Xylem Inc.
Form 10-Q
May 01, 2018

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2018

or

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

For the transition period from to

Commission file number: 1-35229

Xylem Inc.

(Exact name of registrant as specified in its charter)

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

1 International Drive, Rye Brook, NY 10573
(Address of principal executive offices) (Zip code)

(914) 323-5700
(Registrant's telephone number, including area code)

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

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

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

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

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

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

As of April 27, 2018, there were 179,921,349 outstanding shares of the registrant’s common stock, par value $0.01 per share.

Xylem Inc.
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PART I

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

XYLEM INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED INCOME STATEMENTS (Unaudited)
(in millions, except per share data)

For the three months ended March 31,	**2018**	2017
Revenue	**$1,217**	$1,071
Cost of revenue	**757**	659
Gross profit	**460**	412
Selling, general and administrative expenses	**296**	272
Research and development expenses	**41**	42
Restructuring and asset impairment charges, net	**10**	12
Operating income	**113**	86
Interest expense	**21**	20
Other non-operating income (expense), net	**3**	(1)
Gain from sale of business	**—**	5
Income before taxes	**95**	70
Income tax expense	**16**	14
Net income	**$79**	$56
Earnings per share:		
Basic	**$0.44**	$0.31
Diluted	**$0.43**	$0.31
Weighted average number of shares:		
Basic	**179.9**	179.6
Diluted	**181.4**	180.7
Dividends declared per share	**$0.2100**	$0.1800

See accompanying notes to condensed consolidated financial statements.

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

For the three months ended March 31,	**2018**	2017
Net income	**$79**	$56
Other comprehensive income, before tax:		
Foreign currency translation adjustment	**8**	29
Net change in derivative hedge agreements:		
Unrealized gains	**—**	2
Amount of loss reclassified into net income	**(1)**	1
Net change in postretirement benefit plans:		
Amortization of prior service cost	**(1)**	—
Amortization of net actuarial loss into net income	**3**	3
Settlement/Curtailment	**1**	—
Other comprehensive (loss) income, before tax	**10**	35
Income tax benefit related to items of other comprehensive income	**(10)**	(7)
Other comprehensive income, net of tax	**20**	42
Comprehensive income	**$99**	$98

See accompanying notes to condensed consolidated financial statements.

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

	March 31, 2018	December 31, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	**$ 297**	$ 414
Receivables, less allowances for discounts and doubtful accounts of $29 and $35 in 2018 and 2017, respectively	**999**	956
Inventories	**578**	524
Prepaid and other current assets	**192**	177
Total current assets	**2,066**	2,071
Property, plant and equipment, net	**666**	643
Goodwill	**3,082**	2,768
Other intangible assets, net	**1,303**	1,168
Other non-current assets	**233**	210
Total assets	**$ 7,350**	$ 6,860
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	**$ 543**	$ 549
Accrued and other current liabilities	**546**	551
Short-term borrowings and current maturities of long-term debt	**371**	—
Total current liabilities	**1,460**	1,100
Long-term debt	**2,228**	2,200
Accrued postretirement benefits	**446**	442
Deferred income tax liabilities	**285**	252
Other non-current accrued liabilities	**374**	347
Total liabilities	**4,793**	4,341
Commitments and contingencies (Note 18)		
Stockholders' equity:		
Common Stock – par value $0.01 per share:		
Authorized 750.0 shares, issued 192.8 shares and 192.3 shares in 2018 and 2017, respectively	**2**	2
Capital in excess of par value	**1,925**	1,912
Retained earnings	**1,282**	1,227
Treasury stock – at cost 12.8 shares and 12.4 shares in 2018 and 2017, respectively	**(461)**	(428)
Accumulated other comprehensive loss	**(207)**	(210)
Total stockholders' equity	**2,541**	2,503
Non-controlling interests	**16**	16
Total equity	**2,557**	2,519
Total liabilities and stockholders' equity	**$ 7,350**	$ 6,860

See accompanying notes to condensed consolidated financial statements.

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

For the three months ended March 31,	**2018**	2017
Operating Activities		
Net income	**$79**	$56
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	**29**	28
Amortization	**38**	31
Share-based compensation	**9**	6
Restructuring and asset impairment charges	**10**	12
Gain from sale of business	**—**	(5)
Other, net	**(4)**	(2)
Payments for restructuring	**(5)**	(8)
Changes in assets and liabilities (net of acquisitions):		
Changes in receivables	**(9)**	(12)
Changes in inventories	**(40)**	(10)
Changes in accounts payable	**6**	(32)
Other, net	**(50)**	(12)
Net Cash – Operating activities	**63**	52
Investing Activities		
Capital expenditures	**(61)**	(43)
Acquisition of business, net of cash acquired	**(430)**	(6)
Proceeds from sale of business	**—**	11
Net Cash – Investing activities	**(491)**	(38)
Financing Activities		
Short-term debt issued, net	**371**	—
Short-term debt repaid	**—**	(5)
Repurchase of common stock	**(33)**	(5)
Proceeds from exercise of employee stock options	**3**	1
Dividends paid	**(38)**	(33)
Other, net	**(1)**	1
Net Cash – Financing activities	**302**	(41)
Effect of exchange rate changes on cash	**9**	6
Net change in cash and cash equivalents	**(117)**	(21)
Cash and cash equivalents at beginning of year	**414**	308
Cash and cash equivalents at end of period	**$297**	$287
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	**$14**	$12
Income taxes (net of refunds received)	**$17**	$17

See accompanying notes to condensed consolidated financial statements.

