## 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 communications service providers worldwide. We also generate revenue by providing services related primarily to our own products and systems.

In 2006, we began reporting results under three reporting segments: Broadband, Transport and Services. For comparative purposes, we have included corresponding data for 2005.

Our Broadband segment includes the access, managed access and data product portfolios that facilitate the delivery of bundled triple-play services and next-generation wireline and wireless services. We earn revenue from our Broadband segment globally. Revenue from our access products is earned primarily in North America for the support of copper-based and fiber-based networks. Access product revenue is driven by 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 provider of triple-play services. Revenue for our managed access products is earned primarily outside North America. Managed access product revenue is driven by business services for voice and high-speed data as well as network access services for wireless communications. Revenue from our data products is earned globally. Data product revenue is driven by consumer demand for wireless and wireline carriers to deliver business services and next-generation wireless services.

Our Transport segment includes digital cross-connect systems, converged transport systems and voice quality enhancement products. These products enable service providers to manage bandwidth, improve voice quality and transport traffic by adding capacity when and where it is needed. Revenue from our Transport segment is primarily earned in North America. Transport product revenue is driven by the needs of service providers to support wireless services, business services for enterprises and triple-play voice, video and data services for consumers. We are marketing our new Transport segment products in international markets in 2008.

Our Services segment delivers deployment, support, professional consulting, training and systems integration services to Tellabs customers. These services support various phases of the network including planning, installation and on-going support. Revenue from our Services segment is earned globally. Deployment service revenue makes up almost half of our Services revenue, which arises primarily from sales of our transport products in North America, and tends to lag product sales by approximately one fiscal quarter. In addition, revenue comes from support agreements, professional consulting and training.

We operate in a dynamic industry in which both our customers and competitors have consolidated, creating more pricing pressure. In 2007, North American wireless customers spent less, particularly on the Tellabs® 5500 digital cross-connect system, compared with 2006, thus adversely affecting our overall revenue and profitability. It is not clear whether or when these customers will resume spending at previous levels.

We are transforming the company 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 packet-switching and Internet Protocol (IP) technology used in our converged transport, access and multiservice data products. These products are taking root as service providers transform their networks to next-generation capabilities. Some of these products carry gross profit margins lower than our historical average. The mix of our products can affect overall profitability in any given quarter.

In light of these factors, management continues to prepare and implement initiatives to improve our overall performance. On January 21, 2008, we committed to a plan to bring our operating expenses as well as our cost to produce products and deliver services in line with our current revenue and market conditions. To further improve financial performance, we plan on expanding our revenue opportunities to keep us highly competitive in a changing marketplace.

## Results of Operations

Our 2007 net earnings decreased to $65.0 million from $194.1 million in 2006 and $175.8 million in 2005.

In 2007, revenue declined $127.8 million compared with 2006. The decrease for the year was primarily due to reduced product revenue from our Transport segment, including lower revenue from our Tellabs® 5500 digital cross-connect. The decrease was partially offset with higher revenue from our Tellabs® 7100 OTS and increased services revenue from deployment, support and professional services. Our Broadband segment also saw lower revenue from our access and managed access products.

In 2007, our margin decreased 10.5% to 35.2% from 45.7% in 2006. The decrease was primarily due to a product mix shift with fewer Tellabs® 5500 digital cross-connects and more Tellabs® 7100 OTS and Tellabs® 1600 ONTs.

Operating expenses for 2007 decreased by $39.7 million to $647.1 million primarily due to reduced incentive compensation expense. Operating expenses increased to $686.8 million in 2006 from $666.2 million in 2005.

*Segment Revenue*

| In millions | 2007 | 2006 | 2005 | *2007 vs. 2006* | *2006 vs. 2005* |
|---|---|---|---|---|---|
| Broadband | $1,018.6 | $1,080.4 | $1,042.1 | (6)% | *4%* |
| Transport | 672.7 | 778.2 | 674.2 | (14)% | *15%* |
| Services | 222.1 | 182.6 | 167.1 | 22% | *9%* |
| Total revenue | $1,913.4 | $2,041.2 | $1,883.4 | (6)% | *8%* |

*Geographic Revenue*

| In millions | 2007 | % | 2006 | % | 2005 | % |
|---|---|---|---|---|---|---|
| North America | $1,413.5 | 74% | $1,548.4 | 76% | $1,419.4 | 75% |
| International | 499.9 | 26% | 492.8 | 24% | 464.0 | 25% |
| Total revenue | $1,913.4 | 100% | $2,041.2 | 100% | $1,883.4 | 100% |

*Segment Revenue*

Revenue from our Broadband segment in 2007 was $1,018.6 million, down $61.8 million from 2006. For the year, our access and managed access revenue decreased, while our data product revenue increased. Comparatively, revenue increased $38.3 million in 2006 from 2005.

