Management's Discussion and Analysis

Introduction and Overview of Business

Tellabs designs, develops and supports telecommunications networking products. We generate revenue principally through the sale of these products to communications service providers worldwide as both stand-alone network elements and as elements of integrated solutions. We also generate revenue by providing services to our customers. We operate in three business segments: Broadband, Transport and Services.

The Broadband segment includes data, access and managed access product portfolios that facilitate mobile communications, wireline business services and bundled consumer services.

- Revenue from data products is driven by the need for wireless and wireline carriers to deliver next-generation mobile voice and Internet services and business-oriented voice, video and Internet services.
- Revenue from access products is primarily driven by the need for wireline carriers to deliver bundled voice, video and Internet services to residential customers.
- Revenue from managed access products is driven by the need for wireless and wireline carriers to deliver mobile voice and Internet services and business-oriented voice, video and Internet services.

The Transport segment includes optical networking systems, digital cross-connect systems and voice-quality enhancement products. Revenue for these products is driven by the needs of wireless and wireline carriers to deliver mobile services, business-oriented services and residential services.

The Services segment includes deployment, support, training and network design/consulting services. Revenue from deployment, support and training services arises primarily from the sales of products and continues to represent the majority of Services revenue, while network design/consulting services is the fastest growing part of the Services portfolio.

Tellabs operates in a dynamic industry. Customer consolidation, primarily in North America, has reduced overall industry capital spending, which has resulted in increased pricing pressure. In addition, customer spending is pressured and competition is heightened on a global basis by the current economic situation. Some equipment suppliers have consolidated in recent years. Heightened competition by these suppliers has also resulted in increased pricing pressure for Tellabs and some of its direct competitors.

Within this backdrop, we continue to transform the company with new products and services. The company is evolving from a business based primarily on the circuit-switched Time Division Multiplexing (TDM) technology used in our digital cross-connect and managed access products to a business based on the packet-switching and Internet Protocol (IP) technology used in our data and optical networking products. These new products are taking root as service providers transform their networks with next-generation capabilities.

Some of our products carry gross profit margins lower and some carry gross profit margins higher than the corporate average. While we have significantly improved the profitability of these products over time, the mix of products in any given quarter can affect overall profitability.

Management continues to define and implement initiatives to improve overall performance. On February 5, 2009, and July 6, 2009, management initiated restructuring plans to align costs with customer spending and with current market conditions. These restructuring plans primarily implement workforce reductions. However, as a consequence of the Company's increased focus on growth markets and growth products, we expect to hire people with different skill sets as needed around the world.

On December 1, 2009, we acquired WiChorus, Inc. (WiChorus), a supplier of industry-leading infrastructure products for the mobile Internet. Under the terms of the transaction, we paid $180 million in cash for WiChorus' capital stock and vested options, and assumed unvested options. Taking into account WiChorus' $15 million cash balance, the net cash price was approximately $165 million. We believe this transaction will enable us to quickly enter a large and fast growing market with a 3G/4G mobile-network solution that complements our IP mobile backhaul portfolio.

The consolidated balance sheet at January 1, 2010, includes fair values of the assets and liabilities of WiChorus as determined under the accounting rules for purchase acquisitions. The consolidated statement of operations for 2009 includes the operating results of WiChorus from the date of acquisition.

Results of Operations

Net earnings in 2009 were $113.6 million, compared with a net loss of $930.1 million in 2008 when the company recorded a non-cash goodwill impairment charge of $988.3 million. Net earnings in 2007 were $65.0 million.

In 2009, revenue was $1,525.7 million, compared with $1,729.0 million in 2008 and $1,913.4 million in 2007. The decline in total revenue across the three-year period was primarily due to reduced revenue in the Broadband and Transport product segments.

In 2009, gross margin was 43.6%, compared with 38.2% in 2008 and 35.2% in 2007. The 8.4 percentage point improvement in gross margin across the three-year period was primarily due to profitability improvements on access products and increased data product revenue.

Operating expenses in 2009 were $572.3 million, compared with $1,630.1 million in 2008 when operating expenses included the $988.3 million goodwill impairment charge. Operating expenses in 2008 increased by $983.0 million from $647.1 million in 2007 due to the $988.3 million goodwill impairment charge.

