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Xylem Inc. (XYL) CEO Patrick Decker On Q2 2019 Results - Earnings Call Transcript

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Q2: 08-01-19 Earnings Summary

Press Release SEC *10-Q* *Slides*

EPS of $0.79 misses by $-0.00 | Revenue of $1.34B (2.13% Y/Y) misses by $-2.55M

Earning Call Audio

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Xylem Inc. (NYSE:XYL) Q2 2019 Earnings Conference Call August 1, 2019 10:00 AM ET

Company Participants

Matt Latino - Senior Director, IR

Patrick Decker - CEO

Mark Rajkowski - CFO

Conference Call Participants

Nathan Jones - Stifel

Deane Dray - RBC Capital

Scott Davis - Melius Research

John Walsh - Credit Suisse

Ryan Connors - Boenning and Scattergood

Walter Liptak - Seaport Global

Joseph Giordano - Cowen

Pavel Molchanov - Raymond James

Brian Lee - Goldman Sachs

Operator

Welcome to the Xylem Second Quarter 2019 Earnings Conference Call. At this time, all participants have been placed on a listen-only mode and the floor will be open for your questions following the presentation [Operator Instructions]. I would now like to turn the call over to Matt Latino, Senior Director of Investor Relations.

Matt Latino

Thank you, Maria. Good morning everyone and welcome to Xylem's second quarter earnings conference call. With me today are Chief Executive Officer, Patrick Decker and Chief Financial Officer, Mark Rajkowski. They will provide their perspective on Xylem's second quarter 2019 results.

Following our prepared remarks, we will address questions related to the information covered on the call. I will ask that you please keep to one question and a follow-up and then return to the queue. As a reminder, this call and our webcast are accompanied by a slide presentation available in the Investors section of our website at www.xylem.com. A replay of today's call will be available until midnight on September 1st. Please note the replay number is 800-585-8367, and the confirmation code is 8479137. Additionally, the call will be available for playback via the Investors section of our website under the heading Investor events.

Please turn to slide two, we will make some forward-looking statements on today's call, including references to future events or developments that we anticipate will or may occur in the future. These statements are subject to future risks and uncertainties such as those factors described in Xylem's most recent annual report on Form 10-K and in subsequent reports filed with the SEC. Please note that the Company undertakes no obligation to update any forward-looking statements publicly to reflect subsequent events or circumstances and actual events or results could differ materially from those anticipated.

Please turn to slide three, we have provided you with a summary of our key performance metrics, including both GAAP and non-GAAP metrics. For purposes of today's call, all references will be on an adjusted basis unless otherwise indicated, and non-GAAP financials have been reconciled for you and are included in the appendix section of the presentation.

Now, please turn to slide four, and I will turn the call over to our CEO, Patrick Decker.

Patrick Decker

Thanks, Matt. Good morning, everyone. Thank you for joining us today to discuss our second quarter results. Overall, we are pleased with our performance in the quarter which reflect a continued strong revenue growth and margin expansion. Our organic topline growth was broad based driven by solid demand across our end markets and with orders and revenue growth tracking in the mid-single digits. This result marks our eighth consecutive quarter of at least mid-single-digit organic revenue growth.

This reflects the results of our focused investments that are bringing new solutions to the water sector and we believe will drive sustainable attractive margins. We also delivered solid margin expansion of 50 basis points in line with our guidance. In addition, we delivered earnings per share of $0.79 which was also in line with our expectations. That represented a 10% year-over-year increase excluding foreign exchange translation.

As a result of sustained continuing healthy growth, we are narrowing our organic revenue guide and raising the midpoint to the upper end of the range. As a result of near-term mix and targeted investments to accelerate and sustain our growth, we are narrowing our EPS guide to the lower end of the range. We'll get into each of them in a bit more detail.

Looking at the composition of our top line, our regional end-market mix is robust. We turn in solid performance in each of our end markets led by high single digit growth in both utilities and commercial. Regionally, we delivered particularly strong momentum in the US and in our largest emerging markets China and India, each of which grew double digits organically. The high growth in China and India is very pleasing, given we've invested considerably in product localization and our investments there are clearly paying off.

Europe has seen some softening in certain markets, most considerably Italy and Germany driven by broad based industrial weakness. Generally, the rest of Europe shows a steadier picture. Mark will take us into the segment detail in a moment, but I would like to quickly point out that all three segments of our business have turned in solid performances. However, there is a more dynamic picture in MCS. We're very happy with the progress and growth of our Sensus business. Its revenue growth is outpacing Xylem overall, turning a 9% global growth in the quarter and solid double digits in North America.

Our new AIA platform in MCS is in an earlier phase with growth ramp. The acceleration of customer interest is reflected in a 60% expansion of the total AIA deal pipeline over the past 12 months, led by a doubling of opportunities within the new digital solutions portion of that platform.

Moreover, the size and incremental margin profile of that pipeline is very attractive and will be highly accretive to Xylem. The conversion of project to revenue has been slower than expected however. As with any new disruptive technology, our digital platform represents a new approach for customers. So many are prudently taking time to validate the solutions and savings.

As that validation progresses, we are in fact seeing expansions of project scope. Despite slower conversion, the expanding market opportunity we are uncovering continues to affirm our long-term investment thesis. Our approach is to invest just ahead of the adoption curve in order to be positioned to realize the benefit of our first mover advantage and bringing digital intelligence to the water sector. To that end, we are scaling our sales and marketing capacity and continuing to add incremental capabilities to the AIA platform both organically and through M&A as we build out and integrate the portfolio.

