

## Alcatel-Lucent

### Executive Summary

November 8, 2011

Alcatel-Lucent's progress in becoming a normal, profitable global telecommunications equipment and services company may have been interrupted in 2011, as reflected in disappointing third quarter results. Although earnings exceeded the mean estimate of analysts, revenues declined 6.8% year-over-year and free cash flow was decidedly negative. Some of the revenue will be made up in the fourth quarter, as project delays are resolved and transitions to new projects get underway, but revenues may still be pressured by customer capital spending cutbacks and market share losses. Growth in industry revenues in 2012, once anticipated to be in the mid-single digits, now will likely be flat to up slightly at best. The reduced outlook is a consequence of lowered expectations for global economic growth, which could be reversed.

ALU's management has responded to this latest turn of events by stepping up its restructuring program. It now anticipates achieving cost reductions of €500 million in 2012, of which €300 million will come out of fixed costs. This will help the company proceed toward its goal of "normalized" profitability, but some of the savings may be offset by margin pressure in a tougher competitive environment.

The company's share price plunged 16.7% to €1.54 (\$2.12) on the earnings announcement. Investors were more concerned about the sharp drop in ALU's free cash flow, which was due to an increase in operating working capital, mostly from a decline in payables. Since days payable declined to 86 days from 99 one year ago, at least some portion of the payables decline appears to have been discretionary and so the drop in free cash flow is not a major concern at this time.

Based upon these recent developments, I have lowered my projection for 2012 adjusted earnings from \$0.45 to \$0.27 and my 2012 year-end target stock price from \$6.00 to \$4.50. I estimate ALU's intrinsic value today at \$3.50 per share or 16.5 times adjusted earnings of \$0.20 (excluding the benefit from the reversal of the deferred tax valuation allowance). This is down from my previous intrinsic value estimate of \$4.50 per share. With the stock at \$2.12, ALU is trading 35% below my current valuation estimate and more than 50% below my target price for 2012.

### Outstanding (U.S.) Public Securities

S&P 500: 1261.12

Amt. Outst. (\$m)	Debt / Preferred Stock	Recent Price	Coupon	Maturity	Yield	Call Date	Call Price	Conv. Price	Credit Ratings
95.0	Series A, Conv. Sen. Deb. <sup>(1)</sup>	79.25	2.875%	6/15/23	9.75%	current	100	16.75	B1/B+
880.5	Series B, Conv. Sen. Deb. <sup>(1)</sup>	93.13	2.875%	6/15/25	7.50%	6/20/13	100	15.35	B1/B+
300.0	Debentures	87.00	6.500%	1/15/28	7.94%	None	None	None	B1/B+
1,360.0	Debentures	87.50	6.450%	3/15/29	7.72%	None	None	None	B1/B+
931.0	Lucent Tech Cap Tr I Conv Pref. <sup>(2)</sup>	850.00	7.750%	3/15/17	9.12%	Now	100.78	\$24.80	B3/CCC+

- (1) Holders of the Series A Debentures may require the company to repurchase the bonds on 6/15/15 at par plus accrued interest. Holders of the Series B Debentures can put the bonds at par on 6/15/13. Yields shown for both bonds are the yield to the put.
- (2) The Lucent Technologies Capital Trust I Convertible Preferred Stock trades in the pink sheets under the symbol LUTHP.

Shares Outst. (m)	Common Stock	11/7/11 Price	Div. per Share	Tangible Book Val.	Proj. Adj. '11 EPS	'11 P/E Multiple	Proj. Adj. '12 EPS
2,267.1	Alcatel-Lucent ADS (N:ALU)	\$2.12	None	(\$1.61)	\$0.20	10.6	\$0.27

### Positive Investment Considerations

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Strong relationships with major telecommunications service providers around the world. ALU has served its primary customers, the large telecommunications carriers for many years. It has installed much of the equipment that runs their networks and so possesses a deep and intimate knowledge of their operations. As a result, it is well positioned to assist them in developing and implementing new technologies and solutions that can enhance network and business performance.

Significant expertise across a wide range of telecommunications technology platforms. The company has extensive knowledge and skills in wireline and wireless technologies, old and new. It knows how to integrate new technologies and services into older legacy systems. It is therefore better able than many of its competitors to help customers get the most from their existing investments.

Strong positions in key product areas. ALU is the market leader in **wireline broadband access** (DSL and VDSL2), which deliver broadband services over existing copper telephone lines; **CDMA**, a second/third generation wireless technology; **packet microwave transmission**, used in mobile backhaul networks, fixed broadband access and private applications, and **terrestrial and submarine (fiber) optical transport** systems. The company is also among the top three providers of key technologies, such as **Internet Protocol/Multiprotocol Label Switching (IP/MPLS) edge routers**, which help to increase the speed and capacity of carrier networks and **Long-Term Evolution (LTE)**, the emerging 4G wireless standard. It is also a leader in integration services such as **IP/NGN/IMS** (Internet Protocol/Next Generation Networks/IP Multimedia Subsystem), which transition and convert legacy networks into an integrated core for the efficient delivery of voice, data and video applications. This unique combination has helped the company become a leader in such categories as **mobile backhaul networks** and ALU's **Converged Backbone Transformation Solutions**, which further integrate the IP and optical layers of the network.

Demand for broadband capacity and services will likely continue to rise as end-user demand grows. Demand, especially for video services, is expected to continue to grow at an exponential rate, which will help sustain the demand for ALU's sophisticated suite of products and services.

Through its vision of the High Leveraged Network, ALU is focused on delivering products and services which help its core customers generate revenues and maximize return on investment. Although networking technology continues to advance, major carriers are striving to add value to their networks to avoid commoditization and generate new revenue streams. They are also seeking to achieve the greatest improvement in network performance at the lowest possible cost, which will serve to maximize their ROI. For example, ALU's Motive division helps telecommunications carriers to deliver a consistent customer service experience across multiple devices, networks and services. In addition, ALU's VDSL2 technology allows telecom carriers to deliver broadband at speeds over 100 megabytes per second over the existing copper wire infrastructure at one-third the cost of installing fiber optic cable.

New management is focused on reducing fixed costs and increasing organizational flexibility. As attention turns from commoditized hardware to adding value and stretching capital expenditures, ALU recognizes that emerging opportunities will be captured best by those organizations that are quick to spot emerging trends and first to bring new products and services to market. Consequently, a key focus is building flexibility and responsiveness into the organization.

### **Key Concerns**

ALU's financial performance was disappointing in the 2011 third quarter. Although earnings, adjusted for certain non-cash expenses associated with the 2006 merger, were \$0.09 per share and \$0.02 ahead of the average analyst estimate, revenues fell 6.8% year-over-year to €3.8 billion and the company reported negative free cash flow from continuing operations of €436 million. The drop in revenues was due mostly to unexplained declines in the optical and wireline businesses in the Networking segment and the networks application business in the Services, Software and Solutions business (S3) segment. Management withdrew its full year revenue guidance (i.e. to grow in line with the market) and lowered its full-year adjusted operating margin target to 4% from 5%. It also announced a stepped-up restructuring program designed to produce an additional €500 million in savings in 2012. The heightened focus on reducing costs

suggests that management expects further pressure on revenues. Most of the decline in free cash flow was due to a drop in trade and other payables, but since days payable fell from 99 days in 10Q3 to 86 in 11Q3, it appears that much of this decline was discretionary, so the negative free cash flow is not a major concern at this time. Despite the disappointing quarterly performance, management asserted that this was a temporary setback and that the company continues to show good progress on its strategic objectives.

Tough competition. The telecommunications equipment industry has a host of tough competitors, including Ciena, Cisco, Ericsson, Huawei, Juniper Networks, Motorola Solutions, Nokia Siemens Networks, Tellabs and ZTE, among others. The final frontier of telecommunications and IT convergence may very well bring more competitors into the arena, including IBM, Hewlett-Packard, Microsoft and others, especially in the Enterprise space. ALU's relationships with major carriers and its expertise across a wide range of telecommunications technologies give it a strong competitive position, but profit margins may be compromised, especially if the global economy remains weak.

The market for basic telecommunications services is saturated in most developed economies which may limit capital spending growth by major service providers. Wireless telephone penetration exceeds 95% in most of the world's developed economies. For now, the increasing use of data services is helping to support revenue growth at all of the major carriers. However, it remains to be seen whether consumers will willingly continue to pay more to send text messages, download ring tones, listen to their favorite mp3 recordings and watch U-Tube videos, if their incomes are squeezed. For now, revenues from data services are helping to fund the development of advanced telecommunication networks. In the future, the growth of business services, such as smart metering, remote health care monitoring and video conferencing, will help to pay the freight, but implementation of these services could also be delayed in a tough economy.

Financial flexibility is only adequate. At September 30, ALU had €3.8 billion in cash and marketable securities and €37 million of availability under a €1.4 billion syndicated credit facility against €4.5 billion of outstanding debt. Of that debt, €759 million is due within the next 12 month. Given ALU's exposure to the business cycle and therefore the potential volatility in its revenues and profits, its debt is rated B1/B (below investment grade) by Moody's and S&P.