Segment Revenue

In millions	2009	2008	2007	*2009 vs. 2008*	*2008 vs. 2007*
Broadband	$ 785.8	$ 919.9	$1,018.6	(14.6)%	(9.7)%
Transport	509.6	580.1	672.7	(12.2)%	(13.8)%
Services	230.3	229.0	222.1	0.6%	3.1%
Total revenue	$1,525.7	$1,729.0	$1,913.4	(11.8)%	(9.6)%

Geographic Revenue

In millions	2009	%	2008	%	2007	%
North America	$1,005.3	66%	$1,168.6	68%	$1,413.5	74%
International	520.4	34%	560.4	32%	499.9	26%
Total revenue	$1,527.7	100%	$1,729.0	100%	$1,913.4	100%

Segment Revenue

Revenue from the Broadband segment was $785.8 million in 2009, compared with $919.9 million in 2008 and $1,018.6 million in 2007. Across the three-year period, increased revenue from data products was offset by lower managed access and access revenue.

Revenue from data products, the Tellabs® 8600 managed edge system and the Tellabs 8800® multiservice router series, has increased each year since 2003. Data product revenue was $342.0 million in 2009, compared with $215.1 million in 2008 and $160.5 million in 2007. The 112.9% increase in data revenue across the three-year period was primarily driven by the continuing rollout of our next-generation mobile backhaul and business services solutions in multiple geographic regions. Begining in the fourth quarter of 2009, we are including the Tellabs® SmartCore™ 9100 platform with our data products. During the quarter, we began to recognize revenue from this product, which came to us through the December 2009 acquisition of WiChorus.

Access product revenue was $274.4 million in 2009, compared with $414.9 million in 2008 and $566.8 million in 2007. Revenue from the Tellabs® 1000 and 1100 Access platforms decreased across the three-year period. Revenue from the Tellabs® 1600 Optical Network Terminal (ONT) declined in 2009 after increasing in 2008. Overall, revenue from access products has declined, and will likely continue to decline, as several key customers transitioned to alternate network architectures.

Managed access revenue was $169.4 million in 2009, compared with $289.9 million in 2008 and $291.3 million in 2007. Revenue from the Tellabs® 8100 managed access system declined across the three-year period. Revenue for the Tellabs® 6300 SDH transport system declined in 2009 after increasing in 2008. Revenue from both of these products has been affected by economic weakness in Europe and Latin America. In addition, we see our customers migrating from these products to our newer data products.

Revenue from the Transport segment was $509.6 million in 2009, compared with $580.1 million in 2008 and $672.7 million in 2007. Across the three-year period, lower revenue from Tellabs® 5500 system and other digital cross-connect products was partially offset by growth from the Tellabs® 7100 Optical Transport System (OTS). Revenue from Tellabs® 3000 voice-quality enhancement (VQE) solutions, which grew in 2008, declined in 2009.

Services segment revenue increased to $230.3 million in 2009 from $229.0 million in 2008 and $222.1 million in 2007. The revenue increase is primarily due to increased support and network design/consulting services offset by a decline in deployment services revenues across the three-year period. Revenue from training services grew in 2009 after declining in 2008.

Gross Profit and Margin

In millions	2009	2008	2007
Gross profit	$665.8	$660.1	$674.3
Gross margin	43.6%	38.2%	35.2%
Product gross profit	$586.2	$588.0	$605.4
Product margin	45.3%	39.2%	35.8%
Services gross profit	$ 79.6	$ 72.1	$ 68.9
Services margin	34.6%	31.5%	31.0%

Gross Margin

Overall gross margin increased 8.4 percentage points from 2007 through 2009. Across the three-year period, product gross margins grew by 9.5 percentage points and services gross margins grew by 3.6 percentage points.

Product Gross Margin
The improvement in product gross margin in 2009 from 2008 is the result of profitability improvements on the Tellabs® 1600 ONT and increased revenue from the Tellabs® 8600 and 8800 platforms. The improvement in product gross margin in 2008 from 2007 was primarily driven by profitability improvements on the Tellabs® 1600 ONT and the Tellabs® 7100 OTS and higher levels of revenue from the Tellabs® 8600 and 8800 platforms, offset by lower revenue from the Tellabs® 5500 and 1000 platforms.

Services Gross Margin
The increase in services gross margin across the three-year period is primarily the result of growth in higher margin network design/consulting services and support services revenue, coupled with a decline in lower margin deployment services revenue. In 2008, services gross margin improvement was also offset by investments in our services business outside the United States.

Gross Margin Trend
Gross margin is different for each product and services category and for each product within a category because the actual margin depends on the specific system configurations sold as well as customer and geographic pricing differences. This variability, which tends to affect gross margin on a quarterly basis, is likely to continue.

