Management's Discussion and Analysis

Introduction and Overview of Business

Tellabs designs, develops, deploys and supports telecommunications networking products around the world. Our product portfolio includes solutions for wireline and wireless transport, access networking, broadband data, optical transport and voice-quality enhancement.

We generate revenue principally through the sale of telecommunications products, both as stand-alone products and as elements of integrated systems, to many of the world's largest telecommunications service providers. In addition, we generate revenue by providing deployment and professional services related primarily to our own products and systems. In 2006, we began reporting results under three operating segments: Broadband, Transport and Services. For comparative purposes, we have included corresponding data for 2005 and 2004.

The Broadband segment includes the access, managed access and data product portfolios that facilitate the delivery of bundled triple-play services. These products enable service providers to deliver business and next-generation wireline and wireless services to their customers. We earn revenue from our Broadband segment globally. We earn a majority of our access products revenue in North America for the support of copper-based and fiber-based networks. Driving demand for access products are consumer demand for the triple play of bundled voice, video and high-speed Internet/data services in addition to competition among traditional telecommunications companies and cable service operators to be the sole source provider of triple-play services. According to industry analysts, Tellabs has a market-leading position in the North American access market. We generate the majority of our managed access product revenue outside North America. Driving demand for managed access products are business services for voice and high-speed data as well as network transport services for wireless communications. We earn revenue from our data products globally. Driving demand for data products are consumer demand for wireless and wireline carriers to deliver business services and next-generation wireless services.

The Transport segment includes our optical and digital cross-connect and transport systems. We earn a majority of our Transport segment revenue in North America. Revenue is principally derived from our digital cross-connect systems that enable service providers to transport service and manage optical bandwidth by adding capacity when and where it is needed. Driving demand for transport products are the needs of wireline and wireless service providers to support wireless services, business services for enterprises, and triple-play voice, video and data services for consumers. According to industry analysts, Tellabs has a market-leading position in the North American transport market.

The Services segment delivers deployment, support, professional consulting, training and systems integration services to Tellabs customers. These services support all phases of the network: planning, building and operating. We earn revenue from our Services segment globally. Deployment service revenue, which makes up more than half of our Services revenue, arises primarily from sales of our transport products in North America and tends to lag product sales by approximately one fiscal quarter. Revenue from support agreements arises primarily from sales of our transport systems, but can include access, managed access and data products. Revenue from our fastest-growing service, network consulting, more than doubled in 2006 primarily due to demand from North American wireless customers.

On November 30, 2004, Tellabs acquired Advanced Fibre Communication, Inc. (AFC), enhancing our Broadband product portfolio. Our results of operations include AFC's results for the one-month period in 2004 following the acquisition. These products were a significant part of our revenue growth in 2005. Sales grew sequentially each quarter during that year. This growth continued through 2006 as our Broadband product revenue increased from the previous year. To complement our acquisition of AFC, on December 30, 2004, Tellabs acquired Vinci Systems, Inc. (Vinci), a privately held developer. Through the introduction of its ONT product, we were successful at reducing the cost of ONTs in our Broadband product portfolio.

In 2006, revenue growth was broad-based. We benefited from increasing wireless and data traffic by selectively enhancing our Transport products. In addition, we continued to address new and evolving growth opportunities with our Broadband products. Within Services, we also actively pursued revenue opportunities, which have become more diversified to meet our customers' needs.

For 2007, we expect to build upon the success of our next-generation Broadband and Transport products. Within all three segments, we expect to expand our position with existing customers, add new customers in both North America and internationally, and implement cost-reduction programs to improve the profitability of our products.

Results of Operations

Our 2006 net earnings grew 10.4% to $194.1 million from $175.8 million in 2005. Net earnings for both periods were significantly improved from the $29.8 million net loss in 2004, when we recorded significant charges

related to our acquisition of AFC, asset impairments and the sale of real estate at a loss.

The inclusion of AFC for a full year in 2005 was the primary driver of the 53% overall revenue improvement from 2004 to 2005. Excluding AFC, revenue growth in 2005 would have been 7.6%. Including AFC for a full year in 2005 negatively impacted our overall margin because AFC's products carry average margins significantly below Tellabs' historical margins.

Revenue grew in all segments in 2006, resulting in an overall 8% improvement compared with 2005 consolidated revenue. Although our margin improved through the first three quarters of 2006, a combination of unfavorable product mix, lower realized prices on some Broadband products and costs related to deferred revenue in the fourth quarter caused our margin for all of 2006 to be flat with 2005.