Access product revenue decreased to $566.8 million in 2007 from $652.9 million in 2006 due to lower unit prices on our single-family ONTs, lower revenue from fiber-to-the-curb platforms, and lower revenue from independent operating companies for copper-based platforms. The decrease in revenue was partially offset by higher revenue from increased ONT unit volume. In 2006, revenue improved to $652.9 million from $617.0 million in 2005 on stronger ONT unit volume partially offset by lower revenue from copper-access platforms and other fiber-access equipment. In 2007, approximately 69% of access revenue came from fiber-based platforms, with the balance coming from copper-based platforms. This result compares with approximately 57% in 2006 and 50% in 2005.

Managed access revenue declined to $291.3 million in 2007 from $320.4 million in 2006. We had less revenue due to lower demand in our Europe, Middle East and Africa (EMEA) region for our Tellabs® 6300 SDH transport product. In addition, our revenue was lower from our Tellabs® 2300 cable telephony product, which is late in its life cycle. We had higher revenue from our Tellabs® 8100 managed access system, driven by large network expansions. Comparatively, revenue decreased to $320.4 million in 2006 from $364.8 million in 2005 as we saw fewer shipments of our Tellabs® 8100 managed access systems for network expansions.

Revenue from our data products has increased each year since we introduced them in the second half of 2003. In 2007, revenue from these products increased 49.9% to $160.5 million from $107.1 million in 2006. In 2006, revenue nearly doubled to $107.1 million from $60.3 million in 2005. Our revenue growth was driven by demand for wireless backhaul applications and next-generation data products. 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 decreased to $672.7 million in 2007 from $778.2 million in 2006. We had less revenue from our Tellabs® 5500 digital cross-connects, primarily from North American wireless service providers, as 3G network build-outs slowed from previous-year levels. We had more revenue from the roll-out of our Tellabs® 7100 OTS with reconfigurable optical add/drop multiplexer (ROADM), which was deployed into the network of a large North American wireline service provider. Comparatively, revenue 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 40% of all Transport revenue in 2007, compared with 62% in 2006 and 54% in 2005. We shipped approximately 6.4 million T-1 equivalents on the Tellabs 5500 system during 2007, compared with 10.1 million in 2006 and 7.3 million in 2005.

Services revenue increased $39.5 million from 2006 to 2007. We had more revenue from deployment services as a result of the rollout of our Tellabs® 7100 OTS product as well as increased revenue from professional and support services. Comparably, 2006 revenue increased $15.5 million from 2005 primarily due to increasing professional and support services that extended beyond the deployment services that have traditionally led this segment. 2006 was the first year in which professional and support services together accounted for over 50% of total services revenue.

*Gross Profit and Margin*

| In millions | 2007 | 2006 | 2005 |
|---|---|---|---|
| Gross profit | $674.3 | $933.6 | $855.0 |
| Gross margin | 35.2% | 45.7% | 45.4% |
| Product gross profit | $605.4 | $871.6 | $807.5 |
| Product margin | 35.8% | 46.9% | 47.0% |
| Services gross profit | $ 68.9 | $ 62.0 | $ 47.5 |
| Services margin | 31.0% | 34.0% | 28.4% |

*Gross Margin*

Overall gross margin decreased primarily in North America due to higher revenue from lower-margin newer products and lower revenue from established products that carry higher margins. This factor is the primary driver of our overall gross margin decline from 45.4% in 2005 and 45.7% in 2006 to 35.2% in 2007.

*Product Gross Margin*

Product gross margin declined from 2006 to 2007, primarily in North America, due to a product mix shift with fewer Tellabs® 5500 digital cross-connects and more Tellabs® 7100 OTS and ONT products. Product gross margin was relatively flat from 2005 to 2006 since the benefit from lower manufacturing costs was offset by an unfavorable product mix.

