

Alcatel-Lucent

Executive Summary

September 9, 2009

After a long and arduous merger integration process and the economic downturn, which will bring industry revenues down 8% to 12% in 2009, according to management's estimates, Alcatel-Lucent (ALU) appears to be poised for a turnaround. Management has reaffirmed its guidance of breakeven operating profit in 2009 and modest profitability in 2010, even after a dismal first quarter and only tentative signs of improvement in the second quarter. Several significant contract wins and expectations that the major telecom carriers will begin to lift spending have raised optimism about ALU's performance in the second half of the year. This suggests that ALU's stock has significant rebound potential over the next 12 months.

Improved operating and financial performance is also essential for ALU to maintain adequate financial flexibility over the next several years. One of its debt issues, the \$750 million of 2.875% Convertible Senior Notes due 2025, originally issued by Lucent, is likely to come due on June 15, 2010, if holders exercise their option to put the notes back to the company as expected. The €1.0 billion 4.75% OCEANes, also a convertible debt issue, mature in 2011. The company announced last week that it had repurchased about 12% of the 2011 OCEANes and had commenced a private €1.0 billion offering 5% OCEANes due January 1, 2015, which will be convertible at a 35% premium to ALU's share price at the issue date, which is expected to be September 10, 2009. With this offering, ALU will take care of its immediate needs, but it will probably have to come back into the market sometime in 2010.

ALU still faces many challenges over the long-term. Shaky economic conditions could delay or even scuttle plans by carriers and enterprises to upgrade their telecommunications networks. More and more, ALU's customers are placing a priority on getting adequate returns on their investments. This requirement will increase as bandwidth capacity becomes less of a constraint. Ensuring the quality, reliability, security and privacy of networks will always be paramount, but ALU must also help its customers develop applications that exploit fully the capabilities of these advanced networks to help them generate more revenues. Competition in this industry, which is already tough, will get tougher, as IT-centric companies pursue similar solutions for their customers. As a result, Alcatel-Lucent's business will almost certainly change over time, hopefully in ways that will benefit both the company and all of its stakeholders.

Outstanding (U.S.) Public Securities

S&P 500: 1033.37

Amt. Outst. (\$m)	Debt / Preferred Stock	Recent Price	Coupon	Maturity	Yield	Call Date	Call Price	Conv. Price	Credit Ratings
750.0	Series A, Conv. Sen. Deb. ⁽¹⁾	98.12	2.875%	6/15/10	5.41%	6/20/10	100	16.75	B1/B+
880.5	Series B, Conv. Sen. Deb. ⁽¹⁾	82.00	2.875%	6/15/25	8.54%	6/20/13	100	15.35	B1/B+
300.0	Debentures	64.19	6.500%	1/15/28	11.11%	None	None	None	B1/B+
1,360.0	Debentures	63.50	6.450%	3/15/29	11.04%	None	None	None	B1/B+
931.0	Lucent Tech Cap Tr I Conv Pref. ⁽²⁾	745.00	7.750%	3/15/17	13.14%	Now	102.33	\$24.80	B3/CCC+

- (1) Holders of the Series A Debentures may require the company to repurchase the bonds on 6/15/10 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	Recent Price	Div. per Share	Div. Yield	Tangible Book Val.	Projected '09 EPS	P/E Multiple	Projected '10 EPS
2,259.1	Alcatel-Lucent ADS (N:ALU)	\$3.71	None	None	(\$1.69)	(\$0.11)	NM	\$0.15

© 2009 by Lark Research, Inc. All rights reserved. Duplication without permission is prohibited.

FOR INFORMATIONAL PURPOSES ONLY. The information contained in the report has been obtained primarily from a variety of sources which the author believes to be reliable. However, the author does not guarantee accuracy or completeness. This report is published solely for informational purposes and is not to be construed as a solicitation of an offer to buy or sell any security. All opinions offered represent the author's judgment as of this date and are subject to change without notice. Delivery of this report shall not under any circumstances create any implication that there has been no change in the information provided herein from the date of this report which is September 9, 2009.

