Management's Discussion and Analysis

Introduction and Overview of Business

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

The Broadband segment includes access, managed access and data product portfolios that facilitate the delivery of bundled consumer services, wireline business services and wireless communications. We earn revenue from the Broadband segment globally.

- Revenue from access products, earned primarily in North America, is driven by consumer demand for the triple-play of bundled voice, video and high-speed Internet/data services as traditional telecommunications companies and cable service operators compete to be the sole provider of these services to consumers and businesses.
- Revenue from managed access products, earned primarily outside North America, is driven by the need to provide business-oriented voice, video and high-speed Internet/data services and wireless communications.
- Revenue from data products, earned globally, is driven by demand for wireless and wireline carriers to deliver next-generation business services and wireless services.

The Transport segment includes digital cross-connect systems, optical networking systems and voice-quality enhancement products. These products enable service providers to generate revenue from business services, manage bandwidth, add network capacity when and where it is needed, and improve voice quality. Revenue from the Transport segment, earned primarily in North America, is driven by the needs of service providers to deliver wireless services, business services and consumer services.

The Services segment includes deployment, support, training, professional consulting and systems integration services for customers. These services range from network planning and installation to ongoing support. Revenue from the Services segment is earned globally. Deployment service revenue, which makes up almost half of Services revenue, arises primarily from sales of transport products in North America and tends to lag product sales by approximately one fiscal quarter. Professional service revenue, which is earned primarily through network design and consulting services, is the fastest growing part of the Services portfolio.

Tellabs operates in a dynamic industry. Over the last few years, customer consolidation has reduced overall industry capital spending, which together with a lack of consolidation on the part of network equipment companies, has resulted in increased pricing pressure. In addition, customer spending is pressured and competition is heightened by the global economic situation.

Within this backdrop, we continue to transform the company with new products and services. The company is evolving from a business based primarily on the circuit-switched Time Division Multiplexing (TDM) technology used in our digital cross-connect and managed access products to a business based on the packet-switching and Internet Protocol (IP) technology used in our optical networking, access and multiservice data products. These new products are taking root as service providers transform their networks with next-generation capabilities. Some of these products carry gross profit margins lower and higher than the historical average. While we have significantly improved the profitability of these products over time, the mix of products in any given quarter can affect overall profitability.

Throughout 2008, we announced a series of actions intended to sharpen our business focus and improve profitability through reduced operating expenses and improved gross margins. On January 21, 2008, we committed to a plan to bring operating expenses as well as cost to produce products and deliver services in line with current revenue and market conditions.

On April 2, 2008, we announced that we would discontinue one of our two gigabit passive optical network (GPON) next-generation fiber access systems, as management determined that it would continue to hurt our overall profitability in future years. Subsequently we announced, on April 8, 2008, the discontinuation of our investment in the Tellabs® 8865 GPON optical line terminal (OLT) for fiber access networks, for which this carrier was the initial targeted customer. At that time, we began to redirect resources from this access activity to strengthen development efforts on next-generation data solutions for wireless communications and marketing and sales internationally.

Although access revenues declined in 2008, we have a strong embedded base of copper- and fiber-access equipment in carrier networks. Over the past few years, we have made significant investment in access products, including the Tellabs® 1150 multiservice GPON product.

On April 30, 2008, we initiated a plan to consolidate several facilities as a result of the discontinuation of the Tellabs® 8865 OLT and headcount reductions announced in September 2007 and January 2008. On October 20, 2008, we initiated a restructuring plan that resizes Tellabs' business to reflect market conditions. Restructuring actions included reducing future investment in access products and freeing up resources to focus on mobile backhaul, optical networking and multiservice data products and professional services. These actions, together with those announced in September 2007, achieved the $100 million reduction target.

Results of Operations

Net loss in 2008 was $930.1 million, primarily as a result of a non-cash goodwill impairment charge of $988.3 million, compared with net earnings of $65.0 million in 2007 and $194.1 million in 2006.