*Services Gross Margin*

Services gross margin decreased in 2007 due to a higher proportion of revenue from lower-margin deployment services. Services gross margin improved in 2006 due to a change in mix toward support and professional services, which have higher margins.

*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, which is likely to continue.

In 2008, our management announced a plan to improve gross margins and reduce operating expenses. This plan includes workforce reductions and facility closures and consolidations. Through this plan and other cost savings initiatives, we expect to reduce our expenses through the course of 2008 so that when we enter 2009 our cost structure for products and services will be $25 million less than it was in 2007.

*Operating Expenses*

| In millions | Expense 2007 | Expense 2006 | Expense 2005 | Percent of Revenue 2007 | Percent of Revenue 2006 | Percent of Revenue 2005 |
|---|---|---|---|---|---|---|
| Research and development | $343.1 | $356.9 | $344.0 | 17.9% | 17.5% | 18.3% |
| Sales and marketing | 176.6 | 179.8 | 175.5 | 9.2% | 8.8% | 9.3% |
| General and administrative | 99.1 | 113.5 | 95.6 | 5.2% | 5.6% | 5.1% |
| Subtotal | 618.8 | 650.2 | 615.1 | 32.3% | 31.9% | 32.7% |
| Intangible asset amortization | 22.5 | 28.6 | 36.0 | | | |
| Restructuring and other charges | 5.8 | 8.0 | 12.9 | | | |
| Purchased in-process R&D | — | — | 2.2 | | | |
| Total operating expenses | $647.1 | $686.8 | $666.2 | | | |

Operating expenses in 2007 decreased by $39.7 million to $647.1 million compared with 2006. The reduction in our operating expenses during 2007 is primarily due to reduced incentive compensation expense. 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.

In 2008, our management announced a plan to improve gross margins and reduce operating expenses. This plan includes workforce reductions and facility closures and consolidations. Through this plan and other cost savings initiatives, we expect to reduce our expenses through the course of 2008 so that when we enter 2009 our operating cost structure will be $75 million less than it was in 2007.

*Intangible Asset Amortization*

Intangible asset amortization decreased from 2006 to 2007 with certain intangibles reaching full amortization. The decrease in amortization from 2005 to 2006 was due to certain intangibles reaching full amortization, including a $1.4 million impairment charge for developed technology in 2006.

*Restructuring and Other Charges*

Restructuring and other charges were $5.8 million in 2007, $8.0 million in 2006 and $12.9 million in 2005. In 2007, activities included consolidating research and development into fewer locations and shifting them to a lower-cost environment. 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.

*Purchased In-Process Research and Development*

When we acquired AFC and Vinci in 2004, we estimated the fair value of in-process research and development expense (IPR&D). The charge to IPR&D in 2005 finalized the purchase price allocation for these two acquisitions.

*Segment Profit**

| In millions | 2007 | 2006 | 2005 |
|---|---|---|---|
| Broadband | $ 39.1 | $120.4 | $156.2 |
| Transport | 237.5 | 414.5 | 317.5 |
| Services | 72.2 | 65.7 | 47.5 |
| Total segment profit | $348.8 | $600.6 | $521.2 |

* 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).

Our Broadband segment profit for 2007 was $39.1 million, down $81.3 million from a profit of $120.4 million in 2006. The decrease in 2007 was primarily due to higher revenue from single-family ONTs and lower revenue from access products sold into existing copper-based networks, partially offset by an increase in revenue from our data products. Our Broadband segment profit decreased $35.8 million from 2005 to 2006. While we had strong revenues from our access products, a mix shift toward single-family ONTs, which was partially offset by improved revenue from our data products, decreased the overall profit in this segment.

Our Transport segment profit for 2007 was $237.5 million, down from $414.5 million in 2006. The decrease was due to lower segment revenue primarily from our Tellabs® 5500 digital cross-connect and a shift in our product mix, which includes higher amounts of Tellabs® 7100 OTS revenue. Our Transport segment profit increased $97.0 million from 2005 to 2006 due to higher revenue primarily from our Tellabs® 5500 digital cross-connect, improved gross margins, and lower research and development expenses as a percentage of revenue.

Our Services segment profit was $72.2 million in 2007, up $6.5 million from $65.7 million in 2006. The increase was due to higher revenue, including an increase in higher-margin support services. Our Services segment profit increased $18.2 million from 2005 to 2006 due to increased revenue from higher-margin professional and

support services and lower customer service costs as a percentage of revenue.