The funded status of ALU's pension and retiree health care benefits funds deteriorated in the third quarter. At quarter's end its net deficit was €1.2 billion, compared with a net surplus of €0.1 billion in 11Q2, due primarily to a 70 basis point drop in the discount rate. With the expected transfer on December 1 of 10,300 beneficiaries from the U.S. occupational pension plan to the U.S. management pension plan, this funding deficit will decline by \$340 million (€253 million). Despite the big negative swing in funded status, the company is not required to make any extra funding contributions before 2013.

ALU has a weak position in the weak European market. It ranks a distant fourth in market share in legacy GSM/W-CDMA networks, the dominant wireless standards in Europe. As a result of the sovereign debt crisis, the outlook for economic growth in Europe has deteriorated, which has prompted major telecommunications carriers to hold off on upgrading their networks. Although the company is optimistic about its future prospects in Europe, it does not expect a dramatic turnaround in the very near future.

ALU's low stock price contributes to its volatility. Although ALU's stock trades in the low single-digits, its market capitalization is just below €5 billion. The company should consider a reverse stock split of perhaps 1-for-5 to raise its stock price into the mid-€20s. This would help to attract more institutional investors and reduce speculative activity.

## Recent Developments

Alcatel-Lucent was formed in November 2006 by the merger of Alcatel and Lucent Technologies. Both were global suppliers of telecommunications equipment and services. Alcatel was strongest in Europe, Lucent in the United States. The merger held the promise of transforming the two struggling companies into a formidable global competitor.

Early on, however, it became apparent that this transformation would take longer than envisioned. In the first year following the merger, the company posted losses due mostly to integration and other merger-

related costs. As time wore on, sales continued to slip and profits failed to materialize. Many of ALU's primary customers tightened their spending as the global economy began to weaken. The company did not cut costs quickly enough. A clash between American and French managers may have slowed the integration process, hampering the company's ability to compete in this tough market environment.

In late 2008, ALU brought in new senior executives, including Philippe Camus as non-executive Chairman and Ben Verwaayen as CEO. Mr. Camus, a French national, was formerly co-CEO of the European Aeronautic Defense and Space Company and a partner at Evercore Partners in New York. Mr. Verwaayen, was CEO of British Telecom and served as Lucent's vice-chairman in the late 1990s.

Mr. Verwaayen worked quickly to address the company's problems. As a Dutch national and newcomer, he was an impartial arbiter in clashes between Alcatel and Lucent managers. The economic slowdown added urgency to the need to resolve outstanding disagreements and cut costs. In November 2008, Mr. Verwaayen announced a new matrix organization intended to balance efforts aimed at championing products, managing relationships and creating customer solutions. In December 2008, he streamlined ALU's product portfolio, emphasizing areas of strength and strategic importance, and reducing investment in less promising product areas. He also announced additional cost cuts to reduce the company's breakeven by €1 billion.

With the global economy beginning to recover from recession, 2009 was another year that focused primarily on integrating and streamlining operations and especially on reducing costs. Mr. Verwaayen espoused a clear set of objectives for the company's overall financial performance: In 2010, the company would achieve a positive adjusted operating margin. In 2011, it would grow as fast as the industry and begin to report normalized adjusted operating margins of 5% or better.

Alcatel's glidepath toward normalized profitability proceeded according to plan, except that in early 2010, sales and profits were disappointing because of components shortages that prevented the company on meeting delivery schedules on many large projects. Since management left its full year guidance unchanged, it was implicitly forecasting that sales and profits would catch up in subsequent quarters; but the financial markets remained skeptical and ALU's stock performed poorly. When the company finally delivered on its promises in the 2010 fourth quarter earnings report, the stock rebounded sharply, reaching a high of \$6.63 on May 2, 2011. At that price, the stock appeared to me to be overpriced, based upon the company's current and expected near-term performance.

From the May 2 peak, ALU's stock price began to slip, but mostly in line with the broader market, which was becoming increasingly nervous about the U.S. federal budget deficit and European sovereign debt crisis. The stock fell further after the company reported its 2011 second quarter results, which were not quite as robust on an operating basis as anticipated. At the same time, several major telecommunications carriers, including the two behemoths in the U.S., said that they would scale back planned capital spending in the second half of 2011. When queried about the prospects for a revenue slowdown during the second quarter conference call, Mr. Verwaayen said that Alcatel was fully aware of the carriers' spending plans and had taken this into account in reaffirming full year guidance.

It turned out, however, that the market's concerns about slowing revenues was valid. Alcatel reported that its third quarter revenues declined 6.8% year-over-year. It also withdrew its full year revenue guidance (which had simply been to match industry growth rates) and lowered its full year adjusted operating margin guidance from 5% to 4%. ALU's stock price, which had already fallen sharply during the global stock market sell-off in August and September, fell sharply again on the news – by nearly 17% to \$2.30. At this level, the stock appears to have gone the full cycle, from extreme overvaluation to extreme undervaluation, in just five months.

### **Business Overview**

As a long time service provider to major telecommunications carriers, ALU has extensive experience across a wide range of old and new technologies. This has strengthened its ability to integrate new technologies into legacy systems. In this way, ALU has helped customers achieve necessary improvements in network performance at the lowest cost. Over time, however, the addition of each new technological capability contributed to organizational sprawl at ALU, raising its operating costs and slowing its responsiveness to a changing competitive landscape.

As part of its strategic transformation, ALU has reaffirmed its commitment to technologies in which it is a market leader, where it sees the greatest growth potential. These include Internet Protocol (IP) routers and switches, optical networking (both terrestrial and submarine), fixed broadband access and the IP Multimedia Subsystem (IMS) for carriers' core networks. At the same time, it has streamlined product offerings in mature areas, such as older wireless technologies (like CDMA 1x and GSM) and older fixed line data communications technologies (like ATM and ADSL).

ALU has also increased its investment in important growth areas, such as Long-Term Evolution (LTE), the 4G wireless technology standard that will increase the capacity and speed of wireless networks. Major carriers in mature wireless markets around the globe are upgrading their networks to LTE in order to handle the increasing traffic from smartphones and tablets, including the rapid expansion in video services. A couple of years ago, ALU's product offering for LTE was thought to be less robust than competitors like LM Ericsson, but it has caught up quickly, capturing the #2 position with a 30% market share in 2010, according to Dell'Oro.

Along with the growth in LTE, Alcatel has become the market leader in next generation IP platforms, including converged IP backbone, which combines 100 Gigabit per second (100G) Ethernet IP and 100G optical (fiber) technologies to move integrated voice, video and data traffic through the network core, and mobile backhaul, which takes voice and data traffic from celltowers into core networks. Mobile backhaul integrates packet-based wireless transmission with IP networking to increase capacity and thereby facilitate the transition by wireless carriers from 2G to 3G and 4G wireless networks.

Alcatel's IP multimedia subsystems (IMS) core, which operates on its converged IP backbone solution, is seeing a more rapid uptake. The company was among the first to market with this technology, which integrates all types of IP traffic (data, voice and video) to reduce operating costs, while ensuring an optimal end user experience.

The guiding principle behind ALU's product strategy is its focus on products and services that help its primary customers - major telecommunications carriers - improve the "web" experience of end-users while maximizing the carriers' return on investment. It intends to help customers create an ecosystem that will facilitate the development of new and evolving Web 2.0 interactive services, such as social networking and video sharing, on high quality networks that are secure, reliable and protective of privacy. These will help its customers differentiate themselves in the marketplace.

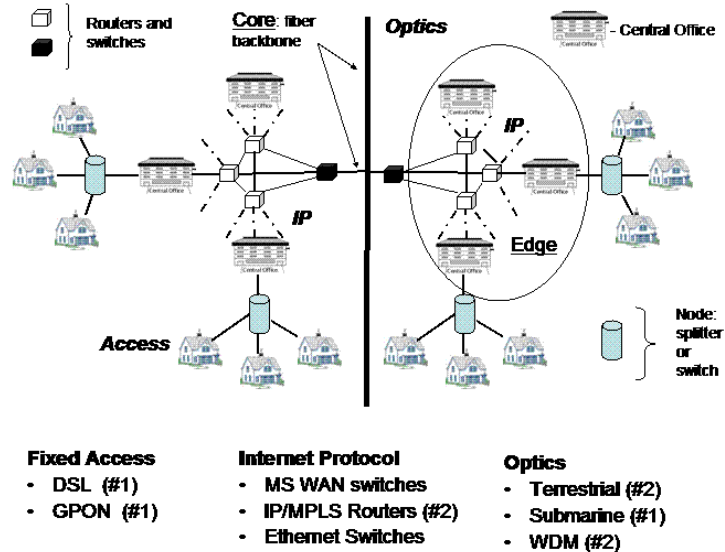
One potential barrier to ALU's primary objective may be governments' stance on network neutrality (i.e. the principle that all users should enjoy the equal access and quality of service). Logically, ALU's vision is the only one that has the potential to deliver the full spectrum of advanced broadband services to businesses and individuals at the lowest cost, but politics could conceivably slow the adoption of these network management technologies.