Positive Investment Considerations

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 has a strong position from which to develop and implement new solutions that can enhance network performance.

Significant expertise across a wide range of telecommunications technology platforms. The company has the 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 maximize the return on their investments.

Most of the heavy lifting in integrating Alcatel and Lucent is now complete. The company has decided upon which products and services to focus and which to exit or de-emphasize. It has reduced redundant staff and shrunk its overall operations to a level that supports its expectations for future baseline revenues and growth. This process has lowered its breakeven significantly. Most of its focus now centers upon developing new technologies and competing effectively in the marketplace.

New management has acted swiftly to address remaining problems and fine tune its strategic focus. It has installed new officers in a matrix organization that should help to achieve a proper balance among products, geography and functional approach. This should facilitate the development of customized solutions that meet the specific needs of its customers.

Strong positions in a few key product areas. ALU is the market leader in **digital subscriber lines (DSL)**, which use existing copper telephone lines to deliver broadband service to households and businesses; **CDMA**, a second generation wireless technology; **WiMAX 802.16e**, a wireless broadband transmission technology that serves mobile users and as an fixed alternative over the last mile of service; and terrestrial and submarine (fiber) **optical transport** systems. The company is also among the top three providers of key technologies, such as **GSM/GPRS/Edge** Radio Access Networks, **W-CDMA** Radio Access Networks (both of which are 3G technologies), and **IP/MPLS** (MultiProtocol Label Switching), where its 100-gigabit-per-second edge routers are used to speed the delivery (and enhance the quality) of video over the internet. Although several of these technologies are mature (and therefore suffering declining sales), ALU's large installed base provides it with opportunities to generate service revenues and give it an edge in competing for new business to deploy the latest generations of these products and new technologies.

Demand for telecommunications equipment and services is likely to rise in the second half of 2009 and into 2010. During the height of the financial crisis and the sharp economic slowdown that followed, many telecommunications carriers scaled back on their capital spending because of concerns about the availability of financing and the strength of future customer demand. As the financial markets have returned to normal and signs of economic recovery have appeared, these carriers have reinstated their capital budgets. Many will make up for earlier cutbacks during the second half of 2009.

Recent project wins and a new alliance with Hewlett-Packard. In recent months, the company has announced (1) a \$1.7 billion frame agreement for the deployment of 3G CDMA networks by China Mobile and China Telecom. As part of this arrangement, ALU recently announced that it would build an IP backbone for China Telecom to deploy advanced broadband service across 10 provinces.; (2) the formation of a joint venture with India's Bharti Airtel to manage Bhart's broadband and telephone services and help it transition to next generation networks; and (3) the construction of a LTE backhaul network, using ALU's next generation optical platform, for Japan's NTT Docomo. In June, ALU announced the formation of a 10-year global alliance with Hewlett-Packard (N:HPQ) to help customers manage the convergence of telecommunications and IT. As part of this agreement, ALU will outsource its IT operations to HP.

Management anticipates that company will post breakeven operating profit in 2009 and modest profits in 2010 with mid-single digit revenue growth. It has left this guidance unchanged from the beginning of the year despite a dismal first quarter and lackluster second quarter results. Anticipated capital spending

increases in the 2009 second half by the major carriers coupled with recent contract wins by the company support management's guidance. Consensus expectations anticipate that the company will become profitable in the 2009 fourth quarter and for all of 2010.

Key Concerns

Product offerings lag behind competitors in some key areas. Most telecommunications industry analysts think that ALU's LTE product offering is not as robust as LM Ericsson's. Although ALU is undoubtedly focused on developing its LTE portfolio, it may take some time to catch up. Nevertheless, the company was the only vendor selected by Verizon for all three phases (radio access network, the enhanced packet core and the IP Multimedia Subsystem) of its initial trials. It was also the first (and still the only) vendor to receive certification from the FCC for its LTE base stations for the 700 Mhz band. It appears, therefore, that ALU's current LTE offering is good enough for now. Delayed implementation of LTE, especially by carriers that have recently made significant investments to upgrade data capabilities on their 3G networks, will give ALU some time to catch up. Even so, tough competition will make it difficult for a company like ALU to remain the market leader in all of its products.