*Other Income*

| In millions | 2007 | 2006 | 2005 |
|---|---|---|---|
| Interest income, net | $50.9 | $45.7 | $28.3 |
| Other expense, net | (7.9) | (7.8) | (4.0) |
| Total | $43.0 | $37.9 | $24.3 |

The *Interest income, net* increase in 2007 was driven by higher invested balances. *Other expense, net* included 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 $0.5 million in 2007, $7.0 million in 2006 and $4.8 million in 2005. In addition, in 2007 we had a charge of $5.2 million for an other-than-temporary impairment from investments in marketable securities.

*Income Taxes*

| In millions | 2007 | 2006 | 2005 |
|---|---|---|---|
| Income tax expense | $(5.2) | $(90.6) | $(37.3) |
| Effective tax rate | 7.4% | 31.8% | 17.5% |

The reduction in our tax expense in 2007 is primarily attributable to a decrease in income earned from domestic operations.

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.

### Financial Condition, Liquidity and Capital Resources

Our principal source of liquidity is our cash, cash equivalents and marketable securities, which totaled $1,218.5 million at the end of 2007.

In 2007, we generated $131.4 million of cash from operating activities compared with $317.8 million in 2006. The decrease for the year was primarily due to lower earnings. We purchased $198.0 million (25.3 million shares) of our common stock. We purchased 22.5 million shares of common stock for $167.1 million under the $300 million repurchase program approved by our Board of Directors on July 31, 2006. We also purchased 2.6 million shares for $28.7 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 January 24, 2008, our Board of Directors authorized a one-year extension of the Rule 10b5-1 stock repurchase program. During 2007, we purchased 0.2 million shares for $2.2 million to cover withholding taxes on shares issued under employee stock plans. On November 8, 2007, our Board of Directors authorized $600 million for a common stock repurchase program. No purchases of our common stock were made under this program as of December 28, 2007. From all stock repurchase programs, we have purchased $660.9 million since 2005. We provide no assurance that we will continue our repurchase activity and we may change or reduce our repurchase activity in the future. We cannot estimate the timing of any such change or the impact on our cash, cash equivalents and marketable securities.

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 use our liquidity, financial strength and stability to expand our business, potentially through acquisitions, to repurchase our common stock and to fund our business operations. We do not anticipate paying a cash dividend in the foreseeable future.

### Subsequent Events

In November 2007, Krish A. Prabhu, Tellabs chief executive officer, president and director, announced his plan to resign from Tellabs, effective February 29, 2008. On February 26, 2008, Tellabs announced that Robert W. Pullen was named Tellabs chief executive officer, president and director, effective March 1, 2008.

On January 21, 2008, our management committed to a plan to improve gross profit margins and reduce operating expenses. We expect to record charges during 2008 in the range of $12 million to $14 million, of which approximately $6 million to $7 million will be for workforce reductions of approximately 225 employees and $6 million to $7 million will be for facility- and asset-related charges. Estimated cash payments under the plan are in the range of $11 million to $12 million. We anticipate a first quarter 2008 charge of approximately $8 million.

Through this plan, the restructuring plan announced in September 2007 for a workforce reduction of approximately 125 employees, and other cost saving initiatives, we expect to achieve $100 million in savings by 2009. Reductions will include $75 million from annual operating expenses and $25 million from overhead costs of products and services.

### Contractual Obligations

The following table sets forth an overview of our contractual obligations as of December 28, 2007, 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 | $ 69.1 | $ 16.0 | $23.5 | $16.0 | $13.6 |
| Operating lease obligations related to restructuring activities, net | 21.2 | 7.5 | 11.5 | 2.2 | — |
| Purchase commitments to contract manufacturers and suppliers | 241.9 | 241.9 | — | — | — |
| Income taxes | 28.2 | 28.2 | — | — | — |
| Stock loan[1] | 291.0 | 291.0 | — | — | — |
| Stock loan borrowing fees[2] | 10.5 | 2.1 | 3.9 | 3.6 | 0.9 |
| Total obligations | $661.9 | $586.7 | $38.9 | $21.8 | $14.5 |

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 $30.17 for the quarter ended December 28, 2007, 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 on criteria defined by us. Under these agreements, the maximum liability for purchase commitments as of December 28, 2007, was $241.9 million, of which $16.9 million was recorded 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.