Even though Tellabs 2005 results included AFC for the full year, consolidated operating expenses fell to 35.4% from 55.9% in 2004 in the absence of acquisition-related costs and other special charges in 2005. Our continuing focus on managing spending allowed us to reduce operating expenses in 2006 to 33.6% of revenue despite the inclusion of stock-based compensation charges in 2006 from adopting SFAS 123R.

Our effective tax rate trended back toward a more normal effective rate in 2006 as the benefit from valuation allowance reversals that impacted 2005 was exhausted.

Segment Revenue

In millions	2006	2005	2004	*2006 vs. 2005*	*2005 vs. 2004*
Broadband	$1,080.4	$1,042.1	$ 401.6	*4%*	*159%*
Transport	778.2	674.2	672.6	*15%*	*0%*
Services	182.6	167.1	157.6	*9%*	*6%*
Total revenue	$2,041.2	$1,883.4	$1,231.8	*8%*	*53%*

Geographic Revenue

In millions	2006		2005		2004	
North America	$1,548.4	76%	$1,419.4	75%	$ 813.0	66%
International	492.8	24%	464.0	25%	418.8	34%
Total revenue	$2,041.2	100%	$1,883.4	100%	$1,231.8	100%

Revenue from our Broadband segment grew in each of the past three fiscal years due to the acquisition of access products from AFC and the successful rollouts of our data products. Fiscal 2005 was the first full year of revenue from AFC in our results.

Access product revenue improved to $652.9 million in 2006 from $617.0 million in 2005 on the strength of significantly stronger volume of single-family ONT sales. The revenue gain from ONT volume was partially offset by lower sales of copper-access platforms and other fiber-to-the-premises equipment. In 2006, approximately 57% of access revenue was for fiber-based platforms, with the balance coming from copper-based platforms. This result compares with approximately 50% in 2005. We believe there was a softening in demand for some of these products related to a purchasing slowdown by major customers in advance of their pending merger. However, we are not certain that the sales volumes for these products will rebound in the near term or that the ONT growth we experienced in 2006 will continue into 2007.

Managed access revenue decreased to $320.4 million in 2006 from $364.8 million in 2005 due primarily to fewer shipments of our Tellabs® 8100 managed access systems. Comparatively, revenue increased to $364.8 million in 2005 from $331.0 million in 2004 on the strength in sales of our managed transport systems and managed access systems driven by Ethernet-over-SDH applications and 3G wireless network build-outs.

Our data products have consistently gained acceptance from customers since we introduced them in the second half of 2003. In 2006, revenue from these products nearly doubled to $107.1 million from $60.3 million in 2005. In 2005, revenue had more than tripled to $60.3 million from $17.3 million in 2004. Growth from these products is the result of a larger customer base across our global markets. Our customers include North American and international Tier 1 wireline and wireless service providers as well as cable TV operators.

Revenue from our Transport segment increased to $778.2 million in 2006 from $674.2 million in 2005 as a result of increased spending by North American wireless carriers to meet growing capacity requirements and to build out their networks to provide 3G services. Shipments to our North American wireless customers

accounted for approximately 62% of all Transport revenue in 2006, compared with 54% in 2005 and 49% in 2004. Approximately 67% of 2006 revenue from wideband cross-connect products, which constitute the majority of Transport revenue, came from port-card growth on our installed base, with the balance consisting of new systems, system expansions and system upgrades. We believe port-card growth indicates that our customers continue to invest in this platform. This compares with 69% in 2005 and 76% in 2004. We shipped approximately 10.1 million T-1 equivalents during 2006 compared with 7.3 million in 2005 and 6.4 million in 2004.

Growth in our Services segment revenue was due to increasing professional and support services that extend beyond the deployment services that have traditionally led this segment. 2006 is the first year in which professional and support services together accounted for over 50% of total services revenue.

In the later part of 2006 we experienced a slowdown in orders for some products, which contributed to our revenue being lower in the fourth quarter of 2006 than in the prior six quarters. We believe the slowdown was attributable in significant part to the pending merger of some major customers, however, we cannot reasonably estimate when or if a recovery will occur or how significant any such recovery might be.

Gross Profit & Margin

In millions	2006	2005	2004
Gross profit	$933.6	$855.0	$657.0
Gross margin	45.7%	45.4%	53.3%
Product gross profit	$871.6	$807.5	$602.1
Product margin	46.9%	47.0%	56.1%
Services gross profit	$ 62.0	$ 47.5	$ 54.9
Services margin	34.0%	28.4%	34.8%

Gross Margin

When we acquired AFC in the fourth quarter of 2004, its access products and related services had an average gross margin that was substantially below the average for Tellabs products and services. This factor is the primary driver of our overall gross margin decline from 53.3% in 2004 to 45.7% in 2006.