In 2008, revenue declined to $1,729.0 million compared with $1,913.4 million in 2007 and $2,041.2 million in 2006. The decrease in 2008 from 2007 was primarily due to reduced product revenue from the Broadband and Transport segments, partially offset by higher revenue in the Services segment.

In 2008, gross margin increased to 38.2% from 35.2% in 2007. Gross margins were 45.7% in 2006. The increase in 2008 from 2007 was primarily due to an improved product and customer mix as well as the realization of product cost reductions.

Operating expenses for 2008 increased to $1,630.1 million from $647.1 million in 2007. The year-over-year increase in operating expenses was driven by the $988.3 million goodwill impairment charge in the third quarter of 2008 and restructuring and other charges of $40.9 million during the year, which offset a $40.4 million decrease in operating expenses, primarily from the $100 million cost-reduction program. Operating expenses for 2007 decreased by $39.7 million from $686.8 million in 2006.

Segment Revenue

In millions	2008	2007	2006	*2008 vs. 2007*	*2007 vs. 2006*
Broadband	$919.9	$1,018.6	$1,080.4	(9.7)%	(5.7)%
Transport	580.1	672.7	778.2	(13.8)%	(13.6)%
Services	229.0	222.1	182.6	3.1%	21.6%
Total revenue	$1,729.0	$1,913.4	$2,041.2	(9.6)%	(6.3)%

Geographic Revenue

In millions	2008	%	2007	%	2006	%
North America	$1,168.6	68%	$1,413.5	74%	$1,548.4	76%
International	560.4	32%	499.9	26%	492.8	24%
Total revenue	$1,729.0	100%	$1,913.4	100%	$2,041.2	100%

Segment Revenue

Revenue from the Broadband segment in 2008 was $919.9 million, down $98.7 million from 2007. For 2008, lower revenue from the access and managed access product portfolios was partially offset by growth from data products. Comparatively, revenue decreased $61.8 million in 2007 from 2006.

Access product revenue decreased to $414.9 million in 2008 from $566.8 million in 2007. Access revenue was lower and will likely continue to decrease as several key customers are transitioning to alternative network architectures. In 2008, approximately 71% of access revenue came from fiber-based platforms, with the balance coming from copper-based platforms. In 2007, access revenue decreased to $566.8 million from $652.9 million in 2006 due to lower unit prices on our single-family ONTs and lower revenue from fiber-to-the-curb and copper-based access platforms. The decrease in revenue was partially offset by higher revenue from increased ONT unit volume. Revenue from fiber-based platforms amounted to approximately 69% of total access revenue in 2007 and 57% in 2006.

Managed access revenue decreased to $289.9 million in 2008 from $291.3 million in 2007. Increased revenue from the Tellabs® 6300 SDH transport was offset by lower revenue from the Tellabs® 8100 managed access system. In 2007, revenue decreased to $291.3 million from $320.4 million in 2006 as higher revenue from the Tellabs 8100 managed access system was offset by lower revenue from the Tellabs® 6300 SDH transport product and the Tellabs® 2300 cable telephony product, which is late in its life cycle.

Revenue from data products has increased each year since we introduced them in the second half of 2003. In 2008, revenue from these products increased 34.0% to $215.1 million from $160.5 million in 2007. Revenue increased from the continuing rollout of our next-generation wireless backhaul solution in multiple geographic regions. In 2007, revenue from these products, driven by demand for wireless backhaul applications and next-generation data products, increased 49.9% to $160.5 million from $107.1 million in 2006.

Revenue from the Transport segment decreased to $580.1 million in 2008 from $672.7 million in 2007. Lower revenue from digital cross-connect products was partially offset by growth from the Tellabs® 7100 OTS and the Tellabs® 3000 voice-quality enhancement (VQE) solutions. Transport revenue decreased in 2007 to $672.7 million from $778.2 million in 2006. Shipments to North American wireless customers accounted for approximately 34% of all Transport revenue in 2008, compared with 40% in 2007 and 62% in 2006. We

shipped approximately 5.7 million T-1 equivalents on the Tellabs® 5500 system during 2008 compared with 6.4 million in 2007 and 10.1 million in 2006.

