative agent, and a syndicate of lenders. The Credit Facility provides for an aggregate principal amount of up to $600 million of: (i) revolving extensions of credit outstanding at any time and (ii) the issuance of letters of credit in a face amount not in excess of $100 million outstanding at any time. The Credit Facility provides for increases of up to $200 million for a possible maximum total of $800 million in aggregate principal amount at our request and with the consent of the institutions providing such increased commitments.
At our election, the interest rate per annum applicable to the revolving loans will be based on either (i) a Eurodollar rate determined by reference to LIBOR, adjusted for statutory reserve requirements, plus an applicable margin or (ii) a fluctuating rate of interest determined by reference to the greatest of: (a) the prime rate of Citibank,

N.A., (b) the U.S. Federal funds effective rate plus half of 1% or (c) the Eurodollar rate determined by reference to LIBOR, adjusted for statutory reserve requirements, in each case, plus an applicable margin.

In accordance with the terms, we may not exceed a maximum leverage ratio of 3.50 to 1.00 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. The Credit Facility also contains limitations on, among other things, incurring secured debt, granting liens, entering into sale and leaseback transactions, mergers, consolidations, liquidations, dissolutions and sales of assets. In addition, the Credit Facility contains other terms and conditions such as customary representations and warranties, additional covenants and customary events of default. As of March 31, 2016, we were in compliance with all covenants.

As of March 31, 2016, the Credit Facility was undrawn.

Research and Development Facility Agreement

On December 3, 2015, the Company amended and restated its Risk Sharing Finance Facility Agreement (the "R&D Facility Agreement") with The European Investment Bank (the "EIB") to amend the maturity date. The facility provides an aggregate principal amount of up to €120 million (approximately $136 million) to finance research projects and infrastructure development in the European Union. The Company's wholly owned subsidiaries in Luxembourg, Xylem Holdings S.á r.l. and Xylem International S.á r.l., are the borrowers under the R&D Facility Agreement. The obligations of the borrowers under the R&D Facility Agreement are guaranteed by the Company under an Amended and Restated Deed of Guarantee, dated as of December 4, 2013, in favor of the EIB. The funds are available during the period from 2013 through 2016 at the Company's facilities in Sweden, Germany, Italy, the United Kingdom, Austria, Norway and Hungary.

Under the R&D Facility Agreement, the borrower was able to draw loans on or before March 31, 2016 with a maturity of no longer than 12 years. The R&D Facility Agreement provides for Fixed Rate loans and Floating Rate loans. The interest rate per annum applicable to Fixed Rate loans is at a fixed percentage rate per annum specified by the EIB which includes the applicable margin. The interest rate per annum applicable to Floating Rate loans is at the rate determined by reference to EURIBOR for loans drawn in Euros and LIBOR for loans drawn in Pounds Sterling or U.S. Dollars, plus an applicable spread specified by the EIB which includes the applicable margin. The applicable margin for both Fixed Rate loans and Floating Rate loans is determined by reference to the credit rating of the Company.

In accordance with the terms of the R&D Facility Agreement, we may not exceed a maximum leverage ratio of 3.50 to 1.00 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. The R&D Facility Agreement also contains limitations on, among other things, incurring debt, granting liens, and entering into sale and leaseback transactions. In addition, the R&D Facility Agreement contains other terms and conditions, such as customary representations and warranties, additional covenants and customary events of default. As of March 31, 2016, we were in compliance with all covenants.

As of March 31, 2016, $120 million was outstanding under the R&D Facility Agreement. Although the borrowing term for this arrangement is up to five years, we have classified it as short-term debt on our Condensed Consolidated Balance Sheet since we intend to repay this obligation in less than a year.

Non-U.S. Operations

We generated approximately 58% and 60% of our revenue from non-U.S. operations for the three months ended March 31, 2016 and 2015, respectively. As we continue to grow our operations in the emerging markets and elsewhere outside of the United States, we expect to continue to generate significant revenue from non-U.S. operations and we expect our cash will be predominately held by our foreign subsidiaries. We expect to manage our worldwide cash requirements considering available funds among the many subsidiaries through which we conduct business and the cost effectiveness with which those funds can be accessed. We may transfer cash from certain international subsidiaries to the U.S. and other international subsidiaries when we believe it is cost effective to do so. We continually review our domestic and foreign cash profile, expected future cash generation and investment opportunities, which support our current designation of a portion of these funds as being indefinitely reinvested and reassess whether there is a demonstrated need to repatriate funds held internationally to support our U.S. operations. If, as a result of our review, it is determined that all or a portion of the funds may be needed for our operations in the United States, we may be required to accrue additional U.S. taxes. As of March 31, 2016, our foreign subsidiaries were holding $719 million in cash or marketable securities.

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Critical Accounting Estimates

Our discussion and analysis of our results of operations and capital resources are based on our condensed consolidated financial statements, which have been prepared in conformity with GAAP. The preparation of these condensed consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses and the disclosure of contingent assets and liabilities. We believe the most complex and sensitive judgments, because of their significance to the condensed consolidated financial statements, result primarily from the need to make estimates about the effects of matters that are inherently uncertain. Management’s Discussion and Analysis of Financial Condition and Results of Operations in the 2015 Annual Report describes the critical accounting estimates used in preparation of the condensed consolidated financial statements. Actual results in these areas could differ from management’s estimates. There have been no significant changes in the information concerning our critical accounting estimates as stated in our 2015 Annual Report.