**Business Segments.** Alcatel-Lucent has tweaked its business segment line-up several times over the past few years. Although such changes can sometimes cause concern, in this case, I believe that it reflects management's attempt to respond to a changing market environment, new business initiatives and its efforts to focus resources where they will likely bring about the greatest success. These recent changes have mostly affected ALU's Enterprise segment, which has presented significant challenges given its wide scope and the growing intensity of competition. The discussion that follows encompasses the company's newest segment line-up, announced in July 2011. These segments include 1) Networking, 2) Software, Services & Solutions (S3) and 3) Enterprise.

**Networking:** (60.3% of 2010 revenues, 64.9% of 2010 adjusted operating income) This family of product offerings includes IP routers and switches, (fiber) optics, microwave radio (for wireless data transmission), wireless radio networks (2G/3G/LTE) and wireline technologies (i.e. DSL and Gigabit Passive Optical Networking) for the fixed broadband access market. ALU ranks among the top 3 companies in many of these product categories. However, its overarching vision is the High Leverage Network (HLN), which allows carriers to incorporate new developments in wireline and wireless broadband access, IP, and optics to keep pace with the evolving needs of their networks and deliver new revenue-enhancing services at the lowest possible cost.

One central feature of HLN is the converged Internet Protocol/Multiprotocol Label Switching (IP/MPLS) network backbone that integrates voice, data and video traffic into a single platform. ALU was the first

to announce product families with speeds of 100 gigabit per second (100G) across both IP and optical transport. It is building intelligence into these converged backbones to recognize and address problems quickly and also to allow them to scale up capacity to meet traffic demand, where and as needed.



**Internet Protocol.** ALU has become one of the top three providers of **IP/MPLS edge routers**, (used primarily to send data from the edge of a telecommunications network to the core). It gained a solid footing in this segment with the acquisition of TiMetra Networks in 2003. In 2010, Alcatel held the #2 position in IP/MPLS edge routers with a market share of 28%, according to Infonetics. Its market share slipped in the second quarter, as market leader Cisco's flexed its muscles, but it improved slightly in the third quarter. Overall, industry sales growth is expected to ease from a mid-double-digit pace to the mid-single digits for the balance of the year.

While ALU elbowed its way into the #2 position in edge routers, it has been unable to crack the Ethernet switch market. Although its Omniswitch family of products has won several awards, ALU's share of the switch market has failed to get above 2%. This is another market dominated by Cisco.

Network switching and routing technology is rapidly advancing beyond the current 10G and newer 40G standards eventually to 100G. But for major carriers, it is not simply a question of installing bigger and faster boxes. In most cases, the transition to newer technologies requires planning to reconfigure the traffic flow and maximize efficiency, quality of service and capacity. For this reason, the widespread adoption of 100G technology may take some time.

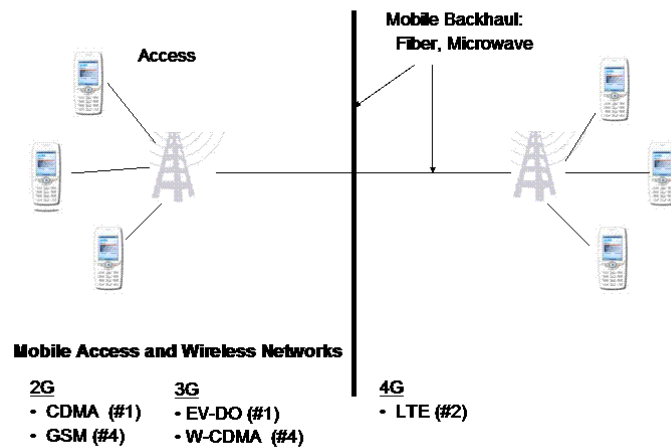
**Wireline.** ALU is the leader in **Digital Subscriber Lines (DSL)** with 39% of 2010 industry revenues. DSL provides broadband service over traditional copper twisted-pair wires. It is now being replaced by second generation very high bitrate DSL (**VDSL2**), which delivers speeds of 100 megabytes per second or better at one-third the cost of fiber. AT&T's Uverse, a "triple play" (i.e. voice, video and high speed internet) offering, is one example of a VDSL implementation. ALU is also the leader in **Gigabit Passive Optical Networking (GPON)** gear. It captured 39% of 2010 GPON port market.

Overall, the fiber access market will continue to grow worldwide, but carriers will likely be more selective in their use of fiber, limiting it to areas where the higher cost is justified by especially high traffic volume. Consequently, ALU's VDSL2 product offering has great potential to meet both the continued growth in demand for broadband and the objectives of many countries to make broadband universally available to their citizens. With its expertise in both VDSL2 and optical networking, ALU is better positioned than most companies to design and implement broadband access networks that deliver a high quality service at the lowest possible cost.

The company ranked third in 2010 in IP Multimedia Subsystem (IMS) offerings with a 14% share of software licenses. Over the past few years, its IMS product offering has become the core network in a

growing number of implementations. IMS works in fixed, mobile or converged networks. It is used often to migrate and upgrade older voice networks to enable the provisioning of new services, such as voice over internet protocol (VOIP – the internet telephony standard) and multimedia (i.e. voice, data and video) and also to replace central office switches. Among other things, it offers scalability and the ability to differentiate quality of service to selected end users.

**Optics.** ALU's Optics division specializes in the installation of equipment for both short- and long-distance transmission of information over fiber optic connections. It is a leader in the deployment of **fiber optic cable** networks, with the #2 position in terrestrial wave division multiplexing (WDM) technology and the #1 position, with an estimated 35%-40% share, in the submarine optical market. The division also includes microwave transmission, used to provide point-to-point transport of data for core networks, mobile backhauling, fixed broadband applications and private systems, including digital television broadcasting, defense, homeland security, energy and utilities.



**Wireless.** ALU is a leader in radio access networks, with an overall 16% market share in 2010, up from 13% in 2009. Its primary focus is now on implementing 4G LTE technology, which is entirely IP-based and thus better able to handle the growing demands for data associated with today's smartphones, tablets and other connected devices. The company's strategy is to help carriers manage their existing investments in 2G/3G in a cost effective manner, while paving the way for an eventual upgrade to LTE.

ALU's traditional strength is in CDMA, a 2G technology, where it is the worldwide leader. In 2010, ALU held a 39% market share in CDMA, according to Dell'Oro. CDMA is considered technologically superior to GSM; but it has been deployed in less than 15% of installations worldwide. It remains a cost effective choice for basic mobile telephone service in developing countries. Carriers in advanced markets may decide to maintain their CDMA voice networks to free up data capacity in their 3G/4G networks.

ALU is a leader in **1X EV-DO**, the leading 3G CDMA technology, which gives operators a cost effective upgrade path for data capacity and coverage. The Revision A upgrade added two-way, real-time data applications, such as mobile video, push-to-talk and VOIP. Revision B, which will soon be available, increases throughput performance significantly with minimal future upgrade costs.

ALU is the fourth largest provider of **GSM**, the 2G standard that has an 80%+ market share worldwide (and is the leading technology in Europe). ALU is also the fourth largest provider of W-CDMA (a/k/a UMTS), the 3G wireless technology derived from the GSM standard. Its position in W-CDMA was enhanced by the acquisition of Nortel's UMTS business in 2007. Although disadvantaged by its relatively weak market position in GSM, its ability to get future business with GSM carriers will depend upon the strength of its 4G offering. A recent contract win from Telefonica to launch 4G pre-commercial pilot networks in Madrid and Barcelona may be a good sign for ALU's future business in Europe.

**Long-Term Evolution** or LTE is a 4G technology that simplifies radio network performance and converges traffic onto a common IP platform, resulting in better performance and lower operating costs.

ALU's LTE offering features a converged (2G/3G/4G) radio access network, a mobile backhaul network and associated services and applications. By my count, the company has entered into 17 contracts to deploy commercial LTE networks, including with Verizon and AT&T, and is engaged in more than 60 LTE trials. In 2010, ALU ranked second in LTE (behind Ericsson) with a 30% market share.

ALU was the only telecom equipment provider to be selected by Verizon Wireless to participate in all three aspects of the trial: the LTE radio access network, the enhanced packet core of that network and the IP Multimedia Subsystem (IMS) deployment that will offer a common platform for multimedia services across all of Verizon's networks, including LTE and FIOS.

lightRadio. In February, ALU unveiled a new mobile broadband infrastructure, developed by BellLabs, called lightRadio. lightRadio seeks to streamline and simplify 4G wireless networks by incorporating a multifrequency antenna, signal amplifier and base station into one small unit (measuring 6 centimeters on each side). The technology is meant to replace today's celltowers. Each lightRadio unit has considerably less capacity than a celltower, but since the units are much smaller, they can be stacked together and located just about anywhere that has a broadband connection. ALU believes that lightRadio can reduce network operating costs by 50% or more.