Tough competition. The telecommunications equipment industry already has a host of tough competitors, including Ciena, Cisco, Ericsson, Juniper Networks, Motorola, Nokia Siemens Networks and Tellabs, among many others. The final frontier of telecommunications and IT convergence may very well bring more competitors into the arena, including IBM, Microsoft and many others. ALU's relationships with major carriers and its expertise across a wide range of telecommunications technologies give it a strong competitive position, but there may not be enough business to satisfy everyone, especially if the global economy remains weak, which could hurt pricing and profit margins.

Market for telecommunications services is saturated in most developed economies which may limit capital spending growth by major service providers. By most tallies, 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 continue to send text messages, download ring tones, listen to their favorite mp3 recordings and watch U-Tube videos with as much fervor, if their incomes are squeezed. For now, these seemingly trivial services are helping to fund the development of these advanced data networks. In the future, though, the growth of business services, such as smart metering, remote health care monitoring and video conferencing, will likely pay the freight, but implementation of these services could also be delayed in a tough economy.

Financial flexibility is only adequate. At June 30, ALU had €4.2 billion in cash and marketable securities and an unused €1.4 billion bank facility against €4.8 billion of debt. A \$750 million debt issue will likely be repaid on June 15, 2010, if holders exercise their option to put their Notes back to the company, as expected. Another €1.0 billion of 4.75% OCEANes (i.e. convertible debt) comes due in 2011. This week, the company announced that it had repurchased 11.97% of the 2011 OCEANes and had launched a private offering of €1.0 billion of 5% OCEANes due January 1, 2015. The new issue will address the company's immediate debt repayment needs and strengthen its financial position. ALU will probably still want to come back into the capital markets sometime in 2010 to refinance the 2011 OCEANes.

Cash flow performance has deteriorated over the past four quarters. ALU's net debt position has worsened over the past year. Most of this year's cash outflows appear to be due to the reduction in accounts payable, which is a good thing. Management says that it expects to generate positive cash from operations during the second half of 2009, mostly through its management of working capital. If so, this will alleviate most of these concerns, but investors should still pay attention to the company's cash flow performance going forward.

Significant pension and other post-retirement benefit obligations. The net funding position of ALU's pension and post-retirement health care benefit obligations deteriorated in the recent stock market sell-off. Still, the company did not fare as badly as many other companies because 60% of its pension fund assets were invested conservatively in fixed income. In addition, the stock market rebound over the past two months should result in an improvement in this funding position when the company reports third quarter

results. Even so, total pension and retiree benefit payments are running at about €2.5 billion annually, most of which are due to the acquisition of Lucent. While the pension fund has significant assets to meet its obligations, health care benefit payments have been dependent in recent years on transfers of pension fund surpluses. If the performance of the pension fund deteriorates, ALU may have to fund retiree health care benefits in the future, if it does not succeed in reducing them.

Business Overview

Alcatel-Lucent was formed in November 2006 by the merger of Alcatel and Lucent Technologies. Both companies were global suppliers of telecommunications equipment and services. Alcatel derived the largest portion of its revenues from Europe, while Lucent sourced most of its business in the United States. Against a backdrop of sluggish industry sales, 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 surely seen as impartial. The economic slowdown added urgency to the need to resolve outstanding disagreements and cut costs. In November, Mr. Verwaayen announced a new matrix organization intended to provide the proper balance among championing products, managing relationships and creating customer solutions. In December, 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 in 2009 and 2010.