Operating Expenses

	Expense			Percent of Revenue		
In millions	2009	2008	2007	2009	2008	2007
Research and development	$268.7	$ 305.2	$343.1	17.6%	17.7%	17.9%
Sales and marketing	165.9	170.0	176.6	10.9%	9.8%	9.2%
General and administrative	101.4	101.8	99.1	6.6%	5.9%	5.2%
Subtotal	536.0	577.0	618.8	35.1%	33.4%	32.3%
Intangible asset amortization	24.6	23.9	22.5			
Restructuring and other charges	11.7	40.9	5.8			
Goodwill impairment	—	988.3	—			
Total operating expenses	$572.3	$1,630.1	$647.1			

Decreased operating expenses in 2009, compared with 2008, were primarily due to the absence of the $988.3 million goodwill impairment. We also realized savings, primarily in the form of reduced research and development costs, from previously announced cost-reduction programs. Operating expenses in 2008 increased by $983.0 million to $1,630.1 million, compared with 2007, as the $988.3 million goodwill impairment charge and restructuring and other charges of $40.9 million more than offset savings from the previously announced cost-reduction programs. General and administrative expenses in 2008 included increased legal expenses as a result of litigation support.

Intangible Asset Amortization
Intangible asset amortization increased slightly in 2009 from 2008 due to the amortization of developed technology acquired in our acquisition of WiChorus. Intangible asset amortization increased slightly in 2008 from 2007 as we reduced the estimated useful lives of some of our developed technology and customer relationships due to revised sales projections related to access products and customers. In addition, we took a charge of $0.6 million for impaired developed technology related to the Tellabs® 1100 access platform in 2008 due to reduced demand.

Restructuring and Other Charges
Since 2007, we have consistently reduced expenses to align costs with market conditions and lower revenue. In 2009, restructuring and other charges consisted primarily of severance and facility- and asset-related charges. In 2008, restructuring and other charges consisted primarily of severance, facility- and asset-related charges and charges for the consolidation of several facilities. In 2007, we consolidated research and development into fewer locations to better align resources with strategic business objectives.

Goodwill Impairment
In the third quarter of 2008, we performed an interim review on all three operating segments because our market capitalization was less than book value for a sustained period and we continued to face challenging market conditions. As a result of the interim review, we recorded a goodwill impairment charge of $988.3 million, of which $594.2 million related to the Broadband segment and $394.1 million related to the Transport segment, completely eliminating their goodwill balances. The Services segment did not incur an impairment of its goodwill because the fair value of the segment was determined to be greater than the carrying value.

*Segment Profit**

In millions	2009	2008	2007
Broadband	$185.7	$115.7	$ 39.1
Transport	139.4	178.0	237.5
Services	81.8	75.5	72.2
Total segment profit	$406.9	$369.2	$348.8

* We define segment profit as gross profit less research and development expenses. Segment profit excludes sales and marketing expenses, general and administrative expenses, the amortization of intangibles, restructuring and other charges, the impact of equity-based compensation (which contains restricted stock and performance stock units granted after June 30, 2006, and stock options), and the goodwill impairment charge.

Broadband segment profit was $185.7 million in 2009, compared with $115.7 million in 2008 and $39.1 million in 2007. The $146.6 million increase in Broadband segment profitability across the three-year-period was driven primarily by margin improvements associated with the Tellabs® 1600 ONT, higher revenue from data products and reduced research and development expenses.

Transport segment profit for 2009 was $139.4 million, compared with $178.0 million in 2008 and $237.5 million in 2007. The decrease in segment profit across the three-year period was primarily due to lower revenue from Tellabs® 5500 system and other digital cross-connect products, which carry gross margins higher than corporate average, partially offset by growth in the Tellabs® 7100 OTS, which carries gross margins below corporate average.

Services segment profit was $81.8 million in 2009, compared with $75.5 million in 2008 and $72.2 million in 2007. Services segment profit increased by $6.3 million in 2009, compared with 2008, due to a decline in lower-margin deployment services revenue. Services segment profit increased $3.3 million in 2008 from 2007 due to increased revenue from higher-margin professional and support services, partially offset by lower-margin deployment services.

Other Income

In millions	2009	2008	2007
Interest income, net	$19.3	$ 34.8	$50.9
Other income (expense), net	0.4	(17.3)	(7.9)
Total other income	$19.7	$ 17.5	$43.0

Interest income, net, decreased in 2009 compared with 2008 due to lower yields during 2009, compared with 2008. *Other income (expense), net,* improved in 2009 from 2008 as a result of gains on sales of investments in marketable securities in 2009 compared with losses in 2008. *Other income (expense), net,* includes charges to write-down long-term equity investments in partnerships and start-up technology companies. These charges were $0.4 million in 2009, $9.9 million in 2008 and $0.5 million in 2007. In addition, we had charges of $0.8 million in 2008 and $5.2 million in 2007 for other-than-temporary impairments from investments in marketable securities.