Product Gross Margin

Product gross margin was relatively flat from 2005 to 2006 since the benefit from lower manufacturing costs was offset by an unfavorable product mix. Product gross margin declined from 2004 to 2005 primarily due to the inclusion of lower-margin access products in 2005 (10.5 percentage points), which was partially offset by lower manufacturing costs.

Services Gross Margin

Services gross margin improved in 2006 due to a change in mix toward support and professional services, which have higher margins. The decrease in services gross margin in 2005 compared with 2004 was primarily due to the addition of services related to access products in 2005 (8.2 percentage points) and higher material costs.

Gross Margin Trend

Our gross margin will continue to be subject to variability due to product mix. Our 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. Over the past few years, this variability has tended to affect our gross margin in the range of 2 to 3 percentage points up or down. Due to the broadened diversity of our products' margin, variability of gross margin may increase.

Operating Expenses

	Expense			Percent of Revenue		
In millions	2006	2005	2004	2006	2005	2004
Research and development	$356.9	$344.0	$250.3	17.5%	18.3%	20.3%
Sales and marketing	179.8	175.5	155.1	8.8%	9.3%	12.6%
General and administrative	113.5	95.6	81.5	5.6%	5.1%	6.6%
Subtotal	650.2	615.1	486.9	31.9%	32.7%	39.5%
Intangible asset amortization	28.6	36.0	17.8			
Restructuring and other charges	8.0	12.9	14.1			
Purchased in-process R&D	—	2.2	102.1			
Asset impairment charge	—	—	47.2			
Net loss on sale of real estate	—	—	20.6			
Total Operating Expenses	$686.8	$666.2	$688.7			

The increase in research and development, sales and marketing, and general and administrative expenses from 2005 to 2006 is due primarily to the inclusion of $32.5 million of stock option expenses in 2006. As a percentage of revenue, both research and development and sales and marketing expenses decreased. The increase in research and development, sales and marketing, and general and administrative expenses from 2004 to 2005 is due primarily to the inclusion of approximately $184.0 million in operating expenses from AFC and Vinci in 2005 compared with $15.5 million of AFC operating expenses in 2004.

Intangible Asset Amortization

Intangible asset amortization decreased from 2005 to 2006 with certain intangibles reaching full amortization, including a $1.4 million impairment charge for developed technology in 2006. The increase in amortization from 2004 to 2005 was due to the amortization of developed technology acquired in our acquisitions of AFC and Vinci in late 2004.

Restructuring and Other Charges

Restructuring and other charges were $8.0 million in 2006, $12.9 million in 2005 and $14.1 million in 2004. In 2006, we consolidated two order configuration and distribution centers into a single location and had a related workforce reduction. The charges in 2005 were related to reorganizing our research and development groups in Denmark and Finland and headcount reductions in other locations. Restructuring charges in 2004 included headcount reductions and facility closures.

Purchased In-Process Research and Development

The charge to in-process research and development expense (IPR&D) was for the estimated fair value of IPR&D that we acquired when we purchased AFC and Vinci. IPR&D refers to the value of technology under development that does not have an alternative use outside of its value within the acquired business. Generally accepted accounting principles require that IPR&D be expensed in whole at the time it is acquired. The value of the IPR&D at AFC was $89.0 million of the total charges, primarily attributable to development of enhanced versions of the company's access products. The remainder was attributable to development of products at Vinci. The IPR&D amount in 2005 was due to the finalization of the purchase price allocation for these two acquisitions.

Asset Impairment Charge

In 2004, we determined that impairment indicators existed for our Tellabs® 5500 NGX switch asset group because actual and forecasted revenue for that group was lower than previously expected. We further determined that future undiscounted cash flows would not be sufficient to support the total carrying value of the asset group. We therefore recorded an impairment charge of $47.2 million to reduce the carrying value of those assets, principally amortizable intangibles, to their fair value. We determined the fair value of the assets by reference to the present value of the cash flows attributable to those assets over the remaining life of the intangibles, the primary asset in the asset group.

Net Loss on Sale of Real Estate

In 2004, we sold an administrative and research and development facility in Denmark, which resulted in a loss of $21.1 million.