As a service provider to major telecommunications carriers, ALU has developed expertise across a wide range of old and new technologies. Over time, this has strengthened its ability to integrate new technologies into legacy systems. This has helped customers achieve the necessary boost in network performance at the lowest cost; but it also 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 will continue to support areas in which it is a market leader. These include Internet Protocol (IP) routers and switches, optical networking (both terrestrial and submarine), broadband access and the IP Multimedia Subsystem (IMS) for carriers' core networks. At the same time, it will streamline its 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 will also boost its investment in important growth areas, such as Long-Term Evolution (LTE), the emerging 4G wireless technology standard that will increase the capacity and speed of wireless networks. Major carriers in mature wireless markets around the globe will upgrade their networks to LTE over the next several years. This will allow them to handle the increases in traffic expected from the growth in use of smartphones, such as Apple's iPhone. ALU's product offering for LTE is not thought to be as robust as its competitors (including LM Ericsson), but it has still been invited by its major customers, such as Verizon and AT&T, to participate in initial LTE trials.

IMS core, another area targeted for growth, has so far been a disappointment. This technology, which promises a more efficient handling of all types of IP traffic (data, voice and video) has been slower on the uptake than ALU had anticipated. ALU's major customers have apparently been able to address specific service needs so far without undertaking a full implementation of IMS core. However, many product trials are still ongoing, so hopefully sales of this product will rise over time, as IP traffic continues to grow and the global economy improves. ALU still believes that this product has good growth potential.

Overarching this product strategy is ALU's belief that it must continue to emphasize products and services that improve the "web" experience of end-users while also maximizing its customers' return on investment. It believes it can achieve this goal by helping its customers provide new and evolving Web 2.0 interactive services, such as social networking and video sharing, on networks that are secure, reliable, high quality and protect privacy. Over time, this is the way that ALU believes that carriers and their major business customers will be able to charge end-users for content.

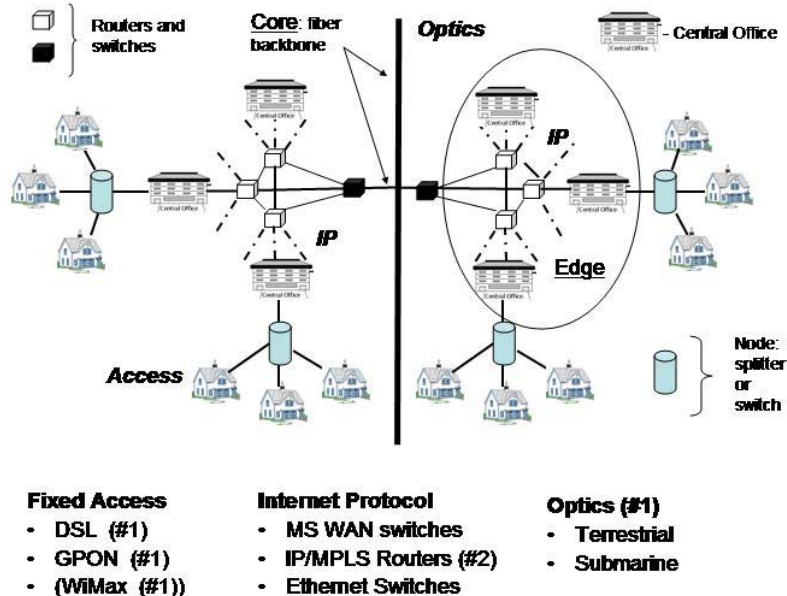
This is a lofty goal, in my mind, because it effectively presumes that governments will compromise their stance on network neutrality (where all users enjoy the same access and quality of service). It may, however, be the only outcome that guarantees a reasonably bright future for network and content providers.

Business Segments. In 2009, ALU changed its business segment reporting to reflect changes within its organization. Prior to the changes, the company operated in three business segments: Carrier, Enterprise and Services. In 2009, it added a fourth segment, Application Software.

Carrier: (68% of 2008 revenues) Over the past 40 years, analog-based, circuit-switched telephone networks have been upgraded and expanded, paving the way for the so-called "triple play" offerings of voice, video and data. Digital technology has mostly replaced analog in the network core (i.e. the trunk lines between central exchange offices). Digital has also replaced analog in the connections between the neighborhood "node" and the central exchange office. However, analog-based, twisted-pair copper wires are still the predominant means of delivering service over the last mile of connections to each subscriber's location. Wireless technology has also grown rapidly, making new services available and challenging land-based ones.