Although ALU has scheduled several demonstrations of the new technology, it does not anticipate rolling it out until 2013 at the earliest. For now, lightRadio is an interesting and unique idea that will undergo significant testing and undoubtedly some modifications before proving its commercial viability.

**Software, Services and Solutions (S3)** (28.4% of 2010 revenues, 10.4% of 2010 adjusted operating income) On July 20, ALU announced the creation of this new business group along with a reshuffling of executive assignments. The announcement was also made in conjunction with ALU's decision to explore strategic options for its Enterprise business.

S3 combines the Networks Application division (which formerly was part of the Applications segment) with the four divisions of its Services segment. With the formation of S3, it looks like ALU is trying to encourage closer cooperation between its services and software groups to create solutions for customers that help them grow revenues or reduce costs.

ALU's Network Applications division develops software and systems that enable telecom carriers to offer new services to end-users across any connected device. So, for example, end-users would be able to watch movies on their flat screen televisions, laptops or even their smartphones. The division also helps carriers to streamline service activation (e.g. adding HBO with a phone call) and customer care (e.g. providing automated trouble-shooting tips). The division's software portfolio focuses on managing end-user experience, enabling networks and creating new services. This includes services that focus on subscriber data management, billing and payment, digital media and unified communication.

ALU's Motive business ([www.motive.com](http://www.motive.com)), which is growing rapidly, helps service providers of all types (fixed, mobile, cable and satellite) to activate, support and manage their various service offerings. It also helps end-users to set up and manage their equipment, devices and services.

Application Enablement, a key strategic priority for ALU, allows telecom carriers to provide key customer-specific information, such as subscriber location and service preferences, in a secure manner to applications developers to facilitate the creation of new and innovative services, which have the potential to enhance the value of their communications networks. In 2010, ALU enhanced its Application Enablement capabilities with the acquisitions of **ProgrammableWeb** ([www.programmableweb.com](http://www.programmableweb.com)), a repository of web Application Programming Interfaces (API) and mash-ups for applications developers, and **OpenPlug** ([www.openplug.com](http://www.openplug.com)), whose suite of developer tools facilitates the creation of new software and services for smartphones, tablets and embedded devices to encourage the development of cross-platform services. ALU generally makes the offerings of ProgrammableWeb and OpenPlug available for free to developers with the aim of building more traffic and revenues for its core telecom carrier customers which will help to drive demand for expanding and upgrading their networks.

Other S3 initiatives include:

- ALU's **Digital Media Store**, which allows service providers to deliver all forms of digital content to their end users.
- **Optism** ([www.optism.com](http://www.optism.com)) facilitates relationships between telecom carriers and advertisers by collecting demographic data and preference-based profiles on smartphone users (who opt-in). The data is aggregated from the carriers and delivered to advertisers through a hosted platform.
- ALU's **Mobile Wallet/Mobile Payment** solution, which allows mobile operators to deliver a mobile payment capability to end-users through their handsets. The service includes mobile e-commerce, proximity payments, person-to-person payments and remote ticketing.

ALU's Services business is organized into four groups:

- **Network and Systems Integration** assists customers in the conversion of legacy systems to IP platforms and in the deployment of multimedia services, such as interactive TV, mobile backhaul networks and wireless base stations. It also helps to integrate new service delivery platforms into existing operational and business support systems.
- **Managed and Outsourcing Solutions** allows telecom carriers to transfer the management and operation of their networks and systems to ALU, either on- or off-premises, for various business purposes, including the transition from legacy to all-IP networks.
- **Multi-Vendor Maintenance** assists carriers who have utilize multi-vendor networks in managing and troubleshooting their networks. Services includes the development of maintenance programs, spare parts management and remote and on-site technical support.
- **Product-Attached Services** include network build and implementation as well as maintenance services for ALU's products through ALU personnel or its global network of qualified partners.

**Enterprise** (7.4% of 2010 revenues, 28.8% of 2010 adjusted operating income) On July 20, ALU announced that it was considering strategic alternatives for its Enterprise business. On October 19, the company announced that it had signed an agreement to sell its Genesys contact management business to Permira, a private equity firm, for \$1.5 billion (€1.2 billion). The transaction, which must receive regulatory approval in the U.S., is expected to close by the end of 2011 or early 2012. Genesys had revenues of €377 million in and pre-tax income of €58 million in 2010. It looks like profits for the business are up so far in 2011.

With the announcement of the sale of Genesys, CEO Ben Verwaayen said that ALU's strategic review for its Enterprise business had concluded. Genesis accounted for 32% of the Enterprise segments 2010 revenues, but nearly 70% of its adjusted operating income.

The balance of the Enterprise segment consists primarily of operations previously housed in ALU's Enterprise Applications business. This group provides software, hardware and services to large and small organizations. ALU's systems can be based on the customer's premises, hosted, managed or outsourced. It sells these products and services directly and through a network of 2,100 business partners. Its product portfolio includes unified communication and collaboration, telephony equipment and devices, network infrastructure (Ethernet local area networks (LANs), wireless LAN and wide area networks), and carrier-grade products and services for strategic industries, such as energy, transportation and governments. ALU's backs its product offerings with a full range of software and services.

As more enterprises have sought the benefits of advanced IP networks and related services, the business has attracted significant competition. Although ALU has been a player in the enterprise space for many years, it has a relatively small position. In 2008, the company announced that it was forming a joint venture with Hewlett-Packard focused on the enterprise market. At the time, CEO Ben Verwaayen said that this was a very important partnership for ALU. It seemed to make a lot of sense. Yet, nothing has been said about it ever since. Perhaps the venture has been slow in taking flight. Certainly, HP may have been distracted with the turnover in its senior executives over the past year and shifting priorities which pulled its focus into other areas (like software). Even so, former ALU CEO Pat Russo was elected to the HP Board of Directors in 2011, so there still may be some promise in the partnership.

## Financial Review

A financial analysis of Alcatel-Lucent is complicated by several factors, most of which are a consequence of the company's 2006 merger.

First, ALU records a non-cash expense each quarter to amortize certain intangible assets, such as in-process research and development costs, that were acquired in the Lucent merger. These "purchase price adjustments," as they are called have lately been running at about €40 million after tax each quarter or less than €0.02 per share. I estimate that this after-tax impact of PPA will be €164 million or about €0.06 per share in 2011. ALU provides a detailed accounting of the impact of these costs on the last page of every quarterly earnings press release. They must be incorporated into every analyst's financial model because the company bases its guidance on its expectations for "adjusted operating margins" (i.e. operating margins excluding PPA).

Second, the company provides a separate line item for restructuring costs. Inclusion of such costs in any earnings analysis is left to the discretion of the analyst. Sometimes, restructuring costs can be excluded because they are truly extraordinary in nature. In ALU's case, however, restructuring costs have had a significant impact on its financial performance from more than the past five years. Eventually, these costs should recede, but for now, I believe that at the very least, restructuring costs that are paid in cash should be included. In recent years, ALU's cash outlays for restructuring have equaled or exceeded the restructuring expense recognized on its income statement. Consequently, I will continue to include restructuring expense as reported in the income statement in my earnings analysis.

Third, in conjunction with losses incurred over many years, such as those resulting from goodwill impairment charges in 2007 and 2008, ALU recognized a deferred tax asset of around €10 billion. Accounting rules required that those assets not be recognized when the company is not generating earnings (and especially if it is not likely to generate future earnings) to which those deferred tax assets can be applied. In that case, the company establishes a deferred tax valuation allowance that reduces the non-recognizable portion of the deferred tax asset to zero. If the company subsequently becomes profitable, the deferred tax asset is recognized by reducing the valuation allowance. This results in an income tax benefit in the earnings statement. In the nine months ended September 30, ALU recognized a deferred tax benefit of €248 million or €0.10 per share, associated with a reduction in the deferred tax valuation allowance. For analysis purposes, this amount should be excluded from any assessment of sustainable earnings per share. Instead, only the cash impact of the deferred tax asset, which is equal to the amount by which this asset actually reduces current period income tax should be recognized. Nevertheless, the recent reduction in the valuation allowance, which was associated with the company's annual tests of goodwill impairment, implies that the value of certain of its businesses improved, based upon expectation of future expected profitability.

Alcatel-Lucent's performance in recent years reflects its efforts to streamline its operations and restore its profitability with the tailwind of a global economic recovery. This recovery was dealt a modest setback in the 2011 third quarter.

**2011 Third Quarter Performance.** Overall third quarter revenues declined 6.8% year-over-year and 2.7% sequentially. At constant currency exchange rates, the declines were 0.7% and 3.8%, respectively. By segment, the drop was greatest in Networks (-7.1%) which saw double-digit declines in the Wireline (-22.2%) and Optics (-10.6%) businesses. S3 suffered a 4.7% revenue decline, mostly because of a 23.5% drop in Network Applications, where the Messaging and Payments businesses suffered big declines. Enterprise revenues bucked the trend, rising 8.9%.