*Segment Profit**

In millions	2006	2005	2004
Broadband	$120.4	$156.2	$ 61.0
Transport	414.5	317.5	293.5
Services	65.7	47.5	54.9
Total segment profit	$600.6	$521.2	$409.4

* 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 purchased deferred stock compensation and intangibles, restructuring and other charges, and the impact of equity-based compensation (which includes restricted stock and performance stock units granted after June 30, 2006, and stock options). Prior year comparisons for 2005 and 2004 exclude the impact from purchased in-process research and development, asset impairment charge and net loss on sale of real estate.

Broadband segment profit decreased from 2005 to 2006. While we had strong revenues from our access products, a mix shift toward single-family ONTs decreased the overall profit in this segment. Partially offsetting the decline was improved revenue from our data products. Broadband segment profit increased from 2004 to 2005 due to the increase in access revenue from the inclusion of AFC in the results for the full year.

Transport segment profit increased from 2005 to 2006 due to higher revenue, improved gross margins, and lower research and development expenses as a percentage of revenue. Consistently strong sales to wireless customers have provided the basis for Transport's profitable growth. However, toward the end of 2006, the initial rollout of new products that have margins lower than our current overall product margin and reduced demand from large customers reduced the growth rate of this segment.

Services segment profit increased from 2005 to 2006 due to greater sales of higher-margin professional and support services and lower customer service costs as a percentage of revenue. Segment profit decreased from 2004 to 2005 due to the inclusion of lower-margin services as a result of the AFC acquisition.

Other Income

In millions	2006	2005	2004
Interest income, net	$45.7	$28.3	$26.9
Other expense, net	(7.8)	(4.0)	(5.4)
Total	$37.9	$24.3	$21.5

The *Interest income, net* increase in 2006 was driven by higher invested balances and average interest rates. *Other expense, net* included impairment charges to write-down the carrying value of certain cost-basis equity investments in start-up technology companies and other long-term equity investments. These charges were $7.0 million in 2006, $4.8 million in 2005 and $11.2 million in 2004. *Other expense, net* in 2004 also included a $6.6 million foreign currency gain resulting from converting a portion of our offshore cash from Euro-denominated investments to investments denominated in U.S. dollars.

Income Taxes

In millions	2006	2005	2004
Income tax expense	$(90.6)	$(37.3)	$(19.6)
Effective tax rate	31.8%	17.5%	192.2%

The increase in our tax expense in 2006 was due primarily to higher income earned from domestic operations and the absence of a benefit from valuation allowance reversals that occurred in 2005.

The increase in our tax expense in 2005 was due principally to a one-time tax expense of $15.4 million associated with our repatriation of $600 million under the American Jobs Creation Act of 2004 and an increase in foreign taxes due to higher foreign source income. The increase was partially offset by $10.1 million attributable to the reversal of reserves due to the expiration of the applicable statute of limitations period for a potential claim in a foreign jurisdiction.

We expect our effective tax rate for 2007 to be approximately 31%.

Financial Condition, Liquidity and Capital Resources

Our principal source of liquidity is our cash, cash equivalents and marketable securities, which totaled $1,300.1 million at the end of 2006.

In 2006, we generated $317.8 million of cash from operating activities and purchased $275.9 million (22.2 million shares) of our common stock. We purchased 7.6 million shares of common stock for $107.4 million under the $300 million repurchase program approved by the Tellabs Board of Directors on February 2, 2005, completing this program. We also purchased 4.5 million shares for $62.1 million under the Company's Rule 10b5-1 stock repurchase program. We intend to continue to use cash generated by employee stock-option exercises (other than those of company officers and board members) to repurchase stock in the manner provided under this program. On February 1, 2007, the Tellabs Board of Directors authorized a one-year extension of the Rule 10b5-1 stock repurchase program. In addition, we purchased 9.9 million shares for $102.9 million under the $300 million repurchase program approved by the Tellabs Board of Directors on July 31, 2006, and 0.2 million shares for $3.5 million to cover withholding taxes on shares issued under employee stock plans. From all stock repurchase programs, we have purchased $465.0 million since 2005.

We believe that the current level of working capital, particularly cash and marketable securities, is sufficient to meet our normal operating requirements for the foreseeable future. Further, we believe that sufficient resources exist to support our future growth and strategic needs. Future available sources of working capital include cash-on-hand, cash generated from future operations, short-term or long-term financing, equity offerings or any combination of these sources. Our current policy is to retain our earnings to provide funds to enhance stockholder value by expanding our business, repurchasing our common stock and for operating activities. We do not anticipate paying a cash dividend in the foreseeable future.