Services revenue increased to $229.0 million in 2008 from $222.1 million in 2007. Increased revenue from professional and support services offset lower deployment services revenue. In 2007, Services revenue increased $39.5 million from 2006 as a result of increased deployment services revenue, driven by the rollout of the Tellabs® 7100 OTS product, as well as increased revenue from professional and support services. In 2006, for the first time, professional and support services together accounted for more than 50% of total Services revenue.

Gross Profit and Margin

In millions	2008	2007	2006
Gross profit	$660.1	$674.3	$933.6
Gross margin	38.2%	35.2%	45.7%
Product gross profit	$588.0	$605.4	$871.6
Product margin	39.2%	35.8%	46.9%
Services gross profit	$ 72.1	$ 68.9	$ 62.0
Services margin	31.5%	31.0%	34.0%

Gross Margin

Overall gross margin increased to 38.2% in 2008 compared with 35.2% in 2007. This increase was driven by margin improvements on the Tellabs® 1600 ONT and the Tellabs® 7100 OTS and higher levels of revenue from the Tellabs® 8600 and 8800 platforms, offset by lower revenue from the Tellabs® 5500 and 1000 platforms. In addition, warranty expense declined due to lower rates of return, volume of shipments and repair costs. In 2007 gross margin decreased 10.5 percentage points from 45.7% in 2006, primarily as a result of higher revenue from lower-margin newer products and lower revenue from established products that carry higher margins.

Product Gross Margin

Product gross margin improved from 2007 to 2008, primarily due to improvements on the Tellabs 1600® ONT and the Tellabs® 7100 OTS and higher levels of revenue from the Tellabs® 8600 and 8800 platforms, offset by lower revenue from the Tellabs® 5500 and 1000 platforms. Product gross margin declined from 2006 to 2007, primarily due to a product mix shift with fewer Tellabs® 5500 digital cross-connects and more Tellabs® 7100 OTS and 1600 ONT products.

Services Gross Margin

Services gross margin was up slightly in 2008 compared with 2007. Growth in higher margin professional services and support services revenue, coupled with a decline in lower margin deployment services revenue, was offset by investments in our services business outside the United States. In 2007 services gross margin decreased from 2006 due to a higher proportion of revenue from lower-margin deployment services.

Gross Margin Trend

Gross margin is different for each product and services category and for each product within a category because the actual margin depends on the specific system configurations sold as well as customer and geographic pricing differences. Over the past few years, this variability, which tends to affect our gross margin, is likely to continue.

Operating Expenses

	Expense			Percent of Revenue		
In millions	2008	2007	2006	2008	2007	2006
Research and development	$305.2	$343.1	$356.9	17.7%	17.9%	17.5%
Sales and marketing	170.0	176.6	179.8	9.8%	9.2%	8.8%
General and administrative	101.8	99.1	113.5	5.9%	5.2%	5.6%
Subtotal	577.0	618.8	650.2	33.4%	32.3%	31.9%
Intangible asset amortization	23.9	22.5	28.6			
Restructuring and other charges	40.9	5.8	8.0			
Goodwill impairment	988.3	—	—			
Total operating expenses	$1,630.1	$647.1	$686.8			

Operating expenses in 2008 increased by $983.0 million to $1,630.1 million compared with 2007. A goodwill impairment charge of $988.3 million in the third quarter and restructuring and other charges of $40.9 million in 2008 more than offset savings from the $100 million cost-reduction program. General and administrative expenses in 2008 included increased legal expenses as a result of current lawsuits. Operating expenses decreased in 2007 from 2006 primarily from lower incentive compensation expenses as compared with the prior year.

Intangible Asset Amortization

Intangible asset amortization increased slightly in 2008 from 2007 as we reduced the estimated useful lives of some of our developed technology and customer relationships due to revised sales projections related to access

products and customers. In addition, we took a charge of $0.6 million for impaired developed technology related to the Tellabs® 1100 access platform due to reduced demand. Amortization decreased in 2007 from 2006 as certain intangibles reached full amortization.