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

Note 1. Background and Basis of Presentation

Background

Xylem Inc. ("Xylem" or the "Company") is a leading equipment and service provider for water and wastewater applications with a broad portfolio of products and services addressing the full cycle of water, from collection, distribution and use to the return of water to the environment. Xylem was incorporated in Indiana on May 4, 2011.

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

Except as otherwise indicated or unless the context otherwise requires, "Xylem," "we," "us," "our" and the "Company" refer to Xylem Inc. and its subsidiaries.

Basis of Presentation

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

The unaudited interim condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC") and, in the opinion of management, reflect all adjustments (which include normal recurring adjustments) considered necessary for a fair presentation of the financial position and results of operations for the periods presented. Certain information and note disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such SEC rules. We believe that the disclosures made are adequate to make the information presented not misleading. We consistently applied the accounting policies described in our Annual Report on Form 10-K for the year ended December 31, 2017 ("2017 Annual Report") in preparing these unaudited condensed consolidated financial statements, with the exception of accounting standard updates described in Note 2. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes included in our 2017 Annual Report.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Estimates are revised as additional information becomes available. Estimates and assumptions are used for, but not limited to, postretirement obligations and assets, revenue recognition, income tax contingency accruals and valuation allowances, goodwill and indefinite lived intangible impairment testing and contingent liabilities. Actual results could differ from these estimates.

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

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Note 2. Recently Issued Accounting Pronouncements

Pronouncements Not Yet Adopted

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

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

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

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

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

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

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

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

Recently Adopted Pronouncements

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

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

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from operations, if one is presented. The amendment also requires entities to disclose the income statement lines that contain the other components if they are not appropriately described. This guidance is effective retrospectively for periods beginning after December 15, 2017, including interim periods within those annual periods. Early adoption is permitted. We adopted this guidance effective the first quarter of 2018. The prior period income statements and segment results have been retrospectively adjusted in accordance with the new guidance. The impact to the presentation between operating income and other non-operating income within Xylem's Consolidated Income Statements was $2 million or less for each of the quarters of 2017 and 2016 and approximately $4 million for the year ended December 31, 2017.
In May 2014, the FASB issued guidance on recognizing revenue from contracts with customers. The guidance outlines a single comprehensive model to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The core principle of the model is that an entity recognizes revenue to portray the transfer of goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The standard also expands disclosure requirements regarding revenue recognition. This guidance is effective for interim and annual reporting periods beginning after December 15, 2017 and may be applied retrospectively to each prior period presented or using a modified retrospective approach with the cumulative effect recognized as of the date of initial application. Early adoption is permitted for interim and annual reporting periods beginning after December 15, 2016. We adopted this guidance as of January 1, 2018 using the modified retrospective transition method. The adoption of the guidance did not have a material impact on our financial condition and results of operations. See Note 4, "Revenue", for further details.

Note 3. Acquisitions and Divestitures

2018 Acquisitions and Divestitures

Pure Technologies Ltd.

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

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

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

(in millions)	Amount	
Cash	$ 14	
Receivables	24	
Inventories	5	
Prepaid and other current assets	1	
Property, plant and equipment	22	
Intangible assets	148	
Other long-term assets	4	
Accounts payable	(3	)
Accrued and other current liabilities	(12	)
Deferred income tax liabilities	(29	)
Other non-current accrued liabilities	(2	)
Total identifiable net assets	172	
Goodwill	262	

Total consideration	$ 434

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

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

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

Category	**Life**	**Amount (in millions)**
Customer Relationships	18 years	$ 83
Technology	3 - 10 years	37
Tradenames	17 years	22
Internally Developed Software	3 years	6
Total		$ 148

The following table summarizes, on an unaudited pro forma basis, the condensed combined results of operations of the Company for the three month periods ended March 31, 2018 and March 31, 2017 assuming the acquisition of Pure was made on January 1, 2017.

(in millions)	Three Months Ended March 31, 2018	Three Months Ended March 31, 2017
Revenue	$ 1,222	$ 1,093
Net income	$ 77	$ 55

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

- Amortization expense of acquired intangibles

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

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

For the two month period ended March 31, 2018 Pure had revenue and operating loss of $16 million and $3 million, respectively.

Other Acquisition Activity
During the three months ended March 31, 2018 we also spent approximately $10 million on other acquisition activity.