Contractual Obligations

The following table sets forth an overview of our contractual obligations as of December 29, 2006, 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	$ 64.5	$ 17.2	$21.9	$12.7	$12.7
Operating lease obligations related to restructuring activities, net	29.0	7.5	15.1	6.1	0.3
Purchase commitments to contract manufacturers and suppliers	296.8	296.8	—	—	—
Stock loan[1]	288.6	288.6	—	—	—
Stock loan borrowing fees[2]	7.7	1.7	3.0	2.1	0.9
Total obligations	$686.6	$611.8	$40.0	$20.9	$13.9

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.

2 For purposes of contractual obligations disclosure, we used Cisco's average share price of $25.78 for the quarter ended December 29, 2006, to determine the hypothetical value of the borrowing fees assuming the loans are settled in 2012.

We use several contract manufacturers and suppliers to provide manufacturing services for our products. During the normal course of business, to reduce manufacturing lead times and ensure adequate component supply, we enter into agreements with certain contract manufacturers and suppliers that enable them to procure inventory based upon criteria defined by us. Under these agreements, the maximum liability for purchase commitments as of December 29, 2006, was $296.8 million, of which $25.9 million was accrued on the balance sheet.

The stock loan borrowing fees that are recorded in the financial statements each period are affected by Cisco's average share price at the end of each quarter.

Off-Balance Sheet Arrangements

None.

Critical Accounting Estimates

The methods, estimates and judgments that we use in applying our 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 our critical accounting estimates to be revenue recognition, the allowance for excess and obsolete inventory and excess purchase commitments (collectively E&O), goodwill valuation, the valuation of amortizable 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 significant judgments about the application of the accounting rules to our customer arrangements.

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.

Customer acceptance provisions are generally considered to be substantive provisions that result in revenue deferral. Many of our contracts contain customer acceptance provisions. In some cases—for example, sales involving new products—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. Our 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 our inventory cost using the first-in, first-out method, and we value our 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 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 our 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 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 our accounting estimate related to E&O is a critical accounting estimate because it requires us to make assumptions about sales volumes and product mix that are highly uncertain, and changes in estimates can have a material effect on our financial statements.

Goodwill

We report operating results for three segments: Broadband, Transport and Services. For evaluation purposes, we tested each operating segment for possible goodwill impairment by comparing each segment's net book value with fair value in accordance with SFAS 142, *Goodwill and Other Intangible Assets*. As each operating segment's fair value was greater than its net book value and no other impairment indicators existed, further impairment tests were not deemed necessary and no impairment loss was recorded.

The process of evaluating the potential impairment of goodwill is subjective and requires significant judgment. In estimating the fair value of the operating segments for the purpose of this analysis, we made estimates and judgments about the future cash flows of our operating segments. Although we base our 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.

We believe that 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.

Intangible Assets

Our intangible assets consist primarily of purchased technology, which arose primarily from acquisitions of businesses in 2004 and 2003.

We evaluate the carrying value of our 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, 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 believe that 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 sales volumes for our products that involve new technologies and uncertainties around customer acceptance of new products or timely introduction into their networks. The recognition of an impairment could be material to our financial statements.

Warranty Costs

We provide warranties for all of our products, which have 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 years to six years. We record warranty expense in cost of revenue on the consolidated statement of operations. We estimate our 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 our customers' sites, among others. Consequently, the changes in our warranty reserves could be material to our financial statements.

Restructuring Reserves – Leases
Our restructuring reserves consist of amounts we owe on leases for facilities we vacated, reduced by an estimate of sublease rental income that arose from closures. 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 it by an estimate of potential sublease income. We examine real estate market conditions in each location where we have a vacated facility.

We believe our 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 our tax returns. When we calculate income tax expense and the related tax liabilities and assets for our 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 our 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 2006, the IRS completed its examination of our federal income tax returns for the years 2001 through 2003 and notified us of its intention to assess additional taxes and interest for those years. We are appealing this decision. The IRS is currently auditing our tax returns for the years 2004 and 2005; however, the audit is in the early stages and is not expected to conclude until mid-2008. Although we have recorded tax reserves for potential IRS adjustments to our 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.

Equity-Based Compensation
We account for stock-based compensation in accordance with SFAS No. 123(R), *Share-Based Payment*. Under the fair value recognition provisions of this statement, we measure share-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 share-based awards at the grant date requires several assumptions, and a change in these assumptions could materially impact our stock-based compensation expense and our 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 to the amount of share-based awards that are expected to be forfeited.