Lastly, before turning over to Mark, I do want to take this opportunity to shine a light on our commitment to sustainability. In developing our new 2025 goals, we took a bold aspirational approach in many industries and business models positive sustainability outcomes are a cost of doing business. For Xylem positive sustainability outcomes are a result of doing business. The technology that we sell address water scarcity, water affordability and resilience to climate change, all while dramatically reducing our customer's energy consumption.

So the more business we do, the more technology we deploy, the more sustainability benefit we generate for the customers and the communities that we serve. The complete list of our commitments is in our sustainability report and a summary of our five signature goals is in the appendix of this earnings package. They are commitments to our shareholders and stakeholders alike, every bit as strong is our commitment to deliver robust growth and financial returns.

Now let me turn over to Mark.

Mark Rajkowski

Thanks, Patrick. Please turn to slide five and I'll begin with our second quarter results. Our overall growth momentum continued in the second quarter with organic revenues up 5% Organic orders were also solid up 4% on a tough comparison of 8% growth last year. Most geographies saw healthy revenue growth led by the US, China, India and Australia which each grew double digits.

However, we did have some specific pockets of slowing within Europe and Latin America due to negative prevailing economic conditions which we expect to continue into the second half of the year. All end markets saw positive organic revenue growth led by 8% in utilities, which was on top of a tough comparison of 11% growth in 2018. This was supported by mid-teens growth in the US where we saw robust growth across both the OpEx and CapEx sides of our utilities business.

Industrial market was up 2%. Healthy project business and price realization in the U.S. combined with the continuation of strong construction and mining activity in our dewatering business was partially offset by moderating industrial demand in several regions. Continued strength in the US and double-digit growth in emerging markets drove commercial market revenues up 7% year-over-year.

The residential market grew 1% which was in line with our expectations. Adjusted operating margin for the quarter expanded 50 basis points to 14.3%. This was primarily driven by 280 basis points of cost savings from our productivity programs and 200 basis points of price realization which more than offset inflation, unfavorable mix and provided funding for our growth investments. Earnings per share was $0.79 in the quarter up 10% versus the prior year excluding foreign currency translations.

Please turn to slide six, and I'll review our segment results. Water infrastructure maintained its top line growth momentum with 4% organic orders and 6% organic revenue growth in the quarter. It's worth noting this performance was on top of a tough comparison of an 11% revenue increase last year. Segment backlog was up 2% to $684 million at the end of the quarter with $449 million shippable this year.

While our shippable backlog for the remainder of 2019 is flat, for 2020 and beyond it is up 10% organically, a very positive sign for future growth momentum in the segment. The US market was up mid-teens in both the utility and industrial end markets. Several large CapEx treatment projects and steady OpEx spending drove our strong utilities performance.

Industrial was driven by another strong quarter from dewatering which continues to benefit from a healthy construction and rental market. Emerging markets were up 3% driven primarily by double digit growth in China more than offsetting declining demand due to economic weakness in Latin America and project timing in the Middle East.

Western Europe declined 1% overall, reflecting low-single-digit growth in utilities, which was more than offset by softness in the industrial market. Segment operating margins grew 130 basis points to 19.1% driven by productivity savings price realization and volume leverage. I'm very pleased with the work the teams have been doing to continue to drive cost savings capture further price and share to fund our growth investments and expand margins.

Please turn to slide seven, the applied water systems segment delivered 4% organic revenue growth and 1% organic orders growth in the quarter. Steady order activity in North America and Asia was largely offset by slowing orders in Europe. Overall backlog was $216 million at the end of the quarter, $175 million is expected to ship this year which is up 5% organically year-over-year.

Geographically, Applied Water results were led by the U.S., up 7%, with growth across all end markets. Results were mixed in emerging markets, which were up 2% overall, led by double-digit growth in China, partially offset by declines in Latin America and the Middle East. Western Europe was down 4%, primarily from lower market demand, reflecting economic weakness in certain countries. End market revenue growth was led by commercial which was up 7%, while industrial revenues increased 1%. Growth in both end markets was driven primarily by delivering on a healthy project pipeline and price realization in the U.S.

Segment operating margins were 16.8%. Inflation negatively impacted the segment's margins by 450 basis points, which included roughly 100 basis points of tariff-related cost. However, the team did an outstanding job capturing 350 basis points of price realization and driving 320 basis points of productivity to deliver 60 basis points of margin expansion in the quarter. Now please turn to slide eight.

Measurement & Control Solutions grew orders 7% in the quarter and delivered 6% organic revenue growth. Segment backlog grew double digits year-over-year to $964 million, with $340 million expected to ship this year. As Patrick mentioned earlier, we continue to see strong momentum within Sensus, especially the North American water business, which grew nearly 20% in the quarter. Software and services revenues were down 9%, primarily due to the lapping of a large high-margin software sale in Europe last year.

The energy business grew 4% despite lapping last year's large Alliant project deployment and our test business revenues were up 1%. Segment operating margins were 8.7%, 40 basis points below the previous year and modestly below our expectations. Adjusted EBITDA margins were down 30 basis points to 18.2%. Higher volume, price realization and productivity were more than offset by unfavorable mix in investments to grow our new AIA platform as well as pursue large AMI deployments.

There are few moving parts to the MCS margins story that are important to unpack to understand the dynamics and relevant trajectory of the components within the segment. Our Sensus business had a terrific quarter. Organic revenues grew 9% and orders grew

13%. Sensus EBITDA margins of 20% expanded 180 basis points driven by volume leverage, price realization and productivity savings.

Revenues across the AIA platform were down low single digits primarily due to delays in converting several large projects. This also had a meaningful impact on segment margins compared to our expectations as the digital solution revenues have a very attractive margin profile.