Restructuring and Other Charges
In 2008, restructuring and other charges consisted primarily of severance, facility- and asset-related charges and charges for the consolidation of several facilities that contribute to cost reductions for the $100 million program. In 2007, we consolidated research and development into fewer locations and shifted them to lower-cost environments. In 2006, we consolidated two order configuration and distribution centers into a single location and had a related workforce reduction.

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

*Segment Profit**

In millions	2008	2007	2006
Broadband	$115.7	$ 39.1	$120.4
Transport	178.0	237.5	414.5
Services	75.5	72.2	65.7
Total segment profit	$369.2	$348.8	$600.6

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

Broadband segment profit for 2008 was $115.7 million, an increase of $76.6 million from $39.1 million in 2007. The increase in segment profit was driven by margin improvements associated with the Tellabs 1600 ONT, higher revenue from data products and reduced research and development expenses. Broadband segment profit decreased $81.3 million in 2007 from 2006, primarily as higher revenue from the Tellabs 1600 ONT and lower revenue from access products sold into existing copper-based networks was partially offset by an increase in revenue from data products.

Transport segment profit for 2008 was $178.0 million, down from $237.5 million in 2007. Transport segment profit decreased $177.0 million in 2007 from 2006. The decrease in both periods was due to lower segment revenue from digital cross-connects, which more than offset higher revenue and margin improvements on the Tellabs 7100 OTS.

Services segment profit was $75.5 million in 2008, up $3.3 million from $72.2 million in 2007. The increase in segment profit came from increased revenue from higher-margin professional and support services, partially offset by lower margin from deployment services. Services segment profit increased $6.5 million in 2007 from 2006 due to higher revenue and an increase in higher-margin support services.

Other Income

In millions	2008	2007	2006
Interest income, net	$ 34.8	$50.9	$45.7
Other expense, net	(17.3)	(7.9)	(7.8)
Total other income	$ 17.5	$43.0	$37.9

Interest income, net decreased in 2008 compared with 2007. To preserve capital, we repositioned our investment portfolio, which now primarily contains government, FDIC-guaranteed, GNMA-guaranteed, foreign government guaranteed, government-agency, and corporate bonds and notes. As a result of this repositioning, the current interest rate environment and lower invested balances, we earned less interest income in 2008 compared with 2007 and 2006. *Other expense, net* includes charges to write-down long-term equity investments in partnerships and start-up technology companies. These charges were $9.9 million in 2008, $0.5 million in 2007 and $7.0 million in 2006. In addition, we had charges of $0.8 million in 2008 and $5.2 million in 2007 for other-than-temporary impairments from investments in marketable securities.

Income Taxes

In millions	2008	2007	2006
Income tax benefit (expense)	$22.4	$(5.2)	$(90.6)
Effective tax rate	2.4%	7.4%	31.8%

We recorded an income tax benefit of $22.4 million in 2008, compared with income tax expense of $5.2 million in 2007. The tax benefit reflects a tax provision on income from foreign operations, offset by a partial benefit on the loss from domestic operations, and a $34.8 million tax benefit, which we recorded in the second quarter of 2008, related to the resolution of domestic federal income tax audits for the period 2001 through 2005. The tax benefit on our domestic operations was limited due to the valuation allowance established against our domestic deferred tax assets. For a more detailed discusion of the valuation allowance established against our domestic deferred tax assets, see Footnote 11 – Income Taxes. The reduction in our tax expense in 2007 is attributable primarily to a decrease in income earned from domestic operations.

Financial Condition, Liquidity and Capital Resources

Our principal source of liquidity remained our cash, cash equivalents and marketable securities of $1,152.1 million as of the end of 2008, which decreased by $66.4 million since year-end 2007. The decrease in cash, cash equivalents and marketable securities for the year reflects cash used to repurchase our common stock and cash used for capital expenditures, partially offset by cash generated from operating activities. In 2008, we generated $130.8 million of cash from operating activities, compared with $133.4 million in 2007 and $320.1 million in 2006.