2017 Acquisitions and Divestitures

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

Note 4. Revenue

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

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

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

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

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

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

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

The transaction price is adjusted for our estimate of variable consideration which may include a right of return, discounts, rebates, penalties and retainage. To estimate variable consideration, we apply the expected value or the most likely amount method, based on whichever method most appropriately predicts the amount of consideration we expect to be entitled to. The method applied is typically based on historical experience and known trends. We constrain the amounts of variable consideration that are included in the transaction price, to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur or when uncertainties around the variable consideration are resolved.
For all contracts with customers, payment received for our products and services may not necessarily follow the same pattern of revenue recognition to which it relates and are dictated by the terms and conditions of our contracts with customers. Payments received for product sales typically occur following delivery and the satisfaction of the performance obligation based upon the terms outlined in the contracts. Payments received for services typically occur following the services being rendered. For long-term construction-type projects, payments are typically made throughout the contract as progress is made.
In limited situations contracts with customers include financing components where payment terms exceed one year, however, we believe that the financing effects are not significant to Xylem. In addition, we apply a practical expedient and do not adjust the promised amount of consideration in a contract for the effects of significant financing components when we expect payment terms to be one year or less from the time the goods or services are transferred until ultimate payment.

Product Warranties

We offer standard warranties for our products to ensure that our products comply with agreed-upon specifications in our contracts. For standard warranties, these do not give rise to performance obligations and represent assurance-type warranties. In certain instances, product warranty terms are adjusted to account for the specific nature of the contract. In these instances, we assess the warranties to determine whether they represent service-type warranties, and should be accounted for as a separate performance obligation in the contract.
For assurance-type warranties, we accrue for the estimated cost of product warranties at the time revenue is recognized and record it as a component of cost of revenue. Our product warranty liability reflects our best estimate of probable liability under the terms and conditions of our product warranties offered to customers. We estimate the liability based on our standard warranty terms, the historical frequency of claims and the cost to replace or repair our products under warranty. Factors that impact our warranty liability include the number of units sold, the length of warranty term, historical and anticipated rates of warranty claims and cost per claim. We also record a warranty liability for specific matters. We assess the adequacy of our recorded warranty liabilities quarterly and adjust amounts as necessary.

Disaggregation of Revenue

The following table illustrates the sources of revenue:

(in millions)	**Three Months Ended March 31, 2018**
Revenue from contracts with customers	1,162
Other	55
Total	1,217

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

(in millions)	Three Months Ended March 31, 2018
Water Infrastructure	
Transport	$347
Treatment	78
Applied Water	
Commercial Building Services	137
Residential Building Services	57
Industrial Water	172
Measurement and Control Solutions	
Water	172
Electric	37
Gas	43
Software and Services/Other	34
Test	85
Total	$1,162

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

(in millions)	Three Months Ended March 31, 2018
Water Infrastructure	
United States	$113
Europe	177
Emerging Markets & Other	135
Applied Water	
United States	188
Europe	98
Emerging Markets & Other	80
Measurement and Control Solutions	
United States	206
Europe	84
Emerging Markets & Other	81
Total	$1,162

Contract Balances

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

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

(in millions)	**Contract Assets (a)**	**Contract Liabilities**
Balance at 1/1/2018	$ 89	$ 107
Additions, net	38	56
Revenue recognized from opening balance	—	(54)
Billings	(34)	—
Other	1	1
Balance at 3/31/2018	$ 94	$ 110

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

Performance obligations

Delivery schedules vary from customer to customer based upon their requirements. Typically, large projects require longer lead production cycles and delays can occur from time to time. As of March 31, 2018, the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied or partially unsatisfied for contracts with performance obligations, amount to $232 million. We expect to recognize revenue upon the completion of satisfying these performance obligations in the following 12 to 60 months. The Company elects to apply the practical expedient to exclude from this disclosure revenue related to performance obligations that are part of a contract whose original expected duration is less than one year.

Contract Costs

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

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

Note 5. Restructuring Charges

From time to time, the Company will incur costs related to restructuring actions in order to optimize our cost base and more strategically position ourselves based on the economic environment and customer demand. During the three months ended March 31, 2018, we recognized restructuring charges of $10 million. We incurred these charges primarily as a continuation of our efforts to reposition our European and North American businesses to optimize our cost structure and improve our operational efficiency and effectiveness. The charges included the reduction of headcount and consolidation of facilities within our Measurement & Control Solutions and Water Infrastructure segments, as well as headcount reductions within our Applied Water segment.

During the three months ended March 31, 2017, we recognized restructuring charges of $7 million. We incurred these charges primarily in an effort to reposition our European and North American businesses to optimize our cost structure and improve our operational efficiency and effectiveness. The charges included the reduction of headcount and consolidation of facilities within our Applied Water and Water Infrastructure segments, as well as Corporate headcount reductions.