Despite the delay in converting projects to revenues in the quarter, we continue to invest to scale our digital solutions business globally to position us to leverage our first-mover advantage. Year-over-year investments to build out our digital intelligence solutions as well as global commercial and service capabilities reduced segment margins by about 100 basis points in the quarter.

Importantly, we see very strong customer engagement and growing interest in our expanding digital solutions project pipeline. And we continue to expect this business will be an important source of revenue growth in margin expansion for the future.

Please turn to slide nine for an overview of the company's financial position. Our cash balance at the end of the quarter was $383 million. We returned $43 million to our shareholders in the quarter through dividends. $60 million was invested in CapEx, which is in line with our plan, and we continue to expect our full year CapEx spend to be between $230 million and $240 million.

Our working capital in the second quarter increased 160 basis points year-over-year to 21.1%. This primarily reflects timing as we continue to be impacted by inventory price at the end of the prior year as well as inventory build in the first quarter related to tariffs and Brexit. This will be worked down through the back half of this year.

Free cash flow conversion in the quarter was 45%, which improved the quarter sequentially but is below the prior year, largely reflecting the year-over-year timing related to working capital in CapEx investments as well as higher cash tax payments we made in the second quarter of 2019.

Keep in mind, that the first half of the year is a seasonally weaker cash flow period than the second half, where we have historically generated between 75% and 90% of our full year cash flow. We continue to forecast improvement as the year progresses, and we remain committed to our target of 105% cash conversion for the year. Please turn to slide 10, and Patrick will cover our 2019 end market outlook.

Patrick Decker

Thanks, Mark. Our view on end markets for the remainder of the year include some small changes in the guidance we provided last quarter, and we will now be narrowing to the upper end of our original growth guidance range. Our healthy orders and backlog support confidence in our growth expectations for the balance of the year and beyond.

In the utilities market, we now expect mid to high single-digit growth, led by a solid U.S. where a healthy aftermarket environment and our project and deal pipeline and water infrastructure in Sensus provide confidence in our outlook. The regulatory mandates and core infrastructure investments in China and India are also expected to continue.

In industrial, we now believe our growth outlook is closer to the low single digits. While the U.S. market continues to be steady and our Applied Water project pipeline remains robust, we do expect there to be some moderation in the second half. We're also seeing weaker economic conditions in certain European countries, which we believe will impact us through the balance of the year.

Our outlook for the commercial market remains unchanged at mid-single digits. Our residential outlook is now flat to low single-digit growth. Please turn to slide 11, and we will provide guidance for the remainder of 2019. We started in the first half of the year with strong top line growth of 6% and continue to expect to deliver organic revenue growth in the mid-single digits of 4% to 5% in the second half and 5% to 6% for the full year.

We're adjusting our operating margin outlook to a range of 14.3% to 14.5%. This represents healthy expansion of 60 to 80 basis points. We expect adjusted EBITDA to be in a range of 20% to 20.2%. This updated outlook takes into account our performance to date and also reflect the softer growth in Europe and project conversion timing in our AIA business. Having said that, we will continue to drive healthy margin expansion across our entire platform so that we deliver our commitments for this year and beyond.

Moving on to adjusted earnings per share. We're narrowing our outlook to a range of $3.12 to $3.22, which reflects the items I just mentioned regarding margin. This represents year-over-year growth of between 8% and 12%. Finally, we continue to expect 105% free cash flow conversion, and we're executing on our plans. Let me now turn it back over to Mark to walk through some of our other full year and third quarter details.

Mark Rajkowski

Thanks, Patrick. Slide 12 includes a seasonal profile of our business as well as highlights of our planning assumptions. By segment, we are narrowing our full year organic revenue growth guidance as follows: we expect 6% to 7% organic growth in Water Infrastructure; 3% to 4% in Applied Water; and 5% to 6% growth in Measurement & Control Solutions. We have lowered our full year estimated effective tax rate from 19.5% to 19%. We continue to assume a euro rate of 1.12, and as usual, our FX sensitivity table is located in the appendix. Our restructuring and realignment costs of $60 million to $70 million remain unchanged for the full year.

In the third quarter, we expect an overall company growth rate of 4% to 5%, led by steady U.S. utility market and continued growth in China and India. Our expected growth rates for the third quarter by segment are 4% to 5% in Water Infrastructure; 3% to 4% in Applied Water; and 5% to 6% for Measurement & Control Solutions.

Third quarter adjusted operating margin is expected to be in the range of 15% to 15.1%, representing 40 or 50 basis points of expansion over the prior year. Measurement & Control Solutions is expected to expand segment margins 20 to 40 basis points in the quarter. We expect 40 to 60 basis points of margin expansion in Water Infrastructure and 30 to 50 basis points of improvement in Applied Water systems.

Now please turn to slide 13, and I'll turn the call back over to Patrick for closing comments.

Patrick Decker

So to wrap up, we are demonstrating solid and consistent growth with healthy margin expansion. We're pleased that our teams are working hard to outperform the market, enabling us to meet our financial commitments, while also continuing to invest in future growth. We have healthy top line momentum and strong project backlog, which gives confidence in continuing mid-single-digits revenue growth through the second half into 2020 and beyond as we continue to drive solid margin expansion.

In that regard, we also look forward to providing you with an updated view of our long-term targets and strategy at our 2020 Investor Day, which we are targeting to be sometime early next year. We will have more details to come on this in our third quarter earnings update. So with that, operator, we are happy to take questions.

Question-and-Answer Session

Operator

[Operator Instructions] Our first question is coming from the line of Nathan Jones of Stifel.