The decline in revenues was especially troubling because modest growth had been anticipated. Currency movements explain much of the shortfall, but it is also clear that many of ALU's businesses experienced declines. Some of those declines were due to project transitions (e.g. wireless in Asia) and delivery delays (e.g. Payments in Network Applications), but management gave an implicit indication that it expected revenues to be challenged for some time to come.

Despite the decline in revenues, operating income for the quarter improved from a loss of €11 million to a profit of €107 million. Excluding PPA, adjusted operating income improved from €61 million to €173 million or from 1.5% to 4.6% of revenues. The company disclosed that €28 million of the improvement,

equal to 74 basis points of operating margin, was due to the positive impact of an extended license fee agreement with TCL Communication Technology Holding of Hong Kong. Even excluding this fee income, the improvement in operating income was impressive.

*Table 1*

**Alcatel-Lucent**

Revenues and Operating Income by Segment for the Quarter and Nine Months Ended Sept. 30, 2011

(in €000s)

	3 Months 30-Sep-10	3 Months 30-Sep-11	Percent Change	9 Months 30-Sep-10	9 Months 30-Sep-11	Percent Change
<b>Revenues</b>						
Networks	€2,459	€2,285	-7.1%	€6,691	€7,178	7.3%
o/w IP	366	376	2.7%	956	1,131	18.3%
o/w Optics	651	582	-10.6%	1,840	1,881	2.2%
o/w Wireless	1,068	1,032	-3.4%	2,908	3,229	11.0%
o/w Wireline	396	308	-22.2%	1,060	974	-8.1%
o/w eliminations	(22)	(13)	NM	(73)	(37)	NM
Software, Services & Solutions	€1,154	€1,100	-4.7%	€3,146	€3,146	0.0%
o/w Services	1,018	996	-2.2%	2,795	2,805	0.4%
o/w Network Applications	136	104	-23.5%	351	341	-2.8%
Enterprise	€293	€319	8.9%	€861	€890	3.4%
Other & eliminations	€168	€93	-44.6%	€436	€226	-48.2%
<b>Total</b>	<b>€4,074</b>	<b>€3,797</b>	<b>-6.8%</b>	<b>€11,134</b>	<b>€11,440</b>	<b>2.7%</b>
<b>Operating income</b>						
Networks	€31	€70	125.8%	(€42)	€181	NM
Software, Services & Solutions	25	55	120.0%	(68)	57	NM
Enterprise	18	29	61.1%	46	63	37.0%
Other & eliminations	(13)	19	NM	(42)	(7)	NM
<b>Total</b>	<b>61</b>	<b>173</b>	<b>183.6%</b>	<b>(106)</b>	<b>294</b>	<b>NM</b>
Purchase price adjustments	(72)	(66)	-8.3%	(213)	(199)	-6.6%
Inc. from oper. act. bef. items	(11)	107	NM	(319)	95	NM
Restructuring costs	(71)	(57)	NM	(291)	(138)	NM
Impairment of assets	0	0		0	2	
Other items	40	(5)	NM	20	66	230.0%
<b>Inc. (loss) from oper. activities</b>	<b>(42)</b>	<b>45</b>	<b>NM</b>	<b>(590)</b>	<b>25</b>	<b>NM</b>

The components of the improvement in operating margin can be seen in Table 2 through the consolidated income statement (shown on the next page). Gross margins improved 250 basis points to 36.3%. Management attributed the improvement to geographical and product mix and also to actions taken across the company to reduce fixed costs. It also cited cost cutting efforts in the 8.3% year-over-year reduction in third quarter operating expenses (3.8% on a constant currency basis). Within the operating expense category, administrative expense was flat as a percent of revenues at 17.6%, while research and development expenses eased from 16.4% to 15.9%.

The improvement in operating income was offset by unfavorable swings in the impact of post-retirement benefit plan amendments and other financial income. Other financial income fell by 50% year-over-year due to the a negative swing in foreign exchange and the absence of last year's benefit from a favorable accounting treatment on ALU's 2.875% Series A Convertible Notes. All of those non-operating items narrowed the improvement in pre-tax income considerably, but the recorded income tax benefit increased sharply from €23 million to €177 million, due to a reduction in its deferred tax valuation allowance (as discussed in greater detail above).. In ALU's case, this quarter's income tax benefit from the valuation allowance reversal equaled €0.06 per share.

On balance, then, this was a rather strange quarter, with lower revenues, but sharply higher operating income, offset by a negative swing in non-operating items, but enhanced by the deferred tax asset valuation allowance reversal. The improvement in operating margin was noteworthy because of the decline in

revenues. A continued favorable mix of revenues could support a higher operating margin, even, to some degree, in the face of ongoing pressure on revenues, but it is not clear whether it will. Still, the benefits of cost cutting should be long lasting. Despite the lingering uncertainty, the improvement in operating margin helps mitigate some of the concerns associated with the drop in revenues.

*Table 2***Alcatel-Lucent and Subsidiaries**

Consolidated Statement of Income for the Quarter and Nine Months Ended Sept. 30, 2011

(in €000s)

	3 Months 30-Sep-10	3 Months 30-Sep-11	9 Months 30-Sep-10	9 Months 30-Sep-11
Revenues	€4,074	€3,797	€11,134	€11,440
Cost of sales	(2,697)	(2,417)	(7,322)	(7,308)
Gross profit	1,377	1,380	3,812	4,132
as % of revenues	33.8%	36.3%	34.2%	36.1%
Admin. & selling expense	(718)	(670)	(2,165)	(2,125)
as % of revenues	-17.6%	-17.6%	-19.4%	-18.6%
Res. & dev. costs bef. cap.	(674)	(612)	(1,954)	(1,915)
Impact of capitalization	4	9	(12)	3
Research & development costs	(670)	(603)	(1,966)	(1,912)
as % of revenues	-16.4%	-15.9%	-17.7%	-16.7%
Inc. from oper. act. bef. items	(11)	107	(319)	95
as % of revenues	-0.1%	0.9%	-2.9%	0.8%
Restructuring costs	(71)	(57)	(315)	(138)
Litigations	10	0	(6)	4
Gain (loss) on disposal	0	(4)	(3)	(2)
Post-ret. ben. plan amend.	30	(1)	30	66
Income from oper. activities	(42)	45	(613)	25
Interest rel. to gross fin. debt	(86)	(83)	(264)	(260)
Interest rel. to cash	10	14	40	43
Net financing costs	(76)	(69)	(224)	(217)
Other financial income (loss)	137	66	222	250
Share in net inc. (loss) of eq. aff.	4	0	12	2
Inc. before tax and items	23	42	(603)	60
Income tax (expense) benefit	23	177	(28)	212
Income tax rate	100.0%	421.3%	4.6%	353.3%
Inc. (loss) from cont. oper.	46	219	(631)	272
Inc. (loss) from disc. oper.	0	0	(13)	
Net income	46	219	(644)	272
Attributable to:				
Equity holders of parent	25	194	(674)	227
Minority interests	21	25	30	45
EPS – Diluted	\$0.01	\$0.08	(€0.30)	€0.10
EPS before disc. oper. - Diluted	\$0.01	\$0.08	(€0.29)	€0.10
EPS from disc. oper. - Diluted	\$0.00	\$0.00	(€0.01)	€0.00
Wtd. avg. shares outstanding Diluted	2,276	2,874	2,260	2,307
Conversion rate: \$/€	1.3601	1.3449	1.3601	1.3449

The table below gives a reconciliation between as reported and adjusted operating profit, operating margin and net income for the 2011 and 2010 third quarters, as disclosed by the company.

*Table 3*

**Alcatel-Lucent and Subsidiaries**

Consolidated Statement of Income for the Quarter and Nine Months Ended Sept. 30, 2011  
(in €000s)

	2010 Q3			2011 Q3		
	As reported	PPA	Adjusted	As reported	PPA	Adjusted
Revenues	€4,074		€4,074	€3,797		€3,797
Cost of sales	(2,697)		(2,697)	(2,417)		(2,417)
Gross profit	1,377	0	1,377	1,380	0	1,380
as % of revenues	33.8%		33.8%	36.3%		36.3%
Admin. & selling expense	(718)	31	(687)	(670)	29	(641)
as % of revenues	-17.6%		-16.9%	-17.6%		-16.9%
Res. & dev. costs	(670)	41	(629)	(603)	37	(566)
as % of revenues	-16.4%		-15.4%	-15.9%		-14.9%
Inc. from oper. act. bef. items	(11)	72	61	107	66	173
as % of revenues	-0.3%		1.5%	2.8%		4.6%
Restructuring costs	(71)		(71)	(57)		(57)
Impairment of assets			0			0
Litigations	10		10	0		0
Gain (loss) on disposal			0	(4)		(4)
Post-ret. ben. plan amend.	30		30	(1)		(1)
Income from oper. activities	(42)	72	30	45	66	111
Financial result (net)	61		61	(3)		(3)
Share in net inc (loss) of eq aff	4		4	0		0
Income tax (expense) benefit	23	(29)	(6)	177	(25)	152
Income tax rate	100.0%	-40.3%	-6.3%	421.1%	-37.9%	140.7%
Inc. (loss) from cont. oper.	46	43	89	219	41	260
Inc. (loss) from disc. oper.			0	0		0
Net income	46	43	89	219	41	260
Attributable to:						
Equity holders of parent	25	43	68	194	41	235
Minority interests	21		21	25		25
EPS - diluted	€0.01		€0.03	€0.07		€0.08
EPS - diluted (\$)	\$0.02		\$0.04	\$0.09		\$0.11
Shares outstanding - diluted	2,276		2,276	2,874		2,874
Conversion rate: \$/€	1.360		1.360	1.345		1.345

During the quarter, ALU lowered the discount rate on its pension and post-retirement healthcare benefit plans by 0.70% to align them better with current interest rates. This caused a €1.07 billion actuarial loss recognized in ALU's statement of comprehensive income. This directly reduced shareholders' equity and increased the pensions and OPEB liability by a corresponding amount on ALU's balance sheet. Despite the increase in liability, ALU is not under any obligation to make an extra funding contribution to its pension and benefit plans before 2013.