Over the years, Alcatel-Lucent has helped its core customers, the major telecommunications carriers, evolve and grow their networks. The company has pursued leading positions in new technologies that offer good growth prospects, while managing the decline in older technologies. These new technologies have at first replaced only a portion of the networks and so had to be integrated into them. For example, most major carriers are well on their way to upgrading the core of their networks to IP-based digital technology and are now working on bringing IP to the edge of their networks, as well.

So ALU must be an expert in both new and older technologies. It must have a strong position in emerging technologies that promise to raise the capacity and capabilities of its customers' networks. It must also devise ways of upgrading networks that provide its customers with the greatest return on their investments.



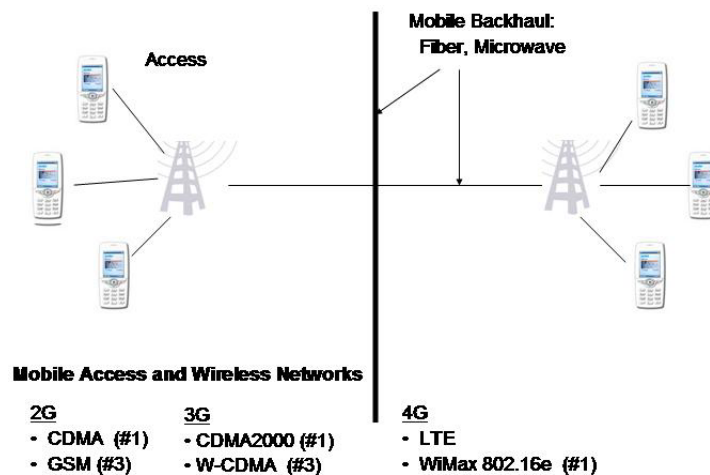
Internet Protocol. ALU has become one of the top three providers of **IP/MPLS edge routers**, (used primarily to send data from the edge of a telecommunications network to the core). It gained a solid footing in this segment with the acquisition of TiMetra Networks in 2003. Today, Alcatel generates over \$1 billion annually from the sales of these routers. For a time, its 100-gigabit edge routers were the fastest offered, but competitors like Cisco and Juniper Networks are now catching up.

Still, ALU is pushing to protect and grow its market share. In a pre-emptive move, the company has announced that it will be the first to offer 100 gigabit per second Ethernet interfaces for its networking gear. These interfaces, available in the form of line cards, will be available in mid-2010. They bring 100 GB speeds to the network edge, giving carriers greater ability to manage the rapid growth in bandwidth demand for both premium services, such as Virtual Private Networks and IPTV, and non-premium web-based video.

IP Fixed Access. Fixed access is the means by which users in a fixed location access a telecommunications network. ALU is the leader in Digital Subscriber Lines (DSL) with 41% of 2008 industry revenues. DSL provides broadband service over traditional, copper twisted-pair wires. On the whole, DSL is a mature technology. Declining sales of DSL were a big factor in the Carrier segment's overall drop in 2009 first half revenues. However, some of the decline has been offset by the growth of VDSL or Very high bitrate DSL, the latest incarnation of this broadband access technology. VDSL allows carriers to offer triple-play services over copper wires. (AT&T's UVerse is one example of a VDSL implementation.)

ALU is also the leader in Gigabit Passive Optical Networking (GPON). It captured 46% of 2008 revenues of GPON Optical Line Termination gear. The company is also a leader in P2P fiber solutions, an alternative to GPON OLT. Overall, the fiber access market will continue to grow worldwide, but carrier spending may shift over time. For example, Verizon will spend less on new geographic market expansion with its FIOS network to focus more growth within existing markets. ALU's GPON sales to Verizon may therefore drop overall, but they will also shift to capture more business from fiber access.