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

	Three Months Ended March 31,	
(in millions)	**2018**	2017
By component:		
Severance and other charges	**$9**	$8
Lease related charges	**1**	—
Reversal of restructuring accruals	**—**	(1)
Total restructuring charges	**$10**	$7
Asset impairment	**—**	5
Total restructuring and asset impairment charges	**$10**	$12
By segment:		
Water Infrastructure	**$3**	$2
Applied Water	**1**	8
Measurement & Control Solutions	**6**	2
Corporate and other	**—**	—

The following table displays a rollforward of the restructuring accruals, presented on our Condensed Consolidated Balance Sheets within accrued and other current liabilities, for the three months ended March 31, 2018 and 2017.

(in millions)	**2018**	2017
Restructuring accruals - January 1	**$7**	$15
Restructuring charges	**10**	7
Cash payments	**(5)**	(8)
Foreign currency and other	**—**	—
Restructuring accruals - March 31	**$12**	$14
By segment:		
Water Infrastructure	**$1**	$1
Applied Water	**1**	7
Measurement & Control Solutions	**6**	4
Regional selling locations (a)	**3**	2
Corporate and other	**1**	—

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

The following is a rollforward for the three months ended March 31, 2018 and 2017 of employee position eliminations associated with restructuring activities.

	2018	2017
Planned reductions - January 1	**47**	188
Additional planned reductions	**102**	28
Actual reductions and reversals	**(45)**	(133)
Planned reductions - March 31	**104**	83

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The following table presents expected restructuring spend:

(in millions)	Water Infrastructure	Applied Water	Measurement & Control Solutions	Corporate	Total
Actions Commenced in 2018:					
Total expected costs	$ 5	$ 1	$ 8	$ —	$14
Costs incurred during Q1 2018	2	1	5	—	8
Total expected costs remaining	**$ 3**	**$ —**	**$ 3**	**$ —**	**$6**
Actions Commenced in 2017:					
Total expected costs	$ 20	$ 12	$ 2	$ —	$34
Costs incurred during 2017	5	4	2	—	11
Costs incurred during Q1 2018	1	—	—	—	1
Total expected costs remaining	**$ 14**	**$ 8**	**$ —**	**$ —**	**$22**
Actions Commenced in 2016:					
Total expected costs	$ 13	$ 14	$ 11	$ 2	$40
Costs incurred during 2016	11	10	6	2	29
Costs incurred during 2017	2	4	3	—	9
Costs incurred during Q1 2018	—	—	1	—	1
Total expected costs remaining	**$ —**	**$ —**	**$ 1**	**$ —**	**$1**

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

Asset Impairment Charges

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

Note 6. Income Taxes

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

The income tax provision for the three months ended March 31, 2018 was $16 million resulting in an effective tax rate of 17.1%, compared to $14 million resulting in an effective tax rate of 20.4% for the same period in 2017. The effective tax rate was lower than the United States federal statutory rate primarily due to the mix of earnings in jurisdictions in both periods. Additionally, the effective tax rate for the current period is lower than the three month period ended March 31, 2017 due to the reduction of the United States federal corporate tax rate, partially offset by the Global Intangible Low-Taxed Income ("GILTI") inclusion.

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, 2018 was $131 million, as compared to $130 million at December 31,

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2017, which if ultimately recognized will reduce our effective tax rate. We do not believe that the unrecognized tax benefits will significantly change within the next twelve months. We classify interest expense relating to unrecognized tax benefits as a component of other non-operating expense, net, and tax penalties as a component of income tax expense in our Condensed Consolidated Income Statements. As of March 31, 2018, we had $4 million of interest accrued for unrecognized tax benefits.

Tax Act

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

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

Because of the complexity of the GILTI tax rules, we are continuing to evaluate this provision of the Act and the application of ASC 740. As noted at year-end, we were not yet able to reasonably estimate the effect of the new GILTI rules. Therefore, no provisional adjustments were recorded as of December 31, 2017. Under U.S. GAAP, we are allowed to make an accounting policy choice of either (1) treating taxes due on future U.S. inclusions in taxable income related to GILTI as a current-period expense when incurred (the “period cost method”) or (2) factoring such amounts into a company’s measurement of its deferred taxes (the “deferred method”). Our selection of an accounting policy related to the new GILTI tax rules will depend, in part, on analyzing our global income to determine whether we expect to have future U.S. inclusions in taxable income related to GILTI and, if so, what the impact is expected to be. Because whether we expect to have future U.S. inclusions in taxable income related to GILTI depends on a number of different aspects of our estimated future results of global operations, we are not yet able to reasonably estimate the long-term effects of this provision of the Tax Act. Therefore, we have not recorded any potential deferred tax effects related to GILTI in our financial statements and have not made a policy decision regarding whether to record deferred taxes on GILTI or use the period cost method. Our accounting for the effects related to GILTI is not complete and we expect to complete our accounting within the prescribed measurement period.