New Accounting Pronouncements

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There has been no material change in the information concerning market risk as stated in our 2015 Annual Report.

ITEM 4. CONTROLS AND PROCEDURES

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

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

PART II

ITEM 1. LEGAL PROCEEDINGS

From time to time, we are involved in legal proceedings that are incidental to the operation of our businesses. Some of these proceedings seek remedies relating to environmental matters, intellectual property matters, personal injury claims, employment and pension matters, government contract issues and commercial or contractual disputes, sometimes related to acquisitions or divestitures. See Note 17 "Commitments and Contingencies" to the condensed consolidated financial statements for further information and any updates.

ITEM 1A. RISK FACTORS

There have been no material changes from the risk factors previously disclosed in our 2015 Annual Report.

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

The following table presents information with respect to purchases of the Company's common stock by the Company during the three months ended March 31, 2016:

(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)
1/1/16 - 1/31/16	—	—	—	$429
2/1/16 - 2/29/16	—	—	—	$429
3/1/16 - 3/31/16	—	—	—	$430

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

(b) On August 24, 2015, our Board of Directors authorized the repurchase of up to $500 million in shares with no expiration date. The program's objective is to deploy our capital in a manner that benefits our shareholders and maintains our focus on growth. There were no shares repurchased under this program during the three months ended March 31, 2016. There are up to $420 million in shares that may still be purchased under this plan as of March 31, 2016.

On August 18, 2012, our Board of Directors authorized the repurchase of up to 2.0 million shares of common stock with no expiration date. The program's objective is to offset dilution associated with various Xylem employee stock plans by acquiring shares in the open market from time to time. There were no shares repurchased under this program during the three months ended March 31, 2016. There are up to 0.3 million of shares (approximately $10 million in value) that may still be purchased under this plan as of March 31, 2016.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

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

SIGNATURES

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

XYLEM INC.
(Registrant)

/s/ John P. Connolly
John P. Connolly
Vice President, Controller and Chief Accounting Officer
(Principal Accounting Officer and Duly Authorized Officer)
May 3, 2016

XYLEM INC.
EXHIBIT INDEX

Exhibit Number	Description	Location
(3.1)	Third Amended and Restated Articles of Incorporation of Xylem Inc.	Incorporated by reference to Exhibit 3.1 of Xylem Inc.'s Form 10-Q filed on July 29, 2014 (CIK No. 1524472, File No. 1-35229).
(3.2)	Amended and Restated By-laws of Xylem Inc.	Incorporated by reference to Exhibit 3.1 of Xylem Inc.'s Form 8-K filed on February 25, 2016 (CIK No. 1524472, File No. 1-35229).
(4.1)	Senior Indenture, dated March 11, 2016, by and between the Company and Deutsche Bank Trust Company Americas, as trustee.	Incorporated by reference to Exhibit 4.1 of Xylem Inc.'s Form 8-K filed on March 11, 2016 (CIK No. 1524472, File No. 1-35229.
(4.2)	Supplemental Indenture No. 1, dated March 11, 2016, by and between the Company and Deutsche Bank Trust Company Americas, as trustee.	Incorporated by reference to Exhibit 4.1 of Xylem Inc.'s Form 8-K filed on March 11, 2016 (CIK No. 1524472, File No. 1-35229.
(4.3)	Supplemental Indenture No. 2, dated March 11, 2016, by and between the Company and Deutsche Bank Trust Company Americas, as trustee (including the form of 2.250% Senior Notes due 2023).	Incorporated by reference to Exhibit 4.1 of Xylem Inc.'s Form 8-K filed on March 11, 2016 (CIK No. 1524472, File No. 1-35229.
(4.4)	Form of 2.250% Senior Notes due 2023.	Incorporated by reference to Exhibit 4.3 of Xylem Inc.'s Current Report on Form 8-K dated March 11, 2016 (CIK No. 1524472, File No. 1-35229).
(11.0)	Statement Re-Computation of Per Share Earnings	Information required to be presented in Exhibit 11 is provided under "Earnings Per Share" in Note 6 to the Condensed Consolidated Financial Statements in Part I, Item 1 "Condensed Consolidated Financial Statements" of this Report in accordance with the provisions of Financial Accounting Standards Board Accounting Standards Codification 260, Earnings Per Share.
(31.1)	Certification pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith.
(31.2)	Certification pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith.

(32.1)	Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	This Exhibit is intended to be furnished in accordance with Regulation S-K Item 601(b) (32) (ii) and shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934 or incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except as shall be expressly set forth by specific reference.
(32.2)	Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	This Exhibit is intended to be furnished in accordance with Regulation S-K Item 601(b) (32) (ii) and shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934 or incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except as shall be expressly set forth by specific reference.

Exhibit Number	Description	Location
(101.0)	The following materials from Xylem Inc.'s Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2016, formatted in XBRL (Extensible Business Reporting Language): (i) Condensed Consolidated Income Statements, (ii) Condensed Consolidated Statements of Comprehensive Income, (iii) Condensed Consolidated Balance Sheets, (iv) Condensed Consolidated Statements of Cash Flows and (v) Notes to Condensed Consolidated Financial Statements	Submitted electronically with this Report.