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 **terrestrial and submarine fiber optic cable** networks, with a 22% market share in 2008, according to Ovum. 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, such as digital television broadcasting, the U.S. Dept. of Defense and utilities.



CDMA. ALU is the worldwide leader in CDMA with a 42% market share in 2008, according to DelP'Oro. A 2G technology, CDMA is considered to be technologically superior to GSM; but it has been deployed in less than 15% of total installations worldwide. Even so, CDMA may still be a cost effective choice for providing mobile telephone services in developing countries. For example, India's CDMA market may grow rapidly once operators there adopt the Open Market Handsets initiative that allows

subscribers to choose from a wider range of available handsets and keep their existing handsets when changing carriers. The latest version of the 2G technology, CDMA 1X Advanced, raises the voice capacity of the network from 40 to 160 simultaneous calls over a single 1.25 MHz channel. As a result, many carriers may decide to maintain their existing CDMA voice networks in order to devote as much capacity as possible to data on their 3G/4G networks.

ALU is also a leader in **CDMA2000**, the leading 3G technology, with over 463 million subscribers worldwide in 2008, according to the CDMA Development Group. ALU says that the technology gives operators an upgrade path to increase both capacity and coverage at minimum cost. Recent enhancements to the **1XEV-DO** upgrade on CDMA2000 networks have added two-way, real-time data applications, such as mobile video, push-to-talk and VOIP. Operators will soon be able to increase throughput performance significantly with minimal upgrades.

Yet, ALU believes that the market for CDMA infrastructure is mature and declining. It is therefore investing to sustain its CDMA revenue, while shifting its focus to 4G. It is seeking to maximize its customers' return on investment by providing cost-effective enhancements to capacity, security and reliability on EV-DO networks, utilizing high efficiency equipment and other assets that are 4G-ready.

Mobile Access. ALU offers several other mobile access technologies. The company is the third largest provider of **GSM**, the 2G standard that has an 80%+ market share worldwide, and includes technology upgrades such as GPRS/EDGE. ALU is also the third largest provider of W-CDMA (also known as 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.

W-CDMA has facilitated the growing use of smartphones, such as Apple's iPhone, because of its broadband service capabilities, which can handle e-mail and other data services. Further enhancements to the technology, along with flat-rate pricing has caused data traffic volume to surge. Recent experience shows, for example, that iPhone subscribers are using 10 times the amount of network capacity as the average smartphone user. Netbooks and other new smartphone devices just now coming on to the market or still under development will raise data traffic demands further. This will push wireless carriers to expand capacity and speed up the shift to 4G technology.

Included in the Mobile Access division is ALU's **Long-Term Evolution** business. LTE is a 4G technology that promises to boost network data capacity sharply, while at the same time minimizing operating expenses and capital expenditures. The rollout of LTE by major telecommunications carriers is just now getting underway. In the U.S., its adoption has been facilitated by the carriers' purchase in 2008 of the 700 Mhz spectrum, formerly held by television broadcasters.

It is not clear just how fast LTE networks will be deployed. Verizon Wireless is moving rapidly to deploy LTE. It currently has several LTE trials underway and expects to roll-out the service nationwide, beginning in mid-2010. AT&T is likely to move more slowly, because it has spent a lot to implement **HSPA+** technology, a 3G data standard, which gives its existing network many of the capabilities offered by LTE. Even so, AT&T will likely begin its rollout of LTE in 2011.

Although many trials are underway, it appears that, except for TeliaSonera in Norway and Sweden, European carriers will likewise begin implementing LTE in a year or two. The same is true for Asia, except for NTT Docomo and KDDI in Japan, who will be early adopters.

It is still unclear how ALU will fare in winning LTE business. Most industry analysts view the Swedish telephone giant LM Ericsson (Nasdaq: ERIC) as the front runner in this technology. Ericsson made the decision in 2005 to exit CDMA in 2005 in order to focus on LTE. Yet, ALU was the first to receive certification from the FCC for its LTE product offering; so it obviously has a viable product.