Income Taxes

In millions	2009	2008	2007
Income tax benefit (expense)	$0.4	$22.4	$(5.2)
Effective tax rate	0.3%	2.4%	7.4%

Income tax benefit was $0.4 million in 2009, compared with an income tax benefit of $22.4 million in 2008. The income tax benefit decreased due to the absence of tax benefits recorded in 2008 for the resolution of tax audits and for the goodwill impairment. This decrease in tax benefit was offset by tax benefits recorded in 2009 related to accounting for the WiChorus acquisition and a tax refund from the carry back of net operating losses. We recorded an income tax benefit of $22.4 million in 2008, compared with income tax expense of $5.2 million in 2007. The tax benefit reflects a tax provision on income from foreign operations, offset by a partial benefit on the loss from domestic operations, and a $34.8 million tax benefit, which we recorded in the second quarter of 2008, related to the resolution of domestic federal income tax audits for the period 2001 through 2005. The tax benefit on domestic operations was limited due to the valuation allowance established against domestic deferred tax assets. For a more detailed discusion of the valuation allowance established against domestic deferred tax assets, see Footnote 12 – Income Taxes.

Financial Condition, Liquidity and Capital Resources

Our principal source of liquidity remained cash, cash equivalents and marketable securities of $1,104.8 million as of the end of 2009, which decreased by $47.3 million since year-end 2008. The decrease in cash, cash equivalents and marketable securities for the full year 2009 is the result of $164.7 million in net cash used for the acquisition of WiChorus and cash used to repurchase common stock and for normal capital expenditures, offset by cash generated from operating activities. In 2009, we generated $234.4 million of cash from operating activities, compared with $130.8 million in 2008 and $133.4 million in 2007.

In 2009, we repurchased 12.9 million shares of common stock at a cost of $82.9 million. We provide no assurance that we will continue repurchase activity and we may change repurchase activity in the future. We cannot estimate the timing of any such change or the impact on cash, cash equivalents and marketable securities.

The majority of our investments are backed by governments or government agencies. We believe that our investments are highly liquid instruments. We may rebalance the portfolio from time to time, which may affect the duration, credit structure and future income of investments.

On January 25, 2010, the Board of Directors approved a cash dividend of $0.02 per share of outstanding common stock payable on February 26, 2010, to stockholders of record as of the close of business on February 12, 2010. The dividend will yield approximately 1.36% annually based upon the stock price on the declaration date. Any future quarterly dividend payment must be approved by the Board of Directors, therefore, we cannot provide any assurance of future dividend payments.

Based on historical performance and current forecasts, we believe the company's cash, cash equivalents and marketable securities will satisfy working capital needs, capital expenditures and other liquidity requirements related to existing operations for the next 12 months. Future available sources of working capital, including cash, cash equivalents and marketable securities, cash generated from future operations, short-term or long-term financing, equity offerings or any combination of these sources, should allow us to meet long-term liquidity needs. Current policy is to use cash, cash equivalents and marketable securities to fund business operations, to expand business, potentially through acquisitions, to repurchase common stock or pay a cash dividend.

Contractual Obligations

The following table sets forth an overview of contractual obligations, as of January 1, 2010, that will affect our liquidity and cash flows in future periods:

		Payments Due by Period			
In millions	Total	Less than 1 Year	1–3 Years	3–5 Years	More than 5 Years
Operating lease obligations	$ 27.1	$ 8.8	$10.1	$ 5.6	$1.8
Operating lease obligations related to restructuring activities, net	17.2	5.8	5.9	4.5	1.0
Purchase commitments to contract manufacturers and suppliers	160.8	160.8	—	—	—
Loan related to other marketable securities[1]	252.8	252.8	—	—	—
Borrowing fees on loan related to other marketable securities[2]	8.4	1.5	3.0	3.0	0.9
Total contractual obligations	$466.3	$429.7	$19.8	$13.1	$3.7

1 Our agreement with the lender of the stock has no defined date when we must repay the loan; however, the loan is callable at the discretion of the lender. Our investment in Cisco stock is maintained at a value equal to or greater than the market value of the loaned securities. See Note 7 for a more complete description of this obligation.

2 For purposes of contractual obligations disclosure, we used Cisco's average share price of $23.74 for the quarter ended January 1, 2010, to determine the hypothetical value of the borrowing fees assuming the loans are settled in 2015.

We use several contract manufacturers and suppliers who provide manufacturing services for our products. During the normal course of business, we enter into agreements with certain contract manufacturers and suppliers that enable them to procure inventory based on criteria defined by us to reduce manufacturing lead times and ensure adequate component supply. Under these agreements, the maximum liability for purchase commitments as of January 1, 2010, was $160.8 million, of which $10.6 million was recorded on the balance sheet.