Nathan Jones

Good morning, everyone.

Patrick Decker

Hey, good morning, Nate.

Mark Rajkowski

Good morning, Nate.

Nathan Jones

I'd like to talk a little bit more about the reduction in the margin guidance here. There's no change to the restructuring and realignment costs that the revenue numbers here is still pretty strong. So, it doesn't look like you see anything structurally that needs to be addressed in the business.

So maybe if we could start with AIA because you guys called out mix and investments as the two main causes for the reduction here. Can you talk about the investment trajectory in AIA? I think it was supposed to begin to ramp down as we went into the back half of the year. Is this related to delays in the projects ramping up? Or is it because you see more opportunities to go off that? Just some color around that.

Patrick Decker

Sure. I'll take that first, Nate. I think it might be helpful for folks to understand kind of what's the waterfall and bridge on the net EPS reduction in terms of lowering the lower end of the guidance range. You're really looking at about $0.04 is coming from, again, the weaker Europe, just given how rich that margin is on our businesses, so we are reflecting that into our guide right now.

Secondly, probably about $0.04 attributable to AIA, and that is a combination of the slower ramp in terms of converting projects to revenue than we expected, although we are seeing scoped increase and we're seeing the funnel, as I mentioned before, has more than doubled in the digital solutions piece of that platform, so we're very encouraged. And based upon that, we are holding our investments.

So, there's a little bit more in there, but we have four investment that we had originally talked about. And then the way we have been mitigating that $0.08 of kind of impact is about $0.03 coming from stronger performance, most notably in the U.S. utility market that we expect to continue through the balance of the year.

Mark Rajkowski

I mean, we've talked about that on our last call and we have a number of actions that are well underway related to simplifying the organization, improving our speed and agility. And those are tracking to our expectations.

Nathan Jones

Maybe another one on AIA here. I think the anticipation from these projects is that they began to ramp-up kind of later in 2019 and really started to hit stride in 2020, and drove some pretty good growth, potentially double-digit growth in the MCS segment next year.

Does that push this out a little bit? Do you still see those ramping up later in the year? Is that kind of number in 2020 still in play? Or has it shifted to the right a little bit here?

Patrick Decker

No. I'd say it's still in play for 2020. And what we also see, we step back and I think you've done a good job, Nate, in kind of parsing. There are two pieces of this MCS segment, and I think folks oftentimes lump them all together. Two very different pieces.

There's Sensus, which is really being driven by good core North America water growth, which is a combination of day-to-day business but also we are seeing -- we're winning a number of AMI, large AMI deals in that space. And so that's certainly going to drive very strong growth late this year in MCS, but also certainly in 2020 and beyond.

The second piece is AIA, and even with an AIA, there is the traditional core, the pure business that we acquired. But there are also a number of these smaller, about 7 of this smaller technology we've acquired in the last few years that we build out to be our digital solutions platform in that business. And that's really the -- and our core pure business actually continue to grow nicely and pretty much on plan or above plan in the quarter and for the full year.

Really, that new digital solutions platform that we're seeing tremendous uptick in the funnel, but converting those from a concept into orders and revenue has taken a little longer than we had anticipated. So net-net, to your answer, we see no change in kind of outlook for 2020. If anything, this further strengthens our view on that based upon the quality and the degree of uptake in terms of customer interest.

Nathan Jones

That’s useful color. Thanks very much. I’ll pass it on.

Patrick Decker

Thanks, Nate.

Operator

Our next question comes from the line of Deane Dray of RBC Capital.

Deane Dray

Thank you. Good morning, everyone.

Patrick Decker

Good morning, Deane.

Mark Rajkowski

Good morning, Deane.

Deane Dray

I'd like to pick it up right there where you ended off with Nate. So on MCS, broadly, thank you for emphasizing that distinction between Sensus and AIA. Sensus is executing really well from our perspective, and we did note that one of Sensus' competitors negatively preannounced this quarter, it looks like they're losing share and you all seem to be outgrowing the market nicely. So that's good news.

Patrick Decker

Thanks, Deane.

Deane Dray

So on AIA, so not too surprised that it's taking time for this from project wins into revenue. You all have disruptive technologies and the water industry is notoriously slow to adopt. So the way I look at it, and just would love to hear your comments on how each of these factors might be at play, but there's three factors.

So do you have the right -- I will take you all three. Do you have the right pricing model yet on these? Because are customers are balking at the price, the Network as a Service contingency kind of payments, so do you have the right model? Or are customers just notoriously slow to adopt and are just taking their time? Or is it macro worries before a little nervous about throwing the switch and committing to the capital? So how do these three factors play out?

Patrick Decker

Sure. Now you've laid it out well, Deane. I would -- the two factors I would pretty much -- I would certainly eliminate the last which is any kind of macro fiscal concerns, we're not seeing that. And if anything, what we're seeing, part of the reasons why there's as much excitement as there is and we are seeing scope expansion in a number of these areas is because what we're really hitting at in a big way here is the affordability issue. And so these technologies, as you well know, and others may or may not know, are getting at the affordability issue in terms of how do you take large-scale CapEx projects and make them more affordable.

And secondly, how do you extend the life and performance of the existing assets. So all of those play very well into the whole affordability equation. What that literally leads to is there is still some work that we're doing around making sure that we got the optimal revenue model here in terms of how we share value in that given how much we're able to disrupt.

But I would say right now the predominant issue is that these are breakthrough technologies. Utilities are conservative, as they should be, and so they want to make sure that they validate the savings, the functionality of this, and it is new and disruptive.