During the last half of 2008, we actively balanced our investment portfolio with the goal of capital preservation. At January 2, 2009, government, FDIC-guaranteed, GNMA-guaranteed, foreign government guaranteed or government-agency bonds and notes were approximately 95% of the portfolio. Substantially all of our investments are highly liquid instruments. We may rebalance our portfolio from time to time, which may affect the duration, credit structure and future income of our investments.

In 2008, we repurchased 24.5 million shares of our common stock at a cost of $153.7 million. We may repurchase shares under the authorized open market program periodically during open trading windows when we do not have material non-public information. We provide no assurance that we will continue our repurchase activity and we may change 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.

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

Contractual Obligations

The following table sets forth an overview of contractual obligations, as of January 2, 2009, 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	$ 30.1	$ 9.4	$10.1	$ 6.9	$3.7
Operating lease obligations related to restructuring activities, net	31.2	9.6	12.1	6.4	3.1
Purchase commitments to contract manufacturers and suppliers	194.8	194.8	—	—	—
Income taxes	1.0	1.0	—	—	—
Stock loan[1]	179.1	179.1	—	—	—
Stock loan borrowing fees[2]	7.1	1.5	2.5	2.5	0.6
Total contractual obligations	$443.3	$395.4	$24.7	$15.8	$7.4

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 $17.30 for the quarter ended January 2, 2009, to determine the hypothetical value of the borrowing fees assuming the loans are settled in 2014.

We use several contract manufacturers and suppliers who provide manufacturing services for our products. During the normal course of business, we enter into agreements with certain contract manufacturers and suppliers that enable them to procure inventory based on criteria defined by us to reduce manufacturing lead times and ensure adequate component supply. Under these agreements, the maximum liability for purchase commitments as of January 2, 2009, was $194.8 million, of which $14.8 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 January 2, 2009, we had unrecognized tax positions of $1.0 million included in short-term income tax liabilities and $37.4 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 judgments about the application of the accounting rules based on the facts and circumstances of each customer arrangement.

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

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

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

Many of our contracts contain customer acceptance provisions. In cases involving sales of new products, for example, we defer revenue until we receive formal customer acceptance. In cases where we can demonstrate that the product or service has met all acceptance criteria prior to formal customer acceptance, or where we have sufficient historical evidence of customer acceptance, we consider acceptance to be perfunctory, and therefore formal customer acceptance is not required. 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 inventory cost using the first-in, first-out method, and we value inventory at the lower of cost or market, with market determined by reference to current replacement cost or net realizable selling price. We determine the amount of inventory that is excess and obsolete (E&O) and purchase commitments in excess of requirements using estimates of future demand for individual components of raw materials and finished goods.

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

We believe 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, which can be highly uncertain. Changes in these estimates can have a material effect on our financial statements.

Goodwill

We currently have goodwill in the Services segment. Goodwill impairment is reviewed annually and when impairment indicators exist by comparing the segment's net book value to fair value in accordance with SFAS 142, *Goodwill and Other Intangible Assets*. If the segment's fair value is greater than its net book value, then further impairment tests are not deemed necessary. If the segment's fair value is less than its net book value, further tests are performed to determine the segment's implied fair value of goodwill. The

implied fair value is then compared against the book value of goodwill to determine the level of impairment.

The process of evaluating the potential impairment of goodwill is subjective because it requires the use of estimates and assumptions. We use the discounted cash flow method to estimate the fair value of the operating segment. In estimating the fair value of the segment for the purpose of this analysis, we made estimates and judgments about the future cash flows of the segment. Although we base our cash flow forecasts on assumptions that are consistent with plans and estimates we use to manage the underlying segment, there is significant judgment in determining the cash flows attributable to the segment.

We believe the accounting estimate related to the valuation of goodwill is a critical accounting estimate because it requires us to make assumptions that are highly uncertain about the future cash flows of our segments.