The borrowing fees on the loan related to other marketable securities that are recorded in the financial statements each period are affected by Cisco's average share price at the end of each quarter.

As of January 1, 2010, we had unrecognized tax benefits of $34.3 million in long-term income tax liabilities. At this time, we are unable to make a reasonable estimate of the timing of payments in individual years beyond 12 months due to uncertainties in the timing of tax audit outcomes.

Off-Balance Sheet Arrangements

None.

Critical Accounting Estimates

The methods, estimates and judgments that we use in applying accounting policies can have a significant impact on the results we report in the consolidated financial statements. Some of these estimates require difficult and subjective judgments, often as a result of the need to estimate matters that are inherently uncertain. For the reasons discussed below, we consider critical accounting estimates to be revenue recognition, the allowance for excess and obsolete inventory and excess purchase commitments (collectively E&O), goodwill and indefinite-lived intangible asset valuation, the valuation of amortizable finite-lived intangible assets, the estimate of the warranty liability, reserve requirements for lease obligations on vacated facilities, income taxes and equity-based compensation.

We have discussed the development and selection of these critical accounting policies and estimates with the Audit and Ethics Committee of Tellabs' Board of Directors.

Revenue Recognition
Determining the proper revenue recognition in our financial statements requires us to make judgments about the application of the accounting rules based on the facts and circumstances of each customer arrangement.

When a customer arrangement involves multiple deliverables, we evaluate all deliverables to determine whether they represent separate units of accounting. This approach involves a determination about:

- whether the delivered item has value to the customer on a stand-alone basis;
- whether there is objective and reliable evidence of the fair value of the undelivered item; and
- whether delivery or performance of the undelivered item is considered probable and is substantially in our control where an arrangement contains a general right of return relative to the delivered item.

The determination of whether software is more than incidental can impact whether revenue is recognized under software revenue recognition guidance or under general revenue recognition guidance. This assessment could impact the amount and timing of revenue recognition.

Many of our contracts contain customer acceptance provisions. In cases involving sales of new products, for example, we defer revenue until we receive formal customer acceptance. In cases where we can demonstrate that the product or service has met all acceptance criteria prior to formal customer acceptance, or where we have sufficient historical evidence of customer acceptance, we consider acceptance to be perfunctory, and therefore formal customer acceptance is not required. Judgment about whether acceptance is perfunctory can impact the timing of revenue for contracts containing acceptance provisions.

Excess & Obsolete Inventory and
Excess Purchase Commitments
We determine inventory cost using the first-in, first-out method, and we value inventory at the lower of cost or market, with market determined by reference to current replacement cost or net realizable selling price. We determine the amount of inventory that is excess and obsolete (E&O) and purchase commitments in excess of requirements using estimates of future demand for individual components of raw materials and finished goods.

To determine E&O, we compare listings of existing piece parts and finished goods to future product demand and usage requirements. We record a full valuation allowance for inventory quantities on hand in excess of two years' expected usage. For inventory quantities that fall between one and two years' demand, we use management's judgment to determine the appropriate E&O amount. We do not record an allowance if the quantity is less than one year's forecasted demand.

We believe the accounting estimate related to E&O is a critical accounting estimate because it requires us to make assumptions about sales volumes and product mix, which can be highly uncertain. Changes in these estimates can have a material effect on our financial statements.

Goodwill
Goodwill impairment is reviewed annually and when impairment indicators exist by comparing the segment's net book value to fair value. If the segment's fair value is greater than its net book value, then further impairment tests are not deemed necessary. If the segment's fair value is less than its net book value, then further tests are performed to determine the segment's implied fair value of goodwill. The implied fair value is then compared against the book value of goodwill to determine the level of impairment.

The process of evaluating the potential impairment of goodwill is subjective because it requires the use of estimates and assumptions. The discounted cash flow method requires us to use estimates and judgments about the future cash flows of the operating segments. Although we base cash flow forecasts on assumptions that are consistent with plans and estimates we use to manage the underlying operating segments, there is significant judgment in determining the cash flows attributable to these operating segments. The market approach is based on a comparison of the Company to comparable publicly traded firms in similar lines of business. This method requires us to use estimates and judgments when determining comparable companies. We assess such factors as size, growth, profitability, risk and return on investment.

We believe the accounting estimate related to the valuation of goodwill is a critical accounting estimate because it requires us to make assumptions that are highly uncertain about the future cash flows of our segments. The recognition of an impairment could be material to our financial statements.