And so what we're seeing though is the reason why there is such an increase in this funnel at this point in time, is word is spreading. Utilities are talking to each other and sharing the pilots that they're looking at getting involved in. And so I really think that this is simply a matter of timing of ramp.

The margins that we see in terms of incremental margins are extremely attractive, very accretive to the overall Xylem, so there's no change in outlook there. And so that's why we're still so encouraged and that's why we said we'd still need to continue our investments in this slightly ahead of the adoption curve. We're not going to go crazy about it we don't need to, but we're still very, very encouraged by what we see.

Deane Dray

That's great to hear. And I really do like seeing the additional investments, even though there's a margin hit associated with it, that's, from our perspective, it's the right thing to do. And just second unrelated question. Lots of anxiety about trade tensions, but it looks like your China business continues to turn very nicely. Maybe just characterize the tone of business, the funnel in China where there are opportunities?

Patrick Decker

Sure. Thanks, Deane. So I think Mark may have mentioned, we expect to note double-digit growth in 2019, which is down from 23% in 2018, so moderate slightly. But -- so two-thirds of business in China is tied to utilities and is relatively well protected. You'll recall that even during the last downturn in China, that part of our business didn't actually decline. It actually held pretty steady and strong. And what's really driving that is, again, water environment quality continues to be a top policy mandate for the Chinese government, as driven by the citizens of the country.

And so we still consider to see very strong pipeline on the bidding site, et cetera. The area that we do keep a close eye on as well as the other third that is tied to industrial and commercial building. We've not seen any downturn in that business, we don't see any signs of such there. So we remain still quite bullish on China. One of the questions we also get is given that we're servicing kind of critical government infrastructure, is there any risk that we could be targeted at some point in time?

And we don't see that. And we keep a close eye on that. We don't see it right now because, as you've seen, Deane, when you visited our facilities there in China, we are a Chinese company in China. I mean there's -- we have the total look and feel of a Chinese company. It just happens that access to global leading technologies along the way, and so we don't really see that we have a threat there.

Deane Dray

Thank you.

Patrick Decker

Thank you.

Operator

Our next question comes from the line of Scott Davis of Melius Research.

Scott Davis

Hi. Good morning, guys.

Patrick Decker

Good morning, Scott.

Scott Davis

Trying to get a sense of -- I know it's very different by business for you guys on inventory levels and such, but some of the declines you saw in Western Europe, would you attribute a certain percentage of that inventory destock? Or is it -- do you already have line of sight sell-through that is pretty consistent?

Mark Rajkowski

Our view on that, Scott, is that there is clearly a slowing in economic conditions. Certainly, we've seen that in Italy, we've seen that in Germany and a couple of other countries. And so, it's really not an overstocked position relative to what's been sold into the channels, but just more of a slowing in the broader economies in some of these countries.

Patrick Decker

Yes, we would say, Scott, that we certainly don't see really anything being attributed to a destocking of inventories. And we've got quite a good line of sight on the businesses there in Europe, which tend to be more of a direct channel. We do have some indirect but we got a healthy direct channel as well.

Scott Davis

Yes. I know that's tough. There's a lot of nuances there, and this is just a follow-up. I know, pure is a really cool asset, but you also paid a pretty good price for it too, it wasn't free.

Patrick Decker

Yes.

Scott Davis

So how is it tracking versus the deal model? And are you getting the kind of revenue take rates that you expected? Or should I say it a different way, with you guys as the owner, have you been able to really drive that model to your liking?

Mark Rajkowski

Yes. Scott, I think there's still plenty of demand. One of the things that we've been working on and investing in is growing out our international business. And there's a lot of activity. This is all new to our teams. We're leveraging the existing commercial capabilities that we have there.

Frankly, that's one of the areas that we need to continue to invest in so we can accelerate some of the growth for opportunities that are clearly there. There's a lot of demand. But as we've talked about it, it's a very different value proposition, it's a different set of selling skills, there is solutions. And so we're migrating up that curve as well. That's probably a little bit slower than we would have liked at this point, but it's not for lack of underlying customer excitement and demand.

Patrick Decker

Yes, the way I'd characterize is, Scott, is there's the pure, the DS and pure technology that we acquired. And that certainly has always been intended to serve as the kind of fundamental platform of some of these new digital solutions that we have acquired through other startups. So the pure business is delivering as we expect this year. It's on plan. The plan's obviously driven by deal model, so that piece is there.

I think what you're seeing right now and you hear us talking about the pushing out of some of the AIA demand is really being driven by the other small startups that we put together and are integrating into the new digital solutions platform.

So, when we talk about some of the validation of savings and these delays and some of the adoption in terms of getting the procurement at the utility, we're really talking about the digital solutions part of the AIA platform, not really the pure piece.

Scott Davis

Okay, very helpful. Thank you. Good luck, guys.

Patrick Decker

Thank you.

Operator

Our next question comes from the line of John Walsh of Credit Suisse.

John Walsh

Hi, good morning.

Patrick Decker

Good morning.

John Walsh

I guess the first question around the margin bridge implied in Q4, can you kind of help unpackage what swings in terms of mix, in terms of restructuring savings, just to kind of get comfortable with the ramp there year-on-year. I think a bunch of it probably comes from leveraging the better organic sales growth in Q4, but anyway to help unpackage that natural buckets would be helpful.

Mark Rajkowski

Sure, John. No doubt, nice ramp there in Q4. Typically, that is our highest margin quarter and you hit on one of the drivers. It's just there's really good volume leverage. The other thing is that I think you touched on also, and we talked earlier one of the questions related to cost reductions from some of the restructuring actions that we've put in place that really ramped significantly in Q4 relative to the timing of when folks are leaving.