*Table 4***Alcatel-Lucent and Subsidiaries**

Consolidated Statement of Financial Position at Sept. 30, 2010, Dec. 31, 2010 and Sept. 30, 2011

(in €000s)

	30-Sep-10	31-Dec-10	30-Sep-11
<b>ASSETS</b>			
Goodwill	\$4,311	\$4,370	\$4,342
Intangible assets, net	2,096	2,056	1,817
PP&E	1,207	1,311	1,221
Share in net assets of eq. affil.	56	9	9
Other non-current fin. assets	430	400	389
Deferred tax assets	922	948	1,177
Prepaid pension costs	2,803	2,746	2,753
Other non-current assets	220	257	380
<b>Total non-current assets</b>	<b>12,045</b>	<b>12,097</b>	<b>12,088</b>
Inventories and w-i-p, net	2,567	2,295	2,251
Trade receivables and rel. accts.	3,323	3,664	3,435
Adv. and progress payments	88	75	74
Other current assets	1,126	885	968
Assets held for sale	219	3	12
Current income taxes	161	168	134
Marketable securities, net	1,197	649	798
Cash and equivalents	3,227	5,040	2,959
<b>Total current assets</b>	<b>11,908</b>	<b>12,779</b>	<b>10,631</b>
<b>TOTAL ASSETS</b>	<b>23,953</b>	<b>24,876</b>	<b>22,719</b>
<b>LIABILITIES AND EQUITY</b>			
Capital stock	€4,636	€4,637	€4,651
Additional paid-in capital	16,718	16,726	16,750
less Treasury stock	(1,566)	(1,566)	(1,567)
Ret. earns, fair value & other res.	(15,913)	(15,139)	(16,526)
Cum. translation adjustments	(824)	(779)	(770)
Net inc. (loss) attrib. to shrhldrs.	(674)	(334)	227
Equity attrib. to shareholders	2,377	3,545	2,765
Minority interests	631	660	705
<b>Total shareholders' equity</b>	<b>3,008</b>	<b>4,205</b>	<b>3,470</b>
Pension and OPEB liabilities	6,014	5,090	5,769
Bonds and notes, long-term	3,479	4,037	4,038
Other long-term debt	61	75	140
Deferred tax liabilities	1,127	1,126	1,012
Other non-current liabilities	247	259	211
<b>Total non-current liabilities</b>	<b>10,928</b>	<b>10,587</b>	<b>11,170</b>
Provisions	1,969	1,858	1,615
CMLTD	1,146	1,266	320
Cust. dep. and advances	915	803	709
Trade payables and rel. accts.	4,173	4,325	3,786
Liabilities rel. to held for sale	71		
Current income tax liabilities	68	137	116
Other current liabilities	1,675	1,695	1,533
<b>Total current liabilities</b>	<b>10,017</b>	<b>10,084</b>	<b>8,079</b>
<b>Total liabilities</b>	<b>20,945</b>	<b>20,671</b>	<b>19,249</b>
<b>TOTAL LIAB. AND EQUITY</b>	<b>23,953</b>	<b>24,876</b>	<b>22,719</b>
Shares issued	2,318	2,318	2,325
Shares outstanding	2,260	2,260	2,267

Table 5

**Alcatel-Lucent and Subsidiaries**

Consolidated Statements of Cash Flow for the Quarter and Nine Months Ended Sept. 30, 2011

(in €000s)

	3 Months 30-Sep-10	3 Months 30-Sep-11	9 Months 30-Sep-10	9 Months 30-Sep-11
<b>Operating activities</b>				
Net income (loss)	€25	€194	(€674)	€227
Minority interests	21	25	30	45
Adjustments	161	(116)	560	128
NCOA bef. work. cap. and other	207	103	(84)	400
Inventories	(109)	25	(686)	(98)
Trade receivables	(137)	103	446	302
Adv. and progress payments	(8)	6	16	1
Trade payables	51	(247)	56	(484)
Customer deposits	121	(175)	103	(190)
Other curr. assets and liabilities	(61)	6	(152)	(217)
NCOA bef. int. and taxes	64	(179)	(301)	(286)
Interest received	8	15	36	47
Interest paid	(100)	(120)	(281)	(288)
Taxes	(61)	(11)	(129)	(65)
Net cash from oper. activities	(89)	(295)	(675)	(592)
<b>Investing activities</b>				
Disposal proceeds	19	1	22	7
Capital expenditures	(184)	(141)	(462)	(407)
of which, cap. of dev. costs	(71)	(70)	(203)	(197)
Loans and non-curr. fin. assets	(18)	6	(15)	15
Acquisitions	(6)	0	(7)	0
Cash from acquisitions	0	0	0	3
Sale of companies	10	3	24	(1)
Marketable securities	583	(243)	831	(153)
Net cash from inv. activities	404	(374)	393	(536)
<b>Financing activities</b>				
Short-term debt	152	(57)	140	(40)
Long-term debt				
Issuance	(9)	0	6	1
Repayment	(27)	(13)	(383)	(861)
Capital increase	0	0		15
Dividends	(8)	(3)	(11)	(72)
Net cash from fin. activities	108	(73)	(248)	(957)
Currency	(249)	227	180	4
Net cash in cash	174	(515)	(350)	(2,081)
Beginning cash	3,053	3,474	3,577	5,040
Ending cash	3,227	2,959	3,227	2,959

One of the primary concerns with ALU's third quarter performance was the sharp drop in free cash flow. ALU's cash flow statement, shown above, shows that its cash flow from operating activities deteriorated from a use of €89 million in the 2010 third quarter to a use of €295 million in the 2011 third quarter. More than all of this deterioration was due to the negative swing in cash used for trade payables of €298 million. I calculate that ALU's days payable actually decreased from 99 days in 10Q3 to 86 days in 11Q3. This suggests that at least some of this use of cash was discretionary. As a result, I do not view the drop in free cash flow as a major concern at this time.

Similarly, ALU's days inventory ratio declined from 61 in 10Q3 to 51 in 11Q3 and its days receivable eased by 3 days to 76 days over the same time frame. Management has vowed to improve its working capital management, especially by reducing inventories where possible. Further cuts may be possible, but it appears nevertheless that management has been doing a reasonably good job in managing the company's working capital already.

Similarly, ALU's cash flow performance over the past five years has been acceptable, in my opinion, especially since the company was not profitable for most of that period. On a net basis, the company has been cash flow positive during that time. There is no clear evidence that the recent deterioration in cash flow performance is reflective of a past or emerging trend. Obviously cash flow management is important and should be watched carefully going forward; but it seems to me that the market has overreacted to ALU's disappointing third quarter free cash flow performance.

### Projections

My projected financial statements reflect recent trends in the company's financial performance and management's guidance.

For the 2011 fourth quarter, my projections assume a revenue decline of 1.3%. This is far less than the 6.8% third quarter decline, but reasonable, I believe, considering that some of the shortfall of the third quarter is expected to be made up in the fourth quarter. For example, management cited project transition in China for some of the decline in third quarter Wireless revenues. It also cited delivery delays in the Payments business (included in Network Applications), which presumably will be resolved in the fourth quarter. In addition, ALU highlighted increases in the Optics backlog, with double-digit gains in WDM and wireless transmission. Wireline, the other business that suffered double-digit declines, is expected to remain weak, but the commercial availability of VDSL2 with vectoring should lead to increasing orders which should convert to revenues in 2012, if not by the 2011 fourth quarter.

Adjusted operating margins for the fourth quarter are assumed to be even with the prior year. Given that operating margins were rose 310 basis points in the 2011 third quarter, I do not believe that this is a heroic assumption. I assume a 30 basis point improvement in gross margins to 26.5%, a similar 30 basis point reduction in the selling and administrative expense ratio to 15.0% and a 60 basis point increase in the R&D expense ratio to 14.9%.