Note 7. Earnings Per Share

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

	Three Months Ended March 31,	
	2018	2017
Net income (in millions)	**$79**	$ 56
Shares (in thousands):		
Weighted average common shares outstanding	**179,858**	179,542
Add: Participating securities (a)	**23**	34
Weighted average common shares outstanding — Basic	**179,881**	179,576
Plus incremental shares from assumed conversions: (b)		
Dilutive effect of stock options	**928**	559
Dilutive effect of restricted stock units and performance share units	**556**	515
Weighted average common shares outstanding — Diluted	**181,365**	180,650
Basic earnings per share	**$0.44**	$ 0.31
Diluted earnings per share	**$0.43**	$ 0.31

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

(b) Incremental shares from stock options, restricted stock units and performance share units are computed by the treasury stock method. The weighted average shares listed below were not included in the computation of diluted earnings per share because to do so would have been anti-dilutive for the periods presented or were otherwise excluded under the treasury stock method. The treasury stock method calculates dilution assuming the exercise of all in-the-money options and vesting of restricted stock units and performance share units, reduced by the repurchase of shares with the proceeds from the assumed exercises and unrecognized compensation expense for outstanding awards. Performance share units will be included in the treasury stock calculation of diluted earnings per share upon achievement of underlying performance or market conditions at the end of the reporting period. See Note 15, "Share-Based Compensation Plans" to the condensed consolidated financial statements for further detail on the performance share units.

	Three Months Ended March 31,	
(in thousands)	**2018**	2017
Stock options	**1,218**	1,772
Restricted stock units	**294**	389
Performance share units	**538**	404

Note 8. Inventories

The components of total inventories are summarized as follows:

(in millions)	**March 31, 2018**	December 31, 2017
Finished goods	**$ 246**	$ 223
Work in process	**53**	42
Raw materials	**279**	259
Total inventories	**$ 578**	$ 524

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Note 9. Property, Plant and Equipment

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

(in millions)	**March 31, 2018**	December 31, 2017
Land, buildings and improvements	**$ 341**	$ 329
Machinery and equipment	**859**	799
Equipment held for lease or rental	**247**	241
Furniture and fixtures	**117**	101
Construction work in progress	**80**	85
Other	**22**	21
Total property, plant and equipment, gross	**1,666**	1,576
Less accumulated depreciation	**1,000**	933
Total property, plant and equipment, net	**$ 666**	$ 643

Depreciation expense of $29 million and $28 million was recognized in the three months ended March 31, 2018 and 2017 respectively.

Note 10. Goodwill and Other Intangible Assets

Goodwill

Changes in the carrying value of goodwill by reportable segment for the three months ended March 31, 2018 are as follows:

(in millions)	**Water Infrastructure**	**Applied Water**	**Measurement & Control Solutions**	**Total**
Balance as of January 1, 2018	$ 667	$ 526	$ 1,575	$2,768
Activity in 2018				
Divested/Acquired	—	—	277	277
Foreign currency and other	9	7	21	37
Balance as of March 31, 2018	**$ 676**	**$ 533**	**$ 1,873**	**$3,082**

Other Intangible Assets

Information regarding our other intangible assets is as follows:

(in millions)	**March 31, 2018**			December 31, 2017		
	Carrying Amount	**Accumulated Amortization**	**Net Intangibles**	Carrying Amount	Accumulated Amortization	Net Intangibles
Customer and distributor relationships	**$991**	**$ (261)**	**$ 730**	$906	$ (241)	$ 665
Proprietary technology and patents	**201**	**(81)**	**120**	163	(75)	88
Trademarks	**154**	**(34)**	**120**	138	(37)	101
Software	**306**	**(142)**	**164**	277	(130)	147
Other	**28**	**(21)**	**7**	26	(20)	6
Indefinite-lived intangibles	**162**	**—**	**162**	161	—	161
Other Intangibles	**$1,842**	**$ (539)**	**$ 1,303**	$1,671	$ (503)	$ 1,168

Amortization expense related to finite-lived intangible assets was $38 million and $31 million for the three months ended March 31, 2018 and 2017, respectively.

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

Note 11. Derivative Financial Instruments

Risk Management Objective of Using Derivatives

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

Cash Flow Hedges of Foreign Exchange Risk

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

Certain business units with exposure to foreign currency exchange risks have designated certain currency forward agreements as cash flow hedges of forecasted intercompany inventory purchases and sales. Our principal currency exposures relate to the Euro, Swedish Krona, British Pound, Canadian Dollar, Polish Zloty and Australian Dollar. We had foreign exchange contracts with purchase notional amounts totaling $372 million and $455 million as of March 31, 2018 and December 31, 2017, respectively. As of March 31, 2018, our most significant foreign currency derivatives included contracts to sell U.S. Dollar and purchase Euro, purchase Swedish Krona and sell Euro, sell British Pound and purchase Euro, purchase Polish Zloty and sell Euro, purchase US Dollar and sell Canadian Dollar, and to sell Canadian Dollar and Purchase Euro. The purchased notional amounts associated with these currency derivatives are $123 million, $116 million, $55 million, $30 million, $23 million and $21 million respectively. As of December 31, 2017, the purchase notional amounts associated with these currency derivatives were $147 million, $149 million, $66 million, $34 million, $28 million and $25 million, respectively.