And I would also mention that the inflation comp starts to get a lot easier than what we've been living with in the first half of the year as some of these tariffs lap, our component shortages are lapping. And we're going to see better mix too. We're going to see better mix in a number of our businesses, including M&CS. I mean, we had a lot of volume last year that had low margins related to some of these large deployments where it was installation-related. So those are really the key drivers that gives us confidence that we will see that ramp in Q4.

Patrick Decker

The other thing I would add is on that mix comment, just to make a finer point there is last year's project revenue was heavily oriented towards the energy side of the equation with heavy install and lower margin on that whereas the mix this quarter in Q4 is going to be heavily water, which carries a much larger incremental margin on it than it does on I think the energy side.

John Walsh

Got you. And then thinking about the current order growth, I mean, obviously, you've been 4% now the last two quarters on very tough comps. You still have very difficult comps here in the back half. But you know, as we think about the mid-single-digit growth construct kind of going forward and into next year, what do you need to see in terms of margins? I mean in orders? What are you guys looking for in terms of order acceleration potentially in the back half? And what drives that?

Patrick Decker

Yes. So I'd lay it out this way, if you look at our three segments are going to be behaving, I think, or going to probably diverge a little bit here in ways that you haven't seen over the last, I'd say, 1.5 to 2 years, where they've all -- they've each kind of been running in that mid-single-digit growth in terms of both revenues and orders. That begins to diverge a little bit so we do expect that Applied Water will likely moderate back to more of a GDP level growth.

We hope to outperform that, but that would be in that kind of low single-digit range. And we're seeing some of that right now play out, as you saw in the orders in Mark's commentary. Water Infrastructure has historically been in that mid-single-digit growth, both in terms of orders as well as organic revenue. And as we mentioned in the quarter, it was up 4% orders, it was against an 8% comp last year in Water Infrastructure.

We don't see that changing so we feel good about that. And really what you begin to see happening here is MCS begins to ramp, and so we do expect those order growths to continue to grow, increase in terms of the rate as well as the organic revenue growth both back half of this year, but also certainly in 2020 and beyond. So you're going to see a little divergence there amongst the three segments that give us confidence around that mid-single-digit organic growth continuing.

John Walsh

Great. Thank you.

Patrick Decker

Thank you.

Operator

Our next question comes from the line of Ryan Connors of Boenning and Scattergood.

Ryan Connors

Great. Thanks for taking my question. I'm wondering if you could actually talk a little bit more about the order book from a pricing perspective. And just give us some take on the success you're having in getting price in this environment? And if so, where?

Mark Rajkowski

Yes. Ryan, we've seen really good success in terms of pricing. We continue to get price in U.S. They actually led the way and worked early to drive good price realization. You saw that particularly this quarter in AWS, which had 350 basis points of price. Europe got on board a little bit later. And even Emerging Markets now is driving for price.

And I think most encouraging is what we saw in M&CS, particularly around the Sensus business, where they are not only driving very strong volumes but also driving good price as well. So when you think about backlogs, I mean our strongest backlogs are in M&CS. A lot of that is Sensus and we feel pretty good about that.

Ryan Connors

Okay. And then my other one is just you've talked a lot about the utility and Sensus and AIA but you haven't really gone as much into the industrial side and you didn't have kind of a negative revision to your outlook there. If you can just kind of unpack the different pieces within industrial? And what's -- where the outlook is? Is it still better? And where the headwinds are coming from.

Mark Rajkowski

Sure. Yes, on the industrial side, let me comment on the full year rather than give you a headache quarter-by-quarter. On the full year, we continue to see solid growth in the U.S., And really there, it's the fact that we're really tied to more of a general light industry. Most of the products resolve there are on a periphery of an industrial complex. And so as long as these complexes are up and running, they're going to burn through our pumps and our treatment needs.

And so we see that continuing to grow in a healthy clip. We also see positives in dewatering on the rental side. We continue to see a very healthy market there. I would say, outside of the U.S., its mixed. You see strength in parts of Asia, and we also see depth of softness in Europe and across the Middle East. And in Europe, it's not entirely broad based, I mean, it's really concentrated on a certain number of markets. We do see some divergence there in Europe. But right now, we're just calling that. We're trying to be prim here. It's a very short cycle business, as you all know, for us in the industrial side.

Ryan Connors

Okay. Thanks for all the color.

Mark Rajkowski

No worries.

Operator

Our next question comes from the line of Walter Liptak of Seaport Global.

Walter Liptak

Hi. Thanks. Good morning.

Patrick Decker

Good morning.

Walter Liptak

I wanted to ask what about the AIA investment. Considering the delays, is that changing anything about your M&A pipeline or your thoughts about timing of deals or other technologies that you might need?

Patrick Decker

Not at all. Not at all. As I mentioned before, but it's worth reiterating, when we think about M&A and utilities, we do think about this predominantly by end-market or vertical, not exclusively. But that's certainly one lens we look at it through.

I'd say on the utility side, we do have a very robust platform now of solution sets that we can bring to the utility customers both on the clean water side, the wastewater side and the outdoor water side, but that's not to say we don't still have -- as we're in there talking to these leaders and learning even more about what some of the other pain points are, there's still a few things out there that we would like to bring into the portfolio. They'll again be smaller tuck-in type acquisitions.

So no, it doesn't change our view on that. It, quite frankly, makes it more robust. But having said that, there really aren't that many more things out there that we really have led a site to that we're interested in at this point of time. We're really focus on executing on the platform that we've built.