Non-operating items are anticipated to reduce fourth quarter pre-tax income by €37 million, compared with a prior year benefit of €39 million. I assume a modest increase in restructuring expense, which may be too light, no benefit from asset sale gains and lower net financial income. If the sale of Genesys closes before the end of the year, I would guess that ALU will record a reasonable gain. My estimate for income tax expense is slightly higher for the 2011 fourth quarter. I assume no further benefit from the reversal of the deferred tax valuation allowance.

With these assumptions, my fourth quarter earnings estimate on an as-reported basis is €0.09 (\$0.13), below the €0.11 (\$0.15) reported in 2010. Excluding PPA of €0.01, my adjusted earnings estimate is €0.10 (\$0.15) vs. €0.13 (\$0.17) last year.

For all of 2011, I project as-reported earnings of €0.18 (\$0.25). Excluding €0.06 of PPA, the adjusted earnings projection is €0.24 (\$0.34). The adjusted earnings estimate includes €0.10 (\$0.14) of benefit from the partial elimination of the deferred tax valuation allowance. Excluding this benefit, my projected adjusted 2011 EPS estimate is €0.14 (\$0.20), upon which I believe ALU's valuation should be based.

My full year 2011 EPS estimate reflects a projected full year adjusted operating margin of 4.2%. This exceeds management's most recent guidance of 4.0%, but I believe that it is reasonable given my flat margin assumptions for the 2011 fourth quarter, as discussed above. Given the strong 2011 third quarter margin performance, I believe that there is some conservatism in the company's 4.0% guidance.

For 2012, my adjusted EPS projection of €0.21 (\$0.27), given on page 21, assumes essentially flat revenues and an adjusted operating margin of 5%. The improvement in operating margin is expected to come through cost cutting. Management has targeted an additional €500 million in savings for the full year, equal to 3.1% of projected revenues. My estimate of a 1.0% improvement in operating margin, therefore, implicitly assumes some erosion in gross margins due to heightened competition.

*Table 6***Alcatel-Lucent and Subsidiaries**

Historical Financial Performance for the quarter and year ended December 31, 2010

(in €000s)

	2010 Q4			2010 YTD		
	As reported	PPA	Adjusted	As reported	PPA	Adjusted
Revenues	€4,862		€4,862	€15,996	€0	€15,996
Cost of sales	(3,103)	1	(3,102)	(10,425)	1	(10,424)
Gross profit	1,759	1	1,760	5,571	1	5,572
as % of revenues	36.2%		36.2%	34.8%		34.8%
Admin. & selling expense	(742)	33	(709)	(2,907)	126	(2,781)
as % of revenues	-15.3%		-14.6%	-18.2%		-17.4%
Res. & dev. costs	(696)	39	(657)	(2,662)	159	(2,503)
as % of revenues	-14.3%		-13.5%	-16.6%		-15.6%
Inc. from oper. act. bef. items	321	73	394	2	286	288
as % of revenues	6.6%		8.1%	0.0%		1.8%
Restructuring costs	(60)		(60)	(375)	0	(375)
Impairment of assets			0	0	0	0
Litigations	(22)		(22)	(28)	0	(28)
Gain (loss) on disposal	65		65	62	0	62
Post-ret. ben. plan amend.			0	30	0	30
Income from oper. activities	304	73	377	(309)	286	(23)
Financial result (net)	54		54	52	0	52
Share in net inc. (loss) of eq. aff.	2		2	14	0	14
Income tax (expense) benefit	(9)	(28)	(37)	(37)	(111)	(148)
Income tax rate	-2.5%	-38.4%	-8.5%	15.2%	-38.8%	-344.0%
Inc. (loss) from cont. oper.	351	45	396	(280)	175	(105)
Inc. (loss) from disc. oper.	1		1	(12)	0	(12)
Net income	352	45	397	(292)	175	(117)
Attributable to:						
Equity holders of parent	340	45	385	(334)	175	(159)
Minority interests	12		12	42	0	42
EPS – diluted	€0.11		€0.13	(€0.15)	€0.07	(€0.07)
EPS - diluted (\$)	\$0.15		\$0.17	(\$0.20)		(\$0.09)
Shares outstanding - diluted	2,957		2,957			2,260
Conversion rate: \$/€	1.327		1.327			1.327

*Table 7***Alcatel-Lucent and Subsidiaries**

Projected Financial Performance for the quarter and year ending December 31, 2011

(in €000s)

	2011 Q4 (Projected)			2011 Full Year (Projected)		
	As reported	PPA	Adjusted	As reported	PPA	Adjusted
Revenues	€4,798		€4,798	€16,238	€0	€16,238
Cost of sales	(3,047)		(3,047)	(10,355)	0	(10,355)
Gross profit	1,751	0	1,751	5,883	0	5,883
as % of revenues	36.5%		36.5%	36.2%		36.2%
Admin. & selling expense	(720)	30	(690)	(2,845)	117	(2,728)
as % of revenues	-15.0%		-14.4%	-17.5%		-16.8%
Res. & dev. costs	(714)	40	(674)	(2,626)	152	(2,474)
as % of revenues	-14.9%		-14.0%	-16.2%		-15.2%
Inc. from oper. act. bef. items	318	70	388	413	269	682
as % of revenues	6.6%		8.1%	2.5%		4.2%
Restructuring costs	(65)		(65)	(203)	0	(203)
Impairment of assets			0	0	0	0
Litigations			0	2	0	2
Gain (loss) on disposal			0	0	0	0
Post-ret. ben. plan amend.			0	66	0	66
Income from oper. activities	253	70	323	278	269	547
Financial result (net)	20		20	53	0	53
Share in net inc. (loss) of eq. aff.	8		8	10	0	10
Income tax (expense) benefit	(14)	(28)	(42)	198	(105)	93
Income tax rate	-5.0%	-40.0%	-12.0%	58.0%	-39.0%	15.2%
Inc. (loss) from cont. oper.	267	42	309	539	164	703
Inc. (loss) from disc. oper.			0	0	0	0
Net income	267	42	309	539	164	703
Attributable to:						
Equity holders of parent	257	42	299	484	164	648
Minority interests	10		10	55	0	55
EPS - diluted	€0.09	€0.01	€0.10	€0.18	€0.06	€0.24
EPS - diluted (\$)	\$0.13		\$0.15	\$0.25		\$0.34
Shares outstanding - diluted			2,875			2,700
Conversion rate: \$/€			1.400			1.400

Table 8

**Alcatel-Lucent and Subsidiaries**

Historical and Projected Business Segment Revenues by Quarter: 2010-2011

(in €000s)

<b>REVENUES</b>	11Q1	11Q2	11Q3	11Q4E	Full Year 2011E	Pct. of Total
Networks						
IP	349	406	376	513	1,644	10.1%
Optics	654	645	582	815	2,696	16.6%
Wireless	1,118	1,079	1,032	1,179	4,408	27.1%
Wireline	309	357	308	439	1,413	8.7%
eliminations	(12)	(12)	(13)	(9)	(46)	-0.3%
Total Networks	2,418	2,475	2,285	2,937	10,115	62.3%
Software, Services & Solutions						
Services	869	940	996	1,223	4,028	24.8%
Network Applications	106	131	104	180	521	3.2%
Total Applications	975	1,071	1,100	1,403	4,549	28.0%
Enterprise	285	286	319	350	1,240	7.6%
Other & eliminations	62	71	93	107	333	2.1%
Total company	3,740	3,903	3,797	4,798	16,238	100.0%

<b>REVENUES</b>	10Q1	10Q2	10Q3	10Q4	Full Year 2010	Pct. of Total
Networks						
IP	272	318	366	508	1,464	9.2%
Optics	567	622	651	815	2,655	16.6%
Wireless	819	1,021	1,068	1,156	4,064	25.4%
Wireline	298	366	396	488	1,548	9.7%
eliminations	(28)	(23)	(22)	(15)	(88)	-0.6%
Total Networks	1,928	2,304	2,459	2,952	9,643	60.3%
Software, Services & Solutions						
Services	825	952	1,018	1,211	4,006	25.0%
Network Applications	96	119	136	180	531	3.3%
Total Applications	921	1,071	1,154	1,391	4,537	28.4%
Enterprise	267	301	293	324	1,185	7.4%
Other & eliminations	131	137	168	195	631	3.9%
Total company	3,247	3,813	4,074	4,862	15,996	100.0%