Hedges of Net Investments in Foreign Operations

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

Cross Currency Swaps

Beginning in 2015, we entered into cross currency swaps to manage our exposure to fluctuations in the Euro-U.S. Dollar exchange rate. The total notional amount of derivative instruments designated as net investment hedges was $463 million and $446 million as of March 31, 2018 and December 31, 2017, respectively.

Foreign Currency Denominated Debt

On March 11, 2016, we issued 2.250% Senior Notes of €500 million aggregate principal amount due March 2023. We designated the entirety of the outstanding balance, or $615 million and $592 million as of March 31, 2018 and December 31, 2017, respectively, net of unamortized discount, as a hedge of a net investment in certain foreign subsidiaries.

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

(in millions)	Three Months Ended March 31, 2018	2017
Cash Flow Hedges		
Foreign Exchange Contracts		
Amount of gain recognized in OCI (a)	**$—**	$2
Amount of (gain) reclassified from OCI into revenue (a)	**(1)**	—
Amount of loss reclassified from OCI into cost of revenue (a)	**—**	1
Net Investment Hedges		
Cross Currency Swaps		
Amount of loss recognized in OCI (a)	**$(23)**	$(8)
Foreign Currency Denominated Debt		
Amount of loss recognized in OCI (a)	**$(23)**	$(14)

(a) Effective portion

As of March 31, 2018, $2 million of net gains on cash flow hedges are expected to be reclassified into earnings in the next 12 months. The ineffective portion of a cash flow hedge is recognized immediately in selling, general and administrative expenses in the Condensed Consolidated Income Statements and was not material for the three months ended March 31, 2018 and 2017.

As of March 31, 2018, no gains or losses on the net investment hedges are expected to be reclassified into earnings over their duration. The net investment hedges did not experience any ineffectiveness for the three months ended March 31, 2018.

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 th at consider various assumptions including yield curves, time value and other measurements.

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

(in millions)	March 31, 2018	December 31, 2017
Derivatives designated as hedging instruments		
Assets		
Cash Flow Hedges		
Other current assets	**$ 7**	$ 3
Liabilities		
Cash Flow Hedges		
Other current liabilities	**$ (5)**	$ (1)
Net Investment Hedges		
Other non-current liabilities	**$ (88)**	$ (64)

The fair value of our long-term debt, due in 2023, designated as a net investment hedge was $666 million and $638 million as of March 31, 2018 and December 31, 2017, respectively.

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Note 12. Accrued and Other Current Liabilities

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

(in millions)	**March 31, 2018**	December 31, 2017
Compensation and other employee benefits	**$ 181**	$ 203
Customer-related liabilities	**129**	119
Accrued taxes	**66**	75
Accrued warranty costs	**54**	55
Other accrued liabilities	**116**	99
Total accrued and other current liabilities	**$ 546**	$ 551

Note 13. Credit Facilities and Debt

Total debt outstanding is summarized as follows:

(in millions)	**March 31, 2018**	December 31, 2017
4.875% Senior Notes due 2021 (a)	**$600**	$ 600
2.250% Senior Notes due 2023 (a)	**620**	597
3.250% Senior Notes due 2026 (a)	**500**	500
4.375% Senior Notes due 2046 (a)	**400**	400
Commercial paper	**39**	—
Research and development finance contract	**130**	125
Term loan	**279**	—
Other	**53**	—
Debt issuance costs and unamortized discount (b)	**(22)**	(22)
Total debt	**2,599**	2,200
Less: short-term borrowings and current maturities of long-term debt	**371**	—
Total long-term debt	**$2,228**	$ 2,200

(a) The fair value of our Senior Notes was determined using quoted prices in active markets for identical securities, which are considered Level 1 inputs. The fair value of our Senior Notes due 2021 was $635 million and $648 million as of March 31, 2018 and December 31, 2017, respectively. The fair value of our Senior Notes due 2023 was $666 million and $638 million as of March 31, 2018 and December 31, 2017, respectively. The fair value of our Senior Notes due 2026 was $486 million and $498 million as of March 31, 2018 and December 31, 2017, respectively.The fair value of our Senior Notes due 2046 was $408 million and $431 million as of March 31, 2018 and December 31, 2017, respectively.

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

Senior Notes

On September 20, 2011, we issued 4.875% Senior Notes of $600 million aggregate principal amount due October 2021 (the "Senior Notes due 2021"). On March 11, 2016, we issued 2.250% Senior Notes of €500 million aggregate principal amount due March 2023 (the "Senior Notes due 2023"). On October 11, 2016, we issued 3.250% Senior Notes of $500 million aggregate principal amount due October 2026 (the “Senior Notes due 2026”) and4.375% Senior Notes of $400 million aggregate principal amount due October 2046 (the “Senior Notes due 2046” and, together with the Senior Notes due 2021, the Senior Notes due 2023 and the Senior Notes due 2026, the “Senior Notes”).