Walter Liptak

Okay. Great. And then just a couple on the sector outlooks. You mentioned in industrial the second half in the U.S. being a little bit weaker. Is that just related to some of the PMIs that have come down and generally slower industrial? Or is there something else going on?

Mark Rajkowski

It's -- we think it's solid to up slightly. It's really what's driving the industrial change in our outlook is what Patrick mentioned before which is really some of the softening conditions and some of what appear to be recessionary trends in parts of Europe. But U.S. we think will remain pretty solid.

Patrick Decker

Yes. I think it's in the U.S. If anything, it's more of a tough comp -- tougher comp in the second half of the year. Kind of mid-single digit last year, that will probably moderate back down to low-single digit in the U.S. It's not, I think, maybe a little bit behind your question, is there any going on in the channel the inventory levels, we're not seeing that, at least in our business.

Walter Liptak

Okay. Okay. Makes sense. Small residential, you talked about the U.S. flattening but I think there is some other companies out there they're saying there's signs of strengthening going on in residential. Are you seeing any hope that the low interest rates in good U.S. economy might be turning residential around finally?

Patrick Decker

We certainly, we always hope so, but I guess it is not a large piece of our business and so we, at this point in time, we just kind of call it based on what we see right now. We haven't seen that kind of recovery so we didn't feel it was prudent to going to bake that into an outlook.

Walter Liptak

Okay. Alright. Thank you.

Patrick Decker

Okay. Thank you.

Operator

Our next question comes from the line of Joe Giordano of Cowen.

Joseph Giordano

Hey, guys. Good morning.

Patrick Decker

Hey, Joe.

Mark Rajkowski

Hey, Joe.

Joseph Giordano

So I just wanted to go back to the kind of ramp as we go through the year here. Just standing check my math. If we're looking at 3Q margins of like roughly 15 and you have a pretty narrow range for the full year expectation on adjusted Op, are we talking like comfortably over 17 for 4Q? I know Mark talked through some of the things hitting in 4Q, but we've seen kind of modest year-on-year expansion through the year, a decline in 1Q and then we're talking like 200-plus basis points in 4Q, so I just really want to make sure I understand how that plays out.

Mark Rajkowski

Yes, Joe, I'd say I wouldn't say it's way over -- comfortably over 17. I think upwards of 200 basis points is certainly what our expectations would be.

Joseph Giordano

Okay. Is that including any of the benefits from the back-office stuff that was kind of getting pushed out? Or is that still a 2020 phenomenon?

Mark Rajkowski

It's limited. I mean, we just launched our latest wave in July, but we're -- there are benefits there. Well behind the track from where we expect to be as we enter the year. And that still pushes out into 2020. And so there's certainly more benefits ahead of us in the fourth quarter.

Patrick Decker

I mean you're looking roughly, Joe, the right math. It is about 180 basis points of margin expansion in Q4 and as Mark mentioned earlier, really is being driven by we do have other restructuring that we announced last quarter that is cost takeout, most notably within our European business but also within our Water Infrastructure, the MCS businesses, MCS have little bit there as well that really ramps in Q4.

You definitely have the attractive volume leverage given a mix of revenues are going to be heavily skewed towards Water Infrastructure and MCS which are going to be higher margins for us. And then as Mark pointed out earlier, we have some easier comps on the inflationary side which is noteworthy when you look at the quarter sequential. That's about 50 bps itself.

Joseph Giordano

Okay. Sorry if I missed this earlier. Is the big failure order you have got, is that in orders already? Is it in backlog?

Mark Rajkowski

Joe, it's in backlog. It's not in orders yet.

Joseph Giordano

It's not in orders yet? Okay. So when do you expect that to start hitting? And can you maybe talk through the timing of one that deploys into revenue and what the margin kind of -- is that accretive to MCS? How do we think about that?

Mark Rajkowski

Yes. Joe, it's certainly our expectation is to see that start to hit in the back half of this year, probably more in fourth quarter. And it's full-bore into 2020. It's a water deal and so the margins are certainly attractive relative to the energy side of the business.

Joseph Giordano

Okay. And maybe last for me, just more high-level. If I think through bolt-on technologies that makes sense for MCS, is there an obvious thing missing right now like some of the stuff that you bolted on recently seems like it fit pretty very clearly into what you're doing. But I guess as we fill out that portfolio, finding obvious holes is a little more challenging. So is there anything that strikes you as we can put a proxy out instead of doing R&D and figuring something out internally if we can go buy something there a piece that is interesting to you Patrick?

Patrick Decker

Yes, I mean there are still few things out there. I probably prefer, Joe, not to come on them publicly because to the extent they are M&A, I don't want to drive the piece up. There is not -- it's not a long list. There are probably a few to a handful of things that are out there that would be, I don’t say -- just kind of nice to have, but they would address some other pain points.

As you think about what we're really bringing to bear here is the capability with our digital solutions platform to be able to go to the utility and work with their operating folks. And better understand how they can drive and improve performance of their existing assets and bring down the costs of the new capital that they are putting in place and get with what they already have.

So, when you think about the landscape of the utility, what their operating budgets are driven by, both CapEx and OpEx, there's a myriad of things that one can do by mining the data for them. And that's, in a simple way, what we're looking to doing in addition to others.

And so we'll keep you guys abreast of acquisitions as they come along. They’re not going to be large acquisitions. They’re going to be tuck-ins and bolt-ons. And I think as we get into Investor Day early next year, that will be a good form for us to kind of paint the picture for everyone as to what are the gaps that we filled out here and what's the landscape that we are operating in.

Joseph Giordano

Okay. Thanks.

Patrick Decker

Thank you.