Strategy and Outlook

We expect capital spending by service providers to increase modestly in 2007 compared with 2006. On a global basis, wireless operators will continue to build next-generation networks to deliver new, data-oriented services. In North America, we expect the regional Bell operating companies to continue to upgrade the access portion of their networks with fiber technology to deliver broadband services to their residential customers. We also expect these customers to continue to upgrade their networks with next-generation optical transport technology. Outside North America, we expect that customers will accelerate spending on data infrastructure equipment for business services and fiber-based broadband equipment for residential services. We also expect that these customers will begin to deploy next-generation optical transport technologies. Tellabs believes that it has products either currently available or in development to address these opportunities.

In 2007, we will continue to focus on our strategies for wireless, residential broadband and business services and next-generation optical transport. We are driving toward a long-term stretch objective that calls for us to achieve 15% annual revenue growth and 20% operating margins. While we have achieved and even exceeded these targets in the past, we cannot say when or if we will achieve them again, given today's market conditions and our product portfolio. Carrier consolidation in North America has reduced the number of customers for our products and services. The remaining carriers are large and can exert considerably more pricing pressure than in years past.

In addition we face more competition globally, especially in the newly emerging growth areas we target.

Since 2003 we have introduced new products to address the emerging demand for wireless, residential broadband and business services as well as the transition to future Ethernet-oriented transport technologies. As we began to see in 2005 and 2006, success with these new products can adversely affect overall profitability. Broadband segment products carry lower overall gross margins than our established transport products. Our new transport products also carry lower gross margins, primarily because they are early in the product lifecycle. The mix of revenue from established and new products can affect overall profitability in any given quarter. We have active cost-reduction programs underway for all our new products. Over time, we expect our data products and our new transport products to carry gross margins more comparable with our established transport products.

Forward-Looking Statements

Except for historical information, the matters discussed or incorporated by reference into this Management's Discussion and Analysis may include forward-looking statements made pursuant to the safe harbor provisions contained in the Securities Act of 1933, as amended and the Securities Exchange Act of 1934, as amended. These statements reflect management's expectations, estimates and assumptions, based on current and available information. 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," "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: economic changes impacting the telecommunications industry; financial condition of telecommunications service providers and equipment vendors, including any impact of bankruptcies; the impact of customer and vendor consolidation; new product acceptance; product demand and industry capacity; competitive products and pricing; competitive pressures from new entrants to the telecommunications industry; 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 should not place undue reliance on the forward-looking statements in determining whether to buy, sell or hold any of our securities. 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 financial statements in this 2006 Annual Report.

Management's Report on Internal Control over Financial Reporting

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 December 29, 2006, 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 framework in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in *Internal Control-Integrated Framework*, our management concluded that our internal control over financial reporting was effective as of December 29, 2006.

Our management's assessment of the effectiveness of our internal control over financial reporting as of December 29, 2006, has been audited by Ernst & Young LLP, an independent registered public accounting firm, as stated in their report that appears on page 31.

Michael J. Birck
Chairman of the Board

Krish Prabhu
President and
Chief Executive Officer

Timothy J. Wiggins
Executive Vice President and
Chief Financial Officer

February 23, 2007

Report of Independent Registered Public Accounting Firm

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 December 29, 2006 and December 30, 2005, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 29, 2006. These 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 financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company at December 29, 2006 and December 30, 2005, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 29, 2006, in conformity with U.S. generally accepted accounting principles.

As disclosed in Note 1 of the notes to the consolidated financial statements, the Company changed its method of accounting for stock-based compensation in 2006.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 29, 2006, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 23, 2007, expressed an unqualified opinion thereon.

Ernst & Young LLP
Chicago, Illinois
February 23, 2007

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

The Board of Directors and Shareholders of Tellabs, Inc.
We have audited management's assessment, included in the accompanying *Management's Report on Internal Control over Financial Reporting*, that Tellabs, Inc. and subsidiaries (the "Company") maintained effective internal control over financial reporting as of December 29, 2006, 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. Our responsibility is to express an opinion on management's assessment and 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, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, 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, management's assessment that the Company maintained effective internal control over financial reporting as of December 29, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 29, 2006, 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 December 29, 2006, and December 30, 2005, and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended December 29, 2006, and our report dated February 23, 2007, expressed an unqualified opinion thereon.

Ernst & Young LLP
Chicago, Illinois
February 23, 2007