Intangible Assets
We categorize intangible assets as finite-lived and indefinite-lived. Finite-lived intangible assets consist primarily of purchased technology, which arose primarily from acquisitions of businesses in 2009, 2004 and 2003. Indefinite-lived intangible assets consist primarily of in-process research and development (IPR&D), which arose from the acquisition of WiChorus in the fourth quarter of 2009.

We evaluate the carrying value of finite-lived intangible assets for impairment whenever indicators of impairment exist. Accounting standards require that if the sum of the future cash flows expected to result from a long-term asset is less than the reported value of the asset, a further review is performed to determine the asset's fair value. If an asset's calculated fair value is less than its net book value, an impairment charge must be recognized in the financial statements. The amount of impairment is calculated by subtracting the fair value of the asset from the reported carrying value of the asset.

We evaluate the carrying value of indefinite-lived intangible assets annually and when impairment indicators exist by comparing the asset's net book value to its fair value. If the asset's fair value is less than its net book value, then further tests are performed to determine the asset's implied fair value. The implied fair value is then compared with the asset's net book value to determine the level of impairment.

We believe the accounting estimate related to valuation of intangible assets is a critical accounting estimate because it requires us to make assumptions about future sales prices and volumes for products that involve new technologies and applications where customer acceptance of new products or timely introduction of new technologies into their networks are uncertain. The recognition of an impairment could be material to our financial statements.

Warranty Costs
We provide warranties for all of our products, with terms and conditions that vary depending on the product sold. We provide a basic limited warranty, including parts and labor, for all products other than access products for periods that range from 90 days to five years. The basic limited warranty for access products covers parts and labor for periods that generally range from two to six years. We record warranty expense in cost of revenue on the consolidated statement of operations. We estimate warranty liability by applying historical warranty return rates and costs per claim to the number of units shipped that are still within their warranty period. In addition, when we judge that a particular warranty claim will involve costs that are out of the ordinary, we separately estimate the costs for that claim and record the amount as an additional warranty expense for the period in which we determine we have a liability.

We believe that the accounting estimate related to warranty costs is a critical accounting estimate because it requires us to make assumptions about matters that are highly uncertain, including: future rates of product failure; repair costs, including availability of materials; shipping and handling; and de-installation and re-installation costs at customers' sites, among others. Consequently, the changes in warranty reserves could be material to our financial statements.

Restructuring Reserves – Leases
Restructuring reserves consist of amounts we owe on leases for facilities we vacated, reduced by an estimate of sublease rental income. We determined the amount of the reserve for each facility by estimating the amount of time it will be vacant before it is sublet and the terms of the sublease agreement compared with our obligation, then reducing the reserve by an estimate of potential sublease income. We examine real estate market conditions in each location where we have a vacated facility.

We believe the accounting estimate of restructuring lease obligations is a critical accounting estimate because it requires us to make assumptions about real estate rental markets and conditions that are highly uncertain, and changes in our estimates could have a material impact on our financial statements.

Income Taxes
We conduct business and file income tax returns in numerous tax jurisdictions around the world. This requires us to interpret tax laws that are often vague and uncertain, and to make judgments about the application of those laws when we prepare tax returns. When we calculate income tax expense and the related tax liabilities and assets for the consolidated financial statements, we use estimates of the amount of income, deductions and credits that we believe are allowable under local tax laws and that should be allowed by tax authorities if the tax returns are audited. However, tax authorities may disagree on the amounts of income, deductions and credits that are allowed to be included in those tax returns. This could result in paying additional taxes or receiving a refund of previously paid taxes.

Because we are a large multi-national corporation, the United States Internal Revenue Service (IRS) generally audits each of our federal income tax returns. During 2008, we reached a settlement with the IRS in connection with their examination of all tax years prior to 2006. During the fourth quarter of 2009, the IRS began its audit of our 2007 and 2008 tax periods. Of our other major jurisdictions, we are currently under audit by the State of California for the 2004 through 2006 tax periods. Although we have accrued tax and related interest for potential adjustments to tax liabilities for prior years, we cannot provide assurance that a material adjustment to our financial statements, either positive or negative, will not result when the audits are concluded.

Valuation Allowance for Deferred Tax Assets
Deferred tax assets arise when we recognize charges or expenses in our financial statements that will not be allowed as income tax deductions until future periods. The term deferred tax asset also includes unused tax net operating losses and tax credits that we are allowed to carry forward to future years. Accounting rules permit us to carry deferred tax assets on the balance sheet at full value as long as it is "more likely than not" the deductions, losses, or credits will be used in the future. A valuation allowance must be recorded against a deferred tax asset if this test cannot be met. The accounting rules state that a company with a recent history of losses would have a difficult, perhaps impossible, time supporting a position that utilization of its deferred tax assets was more likely than not to occur.