Intangible Assets

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

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

Warranty Costs

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

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

Restructuring Reserves – Leases

Restructuring reserves consist of amounts we owe on leases for facilities we vacated, reduced by an estimate of sublease rental income. We determined the amount of the reserve for each facility by estimating the amount of time it will be vacant before it is sublet and the terms of the sublease agreement compared with our obligation, then reducing 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 2008 we reached a settlement with the IRS in connection with their examination of all tax years prior to 2006. Of our major jurisdictions, we are currently under audit by the State of California for the 2004 through 2006 tax periods. We do not expect the outcome of tax examinations to have a material effect on our consolidated results of operations, consolidated financial position or cash flow.

Valuation Allowance for Deferred Tax Assets

Deferred tax assets arise when we recognize charges or expenses in our financial statements that will not be

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

We believe that the loss incurred by the Company in the current year, and the cumulative loss incurred in the current and prior two years, represent sufficient negative evidence to determine that the establishment of a valuation allowance against domestic deferred tax assets is appropriate. Until an appropriate level of profitability is attained, we expect to continue to maintain a valuation allowance on our net deferred tax assets related to future U.S. and certain non-U.S. tax benefits.

Equity-Based Compensation

We account for equity-based compensation in accordance with SFAS No. 123(R), *Share-Based Payment*. Under the fair value recognition provisions of this statement, we measure equity-based compensation cost, at the grant date based on the value of the award, which is recognized as expense over the vesting period. Determining the fair value of equity-based awards at the grant date requires several assumptions, and a change in these assumptions could materially impact our equity-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, we estimate the amount of equity-based awards that are expected to be forfeited.

Strategy and Outlook

Tellabs operates in an industry characterized by excitement, change and uncertainty.

In the wireline sector, telecom service providers face significant competitive threats to their most profitable residential services from cable TV providers in North America and globally from the substitution of mobile services. In an effort to stem line loss and declining voice revenues, carriers have undertaken 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. Wireline carriers and cable TV service providers have also introduced next-generation data technology to deliver new business-oriented voice, video and data/Internet services to their corporate customers.

Over the past few years, wireless carriers, also under competitive pressure, have aggressively invested in network infrastructure to deliver new 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 overall capital spending by carriers.

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

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

We are presented with a challenging economic environment amidst the ongoing global financial crisis. Expectations for capital spending levels by our customers in 2009 vary, and generally speaking, we expect overall global capital spending to modestly decline this year, with greater declines in North America than the rest of the world, where revenue will likely be affected by the uncertainties associated with foreign currency fluctuations. We cannot predict how macroeconomic issues will continue to affect capital spending by our customers in 2009. While the economic environment may be challenging, we believe we are invested in the right solutions for growing markets.

Over the past few years, Tellabs has shifted its product offerings to address the strategic needs of both wireline and wireless carriers. Building on a base of successful established products, we have deployed the fiber-access and ROADM technologies needed for the delivery of combined voice, data and video services to residential customers. Our data products address the changing nature of wireless services and enterprise computing on a global basis.

Late in 2008, we articulated a three-part strategy for the company. Under this strategy we will:

- Focus our development activities on the fastest growing parts of our product and service portfolio: our Dynamic Optical and Carrier Ethernet & IP products and Professional Services.
- Innovate in growth markets where we have incumbent positions and our fastest-growing products are gaining traction: Mobile Backhaul, Optical Networking and Business Services.
- Pursue flawless execution as we work to improve quality, reduce costs and meet commitments.

We expect that executing this strategy of freeing up and redirecting resources to create innovative products and services that help customers succeed will further improve financial performance and fund growth initiatives.

Early in 2009, we initiated a restructuring plan as we continue to align our costs with customer spending and current market conditions. We expect to record pretax charges in the first quarter of 2009 in the range of $2 million to $3 million for workforce reductions. Estimated cash payments under this plan are also expected to be in the range of $2 million to $3 million beginning in the first quarter of 2009 and continuing into the first quarter of 2010.

Since 2005, we have actively returned capital to stockholders through stock buybacks. In 2009, we will continue to evaluate how to best use our balance sheet to increase stockholder value.