Winning new business in LTE is not just about technological superiority. ALU has been invited to participate in most LTE trials. It 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).

Yet, most of the demand generated from sites such as U-Tube and Hulu, it seems to me, can be characterized as non-essential. If the economy remains weak and consumers are pinched further, and

especially if the cost of accessing these services rises, then demand growth could slow considerably. In the long-run, services geared toward businesses, such as video conferencing, smart metering and remote health care monitoring, will likely prove to be more stable and also have greater growth potential.

In an April 2009 report, Infonetics Research has forecast that the LTE infrastructure market could grow to \$5 billion by 2013. The telecommunications consultancy points out that the transition to new spectrum along with the adoption of a flatter, IP-centric architecture, will result in a more substantial and rapid deployment than the transition from 2G to 3G. It forecasts that LTE subscribers could reach 72 million worldwide by 2013, if carriers follow through with their spending and transition from HSPA and EV-DO 3G networks, as planned.

WiMax. ALU is the market leader in WiMax 802.16e, with a 30.2% share of base station revenues in 2008, according to Infonetics Research. As part of its new strategic focus in 2008, the company announced that its WiMax activities would be focused on addressing the “enhanced Wireless DSL” market opportunity. WiMax is a broadband access technology for mobile devices, such as netbooks and smartphones. It is also potentially a fixed access option for residential PC use. WiMax will serve as a lower cost option for delivering broadband in a landline network, especially in remote areas. It may even serve as a cost effective approach in developed areas. (For example, AT&T, which adopted a Fiber-to-the Node (FTTN) strategy in enhancing its landline network might conceivably see WiMax as a better alternative than extending Fiber-to-the Premises (FTTP), the approach used by Verizon for FiOS.) Since 2004, the company has had a partnership with Intel for the development of end-to-end product offerings using WiMax. In 2008, it entered into 34 commercial contracts for WiMax networks, about a third of which are already in operation.

Multicore. The division produces TDM switches, used in classic telephone networks. ALU is the market leader in TDM switches, supporting about 25% of the installed lines globally, but this business has been declining as carriers transition to IP-based technologies.

The company also has IP/NGN (Next Generation Networks) and IP Multimedia Subsystem (IMS) offerings. It has installed its IP/NGN products on 275 fixed and mobile networks around the globe. IMS is used to carry voice, video and data traffic over fixed, mobile and convergent networks. Like 4G, IMS is seen as the holy grail for core network technology. Consequently, IP/NGN is being phased out in favor of IMS. Yet, IMS has been slow on the uptake. At the end of 2008, the company had 30 full IMS network transformation projects underway, so it still has great hope for this emerging standard.

Summary. As a result of declining revenues associated with the cutbacks in customer spending and the rationalization of its product line, the Carrier segment has not posted a profit since the acquisition of Lucent. However, with recent cost cutting initiatives, a more focused product portfolio and an anticipated pick-up in spending by carriers in the second half of 2009, it should return to profitability soon. Although concerns have been raised about the competitiveness of its LTE product offering, the company has strong relationships with carriers around the world and a deep understanding of the structure of their mobile communications networks. Recent contract wins by ALU to provide a LTE mobile backhaul network for NTT Docomo, 3G wireless networks for China Mobile and China Telecom, IP and optical solution for Vietnam Telecom Network and a 100 GB backbone for Qwest all testify to ALU’s strong relationships and market position. The company also has leading market positions across a broad range of products, including those, such as IP routers and IMS, that are at the forefront of network evolution.

Application Software (No revenue breakdown provided in 2008). ALU created this fourth business segment at the beginning of the year by taking the various software businesses from each of the other three segments. Its largest business is the Genesys contact center software business (www.genesyslab.com) taken from its Enterprise segment.. From the Carrier segment, it inherited the Applications Software Group, which consists of (1) multimedia and communications related services, such as IPTV and mobile TV; (2) payment services, which offer solutions like premium telephone numbers, number portability for mobile telephone subscribers and “smart-metering” for utilities; (3) messaging services and (4) subscriber management services. From the Services segment, it got the Operations Support Systems and Business Support Systems (OSS/BSS) software business.