Operator

Our next question comes from the line of Pavel Molchanov of Raymond James.

Pavel Molchanov

Thanks for taking the question. Back on your comments regarding M&A, the fact that it's not a priority as you see it right now. Given the amount of free cash flow that you're generating above and beyond the dividend, what are your latest thoughts on buyback as a way of deploying that surplus cash?

Patrick Decker

Sure, this is Patrick. Just to clarify, my comment was not that we're not interested in M&A, I am specifically talking about the utility space and the bolt-on kind of digital solutions. So we continue to see M&A as an appropriate enabler of our long-term growth in the company.

And I mentioned on other calls that some of the other areas that we're focused on whether that be, again, continuing to look at areas in the industrial water landscape is one example, and there are others that are out there. There's nothing -- I'm not foreshadowing anything here, all I'm saying is we continue to see that as our priority to deploy cash but only for smart disciplined transactions that are out there. So we would certainly be looking to do that before we would be talking about doing share repurchase.

Mark Rajkowski

But we also recognize that unduly large amounts of cash on the balance sheet -- they're not sustainable. So we look at if we see there's nothing out there that we expect to need it for, we certainly look at repurchasing shares.

Pavel Molchanov

Okay. Let me follow-up on what you referenced at the very beginning of the call which is your ESG targets. As I look at your set of targets, separate from some of the kind of philanthropic or charity stuff, do you look at these as margin enhancers? Or are they actually a cost of doing?

Patrick Decker

No. We view these things as very much -- we try to be very clear when we speak externally as well as internally to our folks. And we actually had a great kind of podcast here internally just last week between myself and the executive sponsor of our sustainability program who happens to be our general council. And she and I did a terrific event here I think with our colleagues, really reinforcing to them that we don't have a sustainability strategy that sits separate from our business strategy, they go hand-in-hand.

And so the more that we are able to deliver on the signature goals that we laid out here, no doubt that's also good for business. But that's not the only reason we're doing it. We're doing it because we really believe that we have the responsibility here to really make a positive big impact for communities and for our customers and for our suppliers, but it's also all about making sure that we attract, retain the top talent across the landscape. And people nowadays, as you all know, they want to believe something larger than themselves and they want to work for a company as a purpose.

And we're not the only one out there, I realized that. But that's what's really driving these sustainability goals. It's good for business, it's good for the planet, it's good for everyone involved and we have a unique opportunity and a role to play here and we're doing so. And so that's why you want to move well beyond kind of motherhood and apple pie on just a few things that most companies talk about, in sustainability, we have an opportunity to make a much broader impact than just a few key areas.

Pavel Molchanov

I appreciate the perspective. Thanks.

Patrick Decker

Thank you.

Operator

And ladies and gentlemen, we have time for one more question. Our final question will come from the line of Brian Lee of Goldman Sachs.

Brian Lee

Hey, guys. Good morning. Thanks for squeezing me in.

Patrick Decker

Hey, Brian.

Mark Rajkowski

Hey, Brian.

Brian Lee

Maybe two quick ones and then I'll let us all wrap here. In China, it sounded like results were pretty good but then you did make a little bit of pullout around slowing growth as part of the update for the industrial end market outlook here. Maybe can you elaborate on that? Is that a general flowing in the macro? Tougher comps? Or is there something else going on there?

Patrick Decker

We wouldn't want to overstate any commentary around softness in the industrial in China. We had some tough comps there. It's rather a small piece of our overall business in China. So, we're not probably in the best position to make a call on broader China industrial landscape. We're not seeing anything noteworthy there. I don't know, Mark, if you want to add any commentary?

Mark Rajkowski

Yes. As you said, the comps are tough and it's solid, it's steady, but we grew over 20% in the prior year. So there is no underlying fundamental issue that we see.

Patrick Decker

The primary driver of our growth in China is really the utility side, and it's really the investments being made by the government there across-the-board. So that kind of masks what we see in the industrial space, which again, is just really -- it's a tough comp. So no big read through there on our part.

Brian Lee

Okay. Fair enough. And then just on pricing, I know, I think you had mentioned maybe last quarter that MCS may see more of a tailwind in the second half due to some of the later pricing actions that played out for that segment. So with some of the mixed commentary and the AIA conversion delays, is there any change in that view around pricing trends for that particular segment as we move through the back half?

Mark Rajkowski

Yes. And I mentioned this in the prepared remarks, Brian. One of the encouraging things that we did see, team really got after it this year and we had, it was 100 basis points, maybe a little bit more of price improvement. And we'd expect that to continue through the remainder of this year.

Patrick Decker

And I think a big driver of that, Brian, as we mentioned before, I believe, is more so in the MCS business and certainly Sensus than other segments. These are oftentimes long lead time projects that we would have been locked in. So until new projects have been executed, it's hard to get prices. So team has done a great job on some recent projects on implementing those price increases and that's why you see it really ramp from the first half to the second half of the year.

Mark Rajkowski

And on replacement, the year's end points being sold into their channels as well

Brian Lee

Okay. Appreciate the color. Thanks guys.

Patrick Decker

Thank you.

Operator

And thank you. I'd now like to turn the floor over to Mr. Patrick Decker for any additional or closing remarks.

Patrick Decker

Well, thank you. And thanks for all your time, interest and support. We appreciate your involvement this morning. Thanks for the questions. I'm sure we'll see many of you at conferences and other places in between, so enjoy the balance of your summer, and safe travels, and we'll be in touch on our Q3 earnings call. Thank you all very much.

Operator

Thank you. This does conclude today's Xylem's second quarter earnings conference call. Please disconnect your lines at this time, and have a wonderful day.