We believe that the cumulative loss incurred by the Company in the 2007 through 2009 period, represents sufficient negative evidence to determine that the establishment of a valuation allowance against domestic deferred tax assets is appropriate. Until an appropriate level of profitability is attained, we expect to maintain a valuation allowance on net deferred tax assets related to future U.S. and certain non-U.S. tax benefits.

Equity-Based Compensation

We account for equity-based compensation in accordance with the Financial Accounting Standards Board (FASB) authoritative guidance related to accounting for share-based payments. Under the fair value recognition provisions of this guidance, we measure equity-based compensation cost, at the grant date, based on the value of the award, which is recognized as expense over the vesting period. Determining the fair value of equity-based awards at the grant date requires several assumptions, and a change in these assumptions could materially impact equity-based compensation expense and results of operations. These assumptions include our stock's expected volatility, the risk-free interest rate, expected option term and expected dividend yield. In addition, we estimate the amount of equity-based awards that are expected to be forfeited.

Strategy and Outlook

Tellabs operates in a challenging, exciting industry.

In the wireline sector, telecom service providers face significant competitive threats to their most profitable residential services from cable TV providers in North America and globally from the substitution of mobile services. In an effort to counter line loss and declining voice revenues, in recent years carriers have undertaken ambitious and expensive programs to transform their wireline access networks with fiber-optic technology to deliver a bundle of voice, data and video services that is competitive with or superior to that offered by competitors. After several years of aggressive spending, carriers in North America have signalled that they are moderating investment in their wireline access networks.

On the business side, wireline carriers and cable TV service providers have also introduced next-generation data technology to deliver new business-oriented voice, video and data/Internet services to their corporate customers.

Over the past few years, wireless carriers, also under competitive pressure, have aggressively invested in network infrastructure to deliver new third-generation (3G) data-oriented services. As consumers embrace smartphones and new bandwidth-hungry mobile Internet applications, Tier 1 carriers need to expand the capacity of these networks to keep up with increasing mobile Internet traffic. Looking ahead, carriers are evaluating fourth-generation (4G) network equipment for potential deployment in 2011 and beyond.

Many carriers in North America have consolidated in recent years to achieve the advantages of scale needed to sustain such major network build outs. The remaining large carriers have gained increased pricing power over equipment suppliers such as Tellabs. This consolidation has had an adverse effect on overall capital spending by carriers.

Some equipment suppliers have consolidated in recent years to achieve the scale advantages needed to better address their consolidated customer base. Heightened competition by these suppliers has resulted in increased pricing pressure for Tellabs and some of its direct competitors.

Moreover, in international markets the presence of Asian equipment suppliers challenges our short-term ability to grow profitably. Asian equipment suppliers have significantly lower cost structures than companies such as Tellabs, particularly for research and development.

We are presented with a challenging economic environment amidst the continuing global financial recession. Expectations for capital spending levels by our customers in 2010 vary, and generally speaking, we expect overall global capital spending to increase slightly this year, as carriers continue to shift investment from delivering residential wireline services to expanding mobile network capacity.

We cannot predict how macroeconomic issues will continue to affect capital spending by our customers in 2010. While the economic environment may be challenging, we believe we are invested in the right solutions for growing markets.

Over the past few years, Tellabs has shifted its product offerings to address the strategic needs of both wireline and wireless carriers. Building on a base of successful established products, we have deployed the fiber-access and ROADM technologies needed for the delivery of combined voice, data and video services to residential customers. In addition, our ROADM products address the need to deliver next-generation voice, data and video services to corporate users. Our data products address the changing nature of wireless services and enterprise computing on a global basis. In late 2009, we expanded our data portfolio through the acquisition of WiChorus, which gives us a leadership position in the growing market for Internet-based mobile core networks.

The Company operates using a three-part strategy. Under this strategy we are:

- Focusing our development activities on the fastest growing parts of our product and service portfolio: our Carrier Ethernet and Packet Core products, our Packet Optical products and our Network Design/Consulting Services offerings.
- Innovating in growth markets where we have incumbent positions and our fastest growing products are gaining traction: Mobile, Optical and Business.
- Pursuing flawless execution as we work to improve quality, reduce costs and meet commitments.

We expect that executing this strategy of directing resources to create innovative products and services that help customers succeed will further improve our financial performance.

Since 2005, we have actively returned capital to stockholders through stock buybacks. In 2010, we announced that the Company would pay its first cash dividend to stockholders. Given new product traction and our ability to generate positive cash flow, we have resources in place to fund both organic and inorganic growth, buy back shares and provide a dividend to stockholders.