	Percentage Change: 2010 to 2011				YTD
	Q1	Q2	Q3	Q4	Pct. Chg.
Networks					
IP	28.3%	27.7%	2.7%	1.0%	12.3%
Optics	15.3%	3.7%	-10.6%	0.0%	1.5%
Wireless	36.5%	5.7%	-3.4%	2.0%	8.5%
Wireline	3.7%	-2.5%	-22.2%	-10.0%	-8.7%
eliminations	-57.1%	-47.8%	-40.9%	-40.0%	-47.7%
Total Carrier	25.4%	7.4%	-7.1%	-0.5%	4.9%
Software, Services & Solutions					
Services	5.3%	-1.3%	-2.2%	1.0%	0.6%
Network Applications	10.4%	10.1%	-23.5%	0.0%	-1.9%
Total Software, Serv. & Solutions	5.9%	0.0%	-4.7%	0.9%	0.3%
Enterprise	6.7%	-5.0%	8.9%	8.0%	4.6%
Other & eliminations	-52.7%	-48.2%	-44.6%	-45.0%	-47.2%
Total company	15.2%	2.4%	-6.8%	-1.3%	1.5%

*Table 9***Alcatel-Lucent and Subsidiaries**

Historical and Projected Business Segment Revenues by Quarter: 2010-2011

(in €000s)

<b>ADJ. OPERATING INCOME</b>	11Q1	11Q2	11Q3	11Q4E	Full Year 2011E	Pct. of Total
Networks	63	48	70	214	395	58.0%
Software, Solutions & Services	(50)	52	55	126	183	26.9%
Enterprise	14	20	29	42	105	15.4%
Other & eliminations	(14)	(12)	19	5	(2)	-0.2%
Total group	13	108	173	388	682	100.0%
<b>OPERATING MARGIN</b>	11Q1	11Q2	11Q3	11Q4E	Full Year 2011	
Networks	2.6%	1.9%	3.1%	7.3%	3.9%	
Software, Solutions & Services	-5.1%	4.9%	5.0%	9.0%	4.0%	
Enterprise	4.9%	7.0%	9.1%	12.0%	8.5%	
Other & eliminations	-22.6%	-16.9%	20.4%	5.0%	-0.5%	
Total group	0.3%	2.8%	4.6%	8.1%	4.2%	
<b>ADJ. OPERATING INCOME</b>	10Q1	10Q2	10Q3	10Q4	Full Year 2010	Pct. of Total
Networks	(128)	55	31	229	187	64.9%
Software, Solutions & Services	(76)	(17)	25	98	30	10.4%
Enterprise	9	19	18	37	83	28.8%
Other & eliminations	0	(29)	(13)	30	(12)	-4.2%
Total group	(195)	28	61	394	288	100.0%
<b>OPERATING MARGIN</b>	10Q1	10Q2	10Q3	10Q4	Full Year 2010	
Networks	-6.6%	2.4%	1.3%	7.8%	1.9%	
Software, Solutions & Services	-8.3%	-1.6%	2.2%	7.0%	0.7%	
Enterprise	3.4%	6.3%	6.1%	11.4%	7.0%	
Other & eliminations	0.0%	-21.2%	-7.7%	15.4%	-1.9%	
Total group	-6.0%	0.7%	1.5%	8.1%	1.8%	

Table 10

**Alcatel-Lucent and Subsidiaries**

Historical and Projected Financial Performance: 2008 to 2012

(in €000s)

	12 Months 31-Dec-08	12 Months 31-Dec-09	12 Months 31-Dec-10	12 Months 31-Dec-11	12 Months 31-Dec-12
Revenues	€16,984	€15,157	€15,996	€16,238	€16,000
Cost of sales	(11,190)	(10,046)	(10,425)	10,355	10,320
Gross profit	5,794	5,111	5,571	5,883	5,680
as % of revenues	34.1%	33.7%	34.8%	36.2%	35.5%
Admin. & selling expense	(3,093)	(2,913)	(2,907)	(2,845)	(2,720)
as % of revenues	-18.2%	-19.2%	-18.2%	-17.5%	-17.0%
Research & development costs	(2,757)	(2,523)	(2,662)	(2,626)	(2,480)
as % of revenues	-16.2%	-16.6%	-16.6%	-16.0%	-15.5%
Inc. from oper. act. bef. items	(56)	(325)	2	413	480
as % of revenues	-0.3%	-2.1%	0.0%	2.5%	3.0%
Restructuring costs	(562)	(605)	(375)	(203)	(75)
Litigations		(109)	(28)	2	5
Impairment of assets	(4,725)				
Gain (loss) on disposal	(7)	99	62	0	5
Post-ret. ben. plan amend.	47	248	30	66	60
Income from oper. activities	(5,303)	(692)	(309)	278	475
Net financing costs	(212)	(254)	(304)	(300)	(300)
Other financial income (loss)	366	249	356	353	350
Share in net inc. (loss) of eq. aff.	96	1	14	10	20
Inc. before tax and items	(5,053)	(696)	(243)	341	545
Red. of goodw. rel. to def. tax ass.					
Income tax (expense) benefit	(153)	60	(37)	198	(55)
Income tax rate	46.6%	-8.6%	15.2%	-58.0%	10.0%
Inc. (loss) from cont. oper.	(5,206)	(636)	(280)	539	491
Inc. (loss) from disc. oper.	33	132	(12)		
Net income	(5,173)	(504)	(292)	539	491
Attributable to:					
Equity holders of parent	(5,215)	(524)	(334)	484	431
Minority interests	42	20	42	55	60
EPS					
Basic	(€2.31)	(€0.23)	(€0.15)	€0.21	€0.19
Diluted	(€2.31)	(€0.23)	(€0.15)	€0.18	€0.15
EPS before disc. oper.					
Basic	(€2.32)	(€0.29)	(€0.15)	€0.21	€0.19
Diluted	(€2.32)	(€0.29)	(€0.15)	€0.18	€0.15
EPS from disc. oper.					
Basic	€0.01	€0.06	€0.00	€0.00	€0.00
Diluted	€0.01	€0.06	€0.00	€0.00	€0.00
Purchase price adjustments	€0.14	€0.07	€0.08	€0.06	€0.05
Adjusted EPS	(€2.18)	(€0.22)	(€0.07)	€0.24	€0.20
EPS (\$)	(\$3.23)	(\$0.41)	(\$0.20)	\$0.25	\$0.21
Adjusted EPS (\$)	(\$3.03)	(\$0.31)	(\$0.09)	\$0.34	\$0.27

**Valuation.** At the current price, ALU is valued at 9.6 times non-GAAP earnings (which exclude the deferred tax valuation allowance benefit). Compared with its peers, ALU trades at a much lower multiple. Valuing ALU's anticipated 2011 adjusted EPS of \$0.20 at a multiple of 17.5, which is below the average multiple of 18 for its peer group, give an intrinsic value of \$3.50. My target price of \$4.50 for ALU applies a multiple of 16.5 to projected adjusted 2012 EPS of \$0.27.

ALU deserves at least an average market multiple because of its unique competitive position and strong product and service portfolio. Given recent events, it will probably not achieve that valuation until uncertainties surrounding its revenue outlook and free cash flow generating capability are resolved. On the other hand, any improvement in outlook for the global economy will likely result in even more upside potential in both its projected EPS and its potential valuation multiple.

*Table 11*

**Alcatel-Lucent and Subsidiaries**

Valuation Metrics at November 7, 2011

Recent price	\$2.12	
52-week range	\$2.25	- \$ 6.63
Dividend	\$0.00	
Shares outstanding	2,267	
Market cap.	4,806	millions
	EPS	PE
ttm (GAAP)	0.36	5.9
ttm (non-GAAP)	0.22	9.6
2011E	0.20	10.6
2012E	0.27	7.9
	Per Share	Multiple
Free cash flow	\$0.55	3.9
Book value	\$2.16	1.0
Tangible book	(\$1.61)	NM
Sales (ttm)	\$7.19	0.3
Enterprise value to	TTM	Multiple
EBITDA	1,935	5.8
Sales	23,312	0.5

*Table 12*

**Comparable Valuation Metrics for Alcatel-Lucent and its Peers**

Using Stock Prices as of September 7, 2011

	Price	Yield	Mkt Cap	Bk Val	P/B	'11 E	'11 P/E	'12E	'12 P/E
ALU	2.12	0.0%	4.805B	2.14	1.1	0.31	6.8	0.45	4.7
ARRS	10.74	0.0%	1.281B	8.45	1.3	0.85	12.6	0.97	11.1
ARUN	24.38	0.0%	2.576B	3.29	7.5	0.63	38.7	0.80	30.5
CIEN	13.22	0.0%	1.281B	0.30	46.4	(0.21)	NM	0.74	17.9
CSCO	18.01	1.3%	96.945B	8.70	2.1	1.70	10.6	1.88	9.6
ERIC	10.80	2.4%	34.637B	6.93	1.5	0.91	11.9	0.97	11.1
HLIT	5.59	0.0%	0.647B	4.79	1.2	0.42	13.3	0.53	10.5
JNPR	23.71	0.0%	12.549B	13.11	1.8	1.25	19.0	1.44	16.5
MSI	45.78	1.9%	14.903B	18.73	2.5	2.50	18.3	2.79	16.4
RVBD	28.55	0.0%	4.436B	4.46	6.5	0.89	32.1	1.13	25.3
TLAB	4.44	1.8%	1.620B	5.08	0.9	(0.10)	NM	0.03	148.0

Source: Yahoo! Finance