Forward-Looking Statements

Except for historical information, the matters discussed or incorporated by reference into this report, including the Management's Discussion and Analysis, may include forward-looking statements made pursuant to the safe harbor provisions of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements reflect management's expectations, estimates and assumptions, based on current and available information at the time the document was prepared. These forward-looking statements include, but are not limited to, statements regarding future events, plans, goals, objectives and expectations. The words "anticipate," "believe," "estimate," "target," "expect," "predict," "plan," "possible," "project," "intend," "likely," "will," "should," "could," "may," "foreseeable," "would" and similar expressions are intended to identify forward-looking statements. Forward-looking statements are not guarantees of future performance and involve risks, uncertainties and other factors that may cause our actual performance or achievements to be materially different from any future results, performance or achievements expressed or implied by those statements. Important factors that could cause our actual results to differ materially from those in forward-looking statements include, but are not limited to: overall negative economic conditions generally and disruptions in credit and capital markets, including specific impacts of these conditions on the telecommunications industry; financial condition of telecommunications service providers, equipment vendors and contract manufacturers, including 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; initiatives to improve profitability that may have financial consequences including further restructuring charges and the ability to realize anticipated savings under such cost-reduction initiatives; exiting businesses and product areas; impairment charges and other cost cutting initiatives and related charges and costs; manufacturing efficiencies; research and new product development; protection of and access to intellectual property, patents and technology; ability to attract and retain highly qualified personnel; availability of components and critical manufacturing equipment and capacity; foreign economic conditions, including currency rate fluctuations; the regulatory and trade environment; the impact of new or revised accounting rules or interpretations, including revenue recognition requirements; availability and terms of future acquisitions; divestitures and investments; uncertainties relating to synergies; charges and expenses associated with business combinations and other transactions; and other risks and future factors that may be detailed from time to time in the Company's filings with the SEC. For a further description of such risks and future factors, see Item 1A of our most recently filed Form 10-K. Our actual future results could differ materially from those predicted in such forward-looking statements. In light of the foregoing risks, uncertainties and other factors, investors are advised not to rely on these forward-looking statements when making investment decisions. These factors are not intended to be an all-encompassing list of risks and uncertainties that may affect the operations, performance, development and results of our business. We undertake no obligation to publicly update or revise any forward-looking statements to reflect changed assumptions, the occurrence of anticipated or unanticipated events or changes to future results over time. The foregoing discussion should be read in conjunction with the financial statements and related notes and Management's Discussion and Analysis in this 2008 Annual Report.

Management's Report on Internal Control over Financial Reporting

The management of Tellabs, Inc., and subsidiaries (the "Company") is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rules 13a-15(f) of the Securities Exchange Act of 1934, as amended. Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of the Company's internal control over financial reporting as of January 2, 2009, 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 January 2, 2009.

Robert W. Pullen
President and
Chief Executive Officer

Timothy J. Wiggins
Executive Vice President and
Chief Financial Officer

February 26, 2009

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Tellabs, Inc.
We have audited the accompanying consolidated balance sheets of Tellabs, Inc. and subsidiaries (the "Company") as of January 2, 2009, and December 28, 2007, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended January 2, 2009. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company at January 2, 2009 and December 28, 2007, and the consolidated results of its operations and its cash flows for each of the three years in the period ended January 2, 2009, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 11, 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 January 2, 2009, 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 26, 2009, expressed an unqualified opinion thereon.

Ernst & Young LLP
Chicago, Illinois

February 26, 2009

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

To the Board of Directors and Shareholders of Tellabs, Inc.

We have audited Tellabs, Inc. and subsidiaries' (the "Company") internal control over financial reporting as of January 2, 2009, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

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

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

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

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of January 2, 2009, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company as of January 2, 2009 and December 28, 2007, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended January 2, 2009, and our report dated February 26, 2009 expressed an unqualified opinion thereon.

Ernst & Young LLP
Chicago, Illinois

February 26, 2009