Forward-Looking Statements

Except for historical information, the matters discussed or incorporated by reference into this report, including the Management's Discussion and Analysis, may include forward-looking statements made pursuant to the safe harbor provisions of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements reflect management's expectations, estimates and assumptions, based on current and available information at the time the document was prepared. These forward-looking statements include, but are not limited to, statements regarding future events, plans, goals, objectives and expectations. The words "anticipate," "believe," "estimate," "target," "expect," "predict," "plan," "possible," "project," "intend," "likely," "will," "should," "could," "may," "foreseeable," "would" and similar expressions are intended to identify forward-looking statements. Forward-looking statements are not guarantees of future performance and involve risks, uncertainties and other factors that may cause our actual performance or achievements to be materially different from any future results, performance or achievements expressed or implied by those statements. Important factors that could cause our actual results to differ materially from those in forward-looking statements include, but are not limited to: overall negative economic conditions generally and disruptions in credit and capital markets, including specific impacts of these conditions on the telecommunications industry; financial condition of telecommunications service providers, equipment vendors and contract manufacturers, including the impact of any bankruptcies; the impact of customer and vendor consolidation; integration of a new business; successful expansion into adjacent markets with new and existing products and platforms; new product acceptance; product demand and industry capacity; competitive products and pricing; competitive pressures from new entrants to the telecommunications industry; initiatives to improve profitability that may have financial consequences, including further restructuring charges and the ability to realize anticipated savings under such cost-reduction initiatives; exiting businesses and product areas; impairment charges and other cost cutting initiatives and related charges and costs; manufacturing efficiencies; research and new product development; protection of and access to intellectual property, patents and technology; ability to attract and retain highly qualified personnel; availability of components and critical manufacturing equipment and capacity; foreign economic conditions, including currency rate fluctuations; the regulatory and trade environment; the impact of new or revised accounting rules or interpretations, including revenue recognition requirements; availability and terms of future acquisitions; divestitures and investments; uncertainties relating to synergies; charges and expenses associated with business combinations and other transactions; and other risks and future factors that may be detailed from time to time in the Company's filings with the SEC. For a further description of such risks and future factors, see Item 1A of our most recently filed Form 10-K. Our actual future results could differ materially from those predicted in such forward-looking statements. In light of the foregoing risks, uncertainties and other factors, investors are advised not to rely on these forward-looking statements when making investment decisions. These factors are not intended to be an all-encompassing list of risks and uncertainties that may affect the operations, performance, development and results of our business. We undertake no obligation to publicly update or revise any forward-looking statements to reflect changed assumptions, the occurrence of anticipated or unanticipated events or changes to future results over time. The foregoing discussion should be read in conjunction with the risk factors, financial statements and related notes and Management's Discussion and Analysis in this 2009 Annual Report.

Management's Report on Internal Control over Financial Reporting

The management of Tellabs, Inc., and subsidiaries (the "Company") is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rules 13a-15(f) of the Securities Exchange Act of 1934, as amended. Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of the Company's internal control over financial reporting as of January 1, 2010, as required by Rule 13a-15(c) of the Securities Exchange Act of 1934, as amended. In making this assessment, we used the criteria set forth in the *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under this framework, our management concluded that internal control over financial reporting was effective as of January 1, 2010. The effectiveness of internal control over financial reporting as of January 1, 2010, has been audited by Ernst & Young, LLP, an independent registered certified public accounting firm, as stated in their attestation report, which is included herein.

Bob Pullen

Robert W. Pullen
President and
Chief Executive Officer

Timothy J. Wiggins

Timothy J. Wiggins
Executive Vice President and
Chief Financial Officer

March 1, 2010

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Tellabs, Inc.
We have audited the accompanying consolidated balance sheets of Tellabs, Inc. and subsidiaries (the "Company") as of January 1, 2010 and January 2, 2009, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended January 1, 2010. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company at January 1, 2010, and January 2, 2009, and the consolidated results of its operations and its cash flows for each of the three years in the period ended January 1, 2010, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of January 1, 2010, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 1, 2010, expressed an unqualified opinion thereon.

Ernst + Young LLP

Ernst & Young LLP
Chicago, Illinois

March 1, 2010

Report of Independent Registered Public Accounting Firm on Internal Control over Financial Reporting

To the Board of Directors and Shareholders of Tellabs, Inc.
We have audited Tellabs, Inc. and subsidiaries' (the "Company") internal control over financial reporting as of January 1, 2010, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of January 1, 2010, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company as of January 1, 2010, and January 2, 2009, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended January 1, 2010, and our report dated March 1, 2010, expressed an unqualified opinion thereon.

Ernst & Young LLP

Ernst & Young LLP
Chicago, Illinois

March 1, 2010