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

If a change of control triggering event (as defined in the applicable Senior Notes indenture) occurs, we will be required to make an offer to purchase the Senior Notes at a price equal to 101% of their principal amount plus accrued and unpaid interest to the date of repurchase.

Interest on the Senior Notes due 2021 is payable on April 1 and October 1 of each year. Interest on the Senior Notes due 2023 is payable on March 11 of each year. Interest on the Senior Notes due 2026 and the Senior Notes due 2046 is payable on May 1 and November 1 of each year beginning on May 1, 2017.

As of March 31, 2018, we were in compliance with all covenants for the Senior Notes.

Credit Facilities

Five-Year Revolving Credit Facility

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

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

In accordance with the terms of an amendment to the Credit Facility dated August 30, 2016, we may not exceed a maximum leverage ratio of 4.00 to 1.00 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) for a period of four full fiscal quarters following the Sensus acquisition and a maximum leverage ratio of 3.50 to 1.00 through the rest of the term. The Credit Facility also contains limitations on, among other things, incurring secured debt, granting liens, entering into sale and leaseback transactions, mergers, consolidations, liquidations, dissolutions and sales of assets. In addition, the Credit Facility contains other terms and conditions such as customary representations and warranties, additional covenants and customary events of default. As of March 31, 2018 the Credit Facility was undrawn and we are in compliance with all covenants.

European Investment Bank - R&D Finance Contract

On October 28, 2016, the Company entered into a Finance Contract (the “Finance Contract”) with the European Investment Bank (the “EIB”). The Company's wholly owned subsidiaries in Luxembourg, Xylem Holdings S.á r.l. and Xylem International S.á r.l., are the borrowers under the Finance Contract and Xylem Inc. is the Guarantor. The Finance Contract provides for up to €105 million (approximately $130 million) to finance research, development and innovation projects in the field of sustainable water and wastewater solutions during the period from 2017 through 2019 in Sweden, Germany, Italy, UK, Hungary and Austria. The Company has unconditionally guaranteed the performance of the borrowers under the Finance Contract. Under the Finance Contract, the borrowers are able to draw loans on or before April 28, 2018, with a maturity of no longer than 11 years.

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

Both the Finance Contract and the R&D Facility Agreement provide for fixed rate loans and floating rate loans. Under the Finance Contract, the interest rate per annum applicable to fixed rate loans is at a fixed percentage rate per annum specified by the EIB which includes the applicable margin. The interest rate per annum applicable to floating rate loans is at the rate determined by reference to EURIBOR for loans drawn in Euros and LIBOR for loans drawn in Pounds Sterling or U.S. Dollars, plus an applicable spread specified by the EIB which includes the applicable margin. The applicable margin is 59 basis points (0.59%). As of March 31, 2018 and December 31, 2017, $130 million and $125 million were outstanding under the Finance Contract, respectively.

Term Loan Facility

On January 26, 2018, the Company's subsidiary, Xylem Europe GmbH (the "borrower") entered into a 12-month €225 million (approximately $279 million) term loan facility (the "Term Facility") the terms of which are set forth in a term loan agreement, among the borrower, the Company, as parent guarantor and ING Bank. The Company has entered into a parent guarantee in favor of ING Bank also dated January 26, 2018 to secure all present and future obligations of the borrower under the Term Loan Agreement. The Term Facility was used to partially fund the acquisition of Pure Technologies.

Commercial Paper

Our commercial paper program generally serves as a means of short-term funding and has a combined outstanding limit of $600 million inclusive of the Five-Year Revolving Credit Facility. As of March 31, 2018 and December 31, 2017 $39 million and $0 million of the Company's $600 million commercial paper program was outstanding at a weighted average interest rate of 2.32% and 0%, respectively. We will periodically borrow under this program and may borrow under it in future periods.

Other Borrowings

Effective October 20, 2016, Xylem entered into a revolving line of credit with SEB Bank. The line of credit provides for an aggregate principal amount of up €65 million (approximately $81 million) with a maturity date that has been extended to September 30, 2018. The line of credit was used to partially fund the acquisition of Pure Technologies in 2018. As of March 31, 2018 and December 31, 2017, $53 million and $0 million were outstanding under the revolving line of credit, respectively.