The segment was created to focus on new services and applications that can be provided over technologically sophisticated networks. It aims to develop solutions that help businesses engage their

customers more proactively and develop new revenue generating opportunities, like wireless advertising. Genesys, for example, focuses on utilizing all forms of customer communications to help distribute workloads throughout the organization and prioritize marketing approaches. The segment is also pursuing product development strategies in a number of industry verticals, like financial services and health care.

Although revenues are up slightly so far this year, profits are down, owing to higher R&D costs and the delayed impact from cost cutting initiatives. With the economic recovery, ALU expects that Applications Software will become a significant profit contributor over time.

Enterprise. (9.1% of 2008 revenues) This segment's product portfolio includes communication infrastructure for voice, local, wide and wireless networks and communications-enabled business solutions, such as Unified Communications. Although ALU brings many of the products and skills developed in its Carrier group to Enterprise, it faces much more competition in this segment from information technology (IT)- focused companies, such as IBM, Cisco, Oracle and Dell.

Accordingly, the company announced in June the formation of a 10-year global alliance with Hewlett-Packard to "transform communications networks into converged, next generation infrastructures." This will enable service providers to develop and deliver new revenue-generating services. Although the products and services that spring from this alliance will undoubtedly be utilized by major telecommunications carriers, I see this initiative as targeted more toward enterprises and local service providers. The alliance will also offer services to manage new and existing infrastructures for customers looking for alternative sourcing options. (In addition, ALU will outsource the management of its IT infrastructure to HP, as part of this agreement.)

The alliance is subject to execution of a definitive agreement. In the press release, the companies say that they expect that the alliance will lead to the generation of multi-billions of Euros in revenues over its 10-year term. Since the merger of information and communications technology does seem to represent the "final frontier," this alliance appears to be right on point for the times. Other similar alliances and/or mergers may be forged between IT and telecom equipment suppliers in the future.

At this time, however, the Enterprise segment is having a difficult year, as customers have cut back on their spending in response to the recession. Some analysts have suggested that ALU does not have sufficient scale here, so it should exit the business in order to concentrate on its core carrier customers. I believe that ALU needs to maintain a position in the Enterprise business, however, because helping enterprises is also the main focus of its core customers, the major telecommunications carriers. Hopefully, the alliance with HP will help ALU realize the potential of this business segment, especially in key vertical markets.

Services. (20.3% of 2008 revenues). The Services segment previously included five services areas: (1) *IP Network Transformation* provides assistance to customers in the development of and migration to IP network infrastructures; (2) *Multivendor Maintenance* helps customers manage in a multivendor network environment by helping to diagnose and resolve network problems and providing spare parts; (3) *Systems & Applications Integration* offers consulting services to assist in integration efforts and also to develop new and innovative services; (4) *Managed Services & Networked Operations* allows customers to outsource the operations of their networks; and (5) *Selected Verticals* currently targets customized service offerings for transportation, energy and the public sector.

In 2009, however, it appears that the company has reorganized these operations into three groups: Managed & Outsourcing Solutions, Network and System Integration and Maintenance.

Revenues in the Services business have grown steadily over the past three years. As customers have cutback their capital spending, they have increased their services spending in order to maximize network operating efficiency and accommodate growing end-user data demand. In the first half of 2009, revenues increased nearly 14%, while all other segments reported revenue declines.

Yet, the segment posted an operating loss in the 2009 first quarter due to the mix of service revenues (more lower margin, managed services and less higher margin, network and systems integration) and start-up costs associated with new managed services contracts. Profitability rebounded in the second quarter and management expects further improvement for the balance of the year.

This is the first half of my report on Alcatel-Lucent. For the complete report, which includes a detailed financial review and projections, please contact me directly.

Stephen P. Percoco
Lark Research, Inc.
P.O. Box 1409
Mashpee, MA 02649

(732) 763-0763
spercoco@larkresearch.com