As of December 28, 2007, we had unrecognized tax positions of $28.2 million included in short-term income tax liabilities and $54.6 million included 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 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.

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 (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 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. However, events or circumstances could arise in the future that may create a need to record an impairment adjustment that could be material to our financial statements.

The process of evaluating the potential impairment of goodwill is subjective because it requires the use of estimates and assumptions. We use the discounted cash flow method to estimate the fair value of each operating segment. 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. 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 and the 2002 through 2004 pre-acquisition years of a subsidiary. We expect these examinations will be completed in 2008. Although we have recorded tax reserves for potential IRS adjustments to our tax liabilities for prior years, we cannot provide assurance whether or not these adjustments will have a material impact on our financial statements.

*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**

Tellabs operates in an industry characterized by change and uncertainty.

Our wireline carrier customers face significant competitive threats to their most profitable residential services from other providers in North America and globally from the substitution of mobile services. In an effort to stem line loss and declining voice revenues, carriers have begun ambitious and expensive programs to transform their wireline 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.

Over the past few years, wireless carriers, also under competitive pressures, have aggressively invested in network infrastructure to deliver new, data-oriented services.

Many of these carriers 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 the overall capex growth in 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 lower profits for Tellabs and some of its direct competitors. At the same time, capable suppliers still outnumber North American carrier customers by a wide margin.

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

Expectations for capital spending levels by our customers in 2008 vary, and generally speaking, we expect very modest global overall growth in capex this year. We cannot predict how macro-economic issues will affect capital spending by our customers in 2008.

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 estab-

lished products, we have deployed in North America the new fiber-access and ROADM technologies needed for the delivery of combined voice, data and video services to residential customers. Our new data products address the changing nature of wireless services and enterprise computing on a global basis.

Some of these newer products are less profitable than our established products, given the early-stage nature of their deployment and the conditions surrounding our industry. As we look forward, our strategy is to maximize revenue and profitability from our established products and profitably grow the new product areas.

In response to these changing industry dynamics and our changing product mix, we announced a plan early in 2008 to improve profitability by reducing operating expenses and improving gross margin.

Under this plan, together with the restructuring we announced in September 2007, we expect to reduce our expenses and costs through the course of 2008 so that when we enter 2009 our cost structure will be $100 million lower than what it was in 2007. About three-quarters of the cuts will come in operating expenses, with the balance in supply-chain and services overhead costs. We plan to achieve these results by further headcount reductions through both layoffs and expected normal attrition, lower spending for prototypes and equipment, and reductions in third-party services.

As part of this plan, we expect to incur total charges of about $12 million to $14 million during 2008, with about $8 million of the charges falling in the first quarter.

In addition, we are working to diversify our customer base. We have won significant new customers with our data products and will work to continue that trend. We are focused on increasing sales of our access products with IOC and NLEC customers in the United States. We have introduced new versions of our ROADM platform that are intended specifically for IOC, NLEC and international customers.

Since 2005, we have determined that it is appropriate for us to actively return excess capital to stockholders through stock buybacks. In 2008, the company will continue to evaluate how to use excess cash to increase stockholder value.

### 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 2007 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 December 28, 2007, 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 28, 2007.

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 22, 2008

## 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 28, 2007, and December 29, 2006, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 28, 2007. 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 28, 2007, and December 29, 2006, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 28, 2007, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 10 to the consolidated financial statements, in 2007 the Company changed its method of accounting for uncertain tax positions in connection with the required adoption of FASB Interpretation No. 48. As discussed in Note 1 to the consolidated financial statements, in 2006 the Company changed its method of accounting for share-based payments in connection with the required adoption of Statement of Financial Accounting Standards No. 123(R).

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 December 28, 2007, 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 22, 2008, expressed an unqualified opinion thereon.

Ernst & Young LLP
Chicago, Illinois

February 22, 2008

## 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 Tellabs, Inc. and subsidiaries' (the "Company") internal control over financial reporting as of December 28, 2007, 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 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 December 28, 2007, 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 28, 2007, and December 29, 2006, and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended December 28, 2007, and our report dated February 22, 2008, expressed an unqualified opinion thereon.

Ernst & Young LLP
Chicago, Illinois

February 22, 2008