Note 14. Postretirement Benefit Plans

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

(in millions)	Three Months Ended March 31, 2018	2017
Domestic defined benefit pension plans:		
Service cost	**$1**	$1
Interest cost	**1**	1
Expected return on plan assets	**(2)**	(2)
Amortization of net actuarial loss	**1**	1
Net periodic benefit cost	**$1**	$1
International defined benefit pension plans:		
Service cost	**$2**	$3
Interest cost	**5**	5
Expected return on plan assets	**(9)**	(8)
Amortization of net actuarial loss	**2**	2
Settlement/Curtailment	**1**	—
Net periodic benefit cost	**$1**	$2
Total net periodic benefit cost	**$2**	$3

The components of net periodic benefit cost other than the service cost component are included in the line item "other non-operating income (expense), net" in the Condensed Consolidated Income Statements.
The total net periodic benefit cost for other postretirement employee benefit plans was less than $1 million including amounts recognized in other comprehensive income ("OCI") of $1 million for the three months ended March 31, 2018. The total net periodic benefit cost for other postretirement employee benefit plans was $1 million including amounts recognized in OCI of less than $1 million for the three months ended March 31, 2017.

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We contributed $6 million and $6 million to our defined benefit plans during the three months ended March 31, 2018 and 2017, respectively. Additional contributions ranging between approximately $14 million and $24 million are expected during the remainder of 2018.

Note 15. Share-Based Compensation Plans

Share-based compensation expense was $9 million and $6 million during the three months ended March 31, 2018 and 2017, respectively. The unrecognized compensation expense related to our stock options, restricted stock units and performance share units was $9 million, $29 million and $25 million, respectively, at March 31, 2018 and is expected to be recognized over a weighted average period of 2.3, 2.4 and 2.2 years, respectively. The amount of cash received from the exercise of stock options was $3 million and $1 million for the three months ended March 31, 2018 and 2017, respectively.

Stock Option Grants

The following is a summary of the changes in outstanding stock options for the three months ended March 31, 2018.

	Share units (in thousands)	**Weighted Average Exercise Price / Share**	**Weighted Average Remaining Contractual Term (Years)**	**Aggregate Intrinsic Value** (in millions)
Outstanding at January 1, 2018	2,076	$ 37.44	7.0	
Granted	309	75.18		
Exercised	(97)	35.81		
Forfeited and expired	(29)	44.57		
Outstanding at March 31, 2018	**2,259**	**$ 42.58**	**7.2**	**$ 78**
Options exercisable at March 31, 2018	**1,515**	**$ 35.21**	**6.2**	**$ 63**
Vested and expected to vest as of March 31, 2018	**2,150**	**$ 40.92**	**5.9**	**$ 76**

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, 2018 was $3.7 million.

Stock Option Fair Value

The fair value of each option grant was estimated on the date of grant using the binomial lattice pricing model which incorporates multiple and variable assumptions over time, including assumptions such as employee exercise patterns, stock price volatility and changes in dividends. The following are weighted-average assumptions for 2018 grants.

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

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

Restricted Stock Unit Grants

The following is a summary of restricted stock unit activity for the three months ended March 31, 2018. The fair value of the restricted stock units is equal to the closing share price on the date of the grant.

	Share units (in thousands)	**Weighted Average Grant Date Fair Value /Share**
Outstanding at January 1, 2018	779	$ 35.39
Granted	225	75.18
Vested	(404)	39.56
Forfeited	(20)	42.04
Outstanding at March 31, 2018	**580**	**$ 57.04**

ROIC Performance Share Unit Grants

The following is a summary of Return on Invested Capital ("ROIC") performance share unit grants for the three months ended March 31, 2018. The fair value of the ROIC performance share units is equal to the closing share price on the date of the grant.

	Share units (in thousands)	**Weighted Average Grant Date Fair Value /Share**
Outstanding at January 1, 2018	298	$ 41.48
Granted	76	75.18
Forfeited	(93)	36.69
Outstanding at March 31, 2018	**281**	**$ 52.14**

TSR Performance Share Units Grants

The following is a summary of our Total Shareholder Return ("TSR") performance share unit grants for the three months ended March 31, 2018.

	Share units (in thousands)	**Weighted Average Grant Date Fair Value /Share**
Outstanding at January 1, 2018	213	$ 47.04
Granted	76	99.24
Forfeited	(8)	45.50
Outstanding at March 31, 2018	**281**	**$ 61.15**

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

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

Note 16. Capital Stock

For the three months ended March 31, 2018 the Company repurchased approximately 0.4 million shares for $33 million. Repurchases include both share repurchase programs approved by the Board of Directors and repurchases in relation to settlement of employee tax withholding obligations due as a result of the vesting of restricted stock units. The detail of repurchases by each program are as follows:

On August 24, 2015, our Board of Directors authorized the repurchase of up to $500 million in shares with no expiration date. The program's objective is to deploy our capital in a manner that benefits our shareholders and maintains our focus on growth. For the three months ended March 31, 2018, we repurchased approximately 0.3 million shares for $25 million. There were no shares repurchased under this program for the three months ended March 31, 2017. There are up to $388 million in shares that may still be purchased under this plan as of March 31, 2018.

Aside from the aforementioned repurchase programs, we repurchased approximately 0.1 million shares and 0.1 million shares for $