HIGHLIGHTS

Lucent Technologies Inc. ("Lucent" or the "Company") is one of the world's leading designers, developers and manufacturers of communications systems, software and products. These integrated systems and software applications enable network operators and business enterprises to connect, route, manage and store information between and within locations. Lucent is a global market leader in the sale of public communications systems, and is a supplier of systems and software to the world's largest networks. Lucent is also a global leader in the sale of business communications systems and microelectronic components for communications systems and computer manufacturers. Lucent was formed from the systems and technology units that were formerly part of AT&T Corp. ("AT&T"), including the research and development capabilities of Bell Laboratories.

In 1996, Lucent changed its fiscal year to begin October 1st and end September 30th. Due to this change, Lucent reported 1996 audited financial results for a short fiscal period beginning on January 1, 1996 and ending on September 30, 1996. For comparability to the audited financial statements, Lucent has provided unaudited statements of income and cash flows for the twelve months ended September 30, 1996 and for the nine months ended September 30, 1995.

For the fiscal year ended September 30, 1997, Lucent reported net income of $541 million or $0.84 per share compared with a net loss of $793 million or $1.37 per share for the twelve months ended September 30, 1996. During fiscal 1997, Lucent recognized one-time charges related to its acquisition of Octel Communications Corporation ("Octel"), including $945 million for purchased in-process research and development costs. For the twelve months ended September 30, 1996, Lucent recorded $2,801 million of business restructuring and other charges. Excluding these charges from both periods, net income was $1,507 million or $2.34 per share in fiscal 1997 compared with $1,054 million or $1.65 per share (computed on a pro forma basis) for the twelve months ended September 30, 1996. The pro forma presentation assumes that all 636,661,931 common shares outstanding following the completion of Lucent's Initial Public Offering ("IPO") on April 10, 1996 were outstanding since January 1, 1995, and gives no effect to the use of proceeds from the IPO.

STRATEGIC TRANSACTIONS

Since October 1, 1996, Lucent has completed a number of strategic transactions intended to improve the Company's focus on its core businesses. In October 1996, Lucent acquired Agile Networks, Inc. ("Agile"), a provider of advanced intelligent data switching products that support Ethernet as well as emerging asynchronous transfer mode ("ATM") technology. These products enable business customers to manage multimedia networks more effectively. In September 1997, Lucent acquired Octel, a provider of voice, fax and electronic messaging technologies that complement those offered by Lucent. In October 1997, Lucent agreed to acquire Livingston Enterprises, Inc., a global provider of equipment used by Internet service providers to connect their subscribers to the Internet. Such investments provide Lucent additional ways to invest in research and development of leading edge technologies.

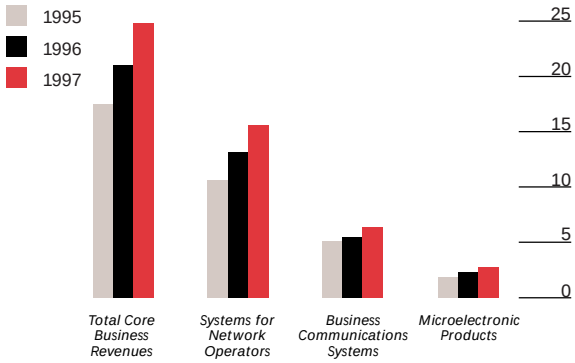
On October 1, 1997, Lucent contributed its Consumer Products business to a new venture formed by Lucent and Philips Electronics N.V. ("Philips"). The venture, which is 40% owned by Lucent, is a worldwide provider of a complete range of personal communications products, including digital and analog wireless phones, corded and cordless phones, answering machines, screen phones and pagers.

During fiscal 1996, Lucent completed the sale of its Paradyne subsidiary. In addition, Lucent completed the sale of its interconnect products and Custom Manufacturing Services businesses in December 1996, and its Advanced Technology Systems ("ATS") unit in October 1997.

The following chart provides Lucent's revenues trend from its three core businesses and excludes revenues from its Consumer Products unit and from Other Systems and Products:

THREE CORE BUSINESSES
ANNUAL REVENUES

(in billions of dollars)
For the twelve months ended September 30



Revenues for 1997 from Lucent's three core businesses: Systems for Network Operators, Business Communications Systems and Microelectronic Products, increased 17.9% compared with 1996.

LUCENT'S FORMATION

Prior to February 1, 1996, AT&T conducted Lucent's business through various divisions and subsidiaries. On February 1, 1996, AT&T began executing its decision to separate Lucent into a stand-alone company (the

"Separation") by transferring to Lucent the assets and liabilities related to its business. Additionally, AT&T retained $2,000 million of accounts receivable. In April 1996, Lucent completed the IPO and on September 30, 1996, became independent of AT&T when AT&T distributed to its shareowners all of its Lucent shares.

Lucent's consolidated financial statements for periods prior to February 1, 1996 reflect the financial position, results of operations and cash flows of the operations transferred to Lucent from AT&T in the Separation and were carved out from the financial statements of AT&T using the historical results of operations and historical basis of the assets and liabilities of the business. Additionally, Lucent's 1995 consolidated financial statements include certain assets, liabilities, revenues and expenses which were not historically recorded at the level of, but are primarily associated with, the business. Management believes the assumptions underlying these financial statements are reasonable, although these financial statements may not necessarily reflect the results of operations or financial position had Lucent been a separate, stand-alone entity.

KEY BUSINESS CHALLENGES

Lucent continues to face significant competition and expects that the level of competition on pricing and product offerings will intensify. Lucent expects that new competitors will enter its markets as a result of both the trend toward global expansion by foreign and domestic competitors as well as continued changes in technology and public policy. These competitors may include entrants from the telecommunications, software, data networking and semiconductor industries. Existing competitors have, and new competitors may have, strong financial capability, technological expertise and well-recognized brand names. As a result, Lucent's management periodically assesses market conditions and redirects the Company's resources to meet the challenges of competition. Steps Lucent may take include acquiring and investing in new businesses, partnering with existing businesses, delivering new technologies, closing and consolidating facilities, disposing of assets, reducing workforce levels or withdrawing from markets.

Lucent's sales continue to be highly seasonal. Many of Lucent's large customers have historically delayed a disproportionate percentage of their capital expenditures until the fourth quarter of the calendar year. Consequently, Lucent's results of operations for the first three quarters of each calendar year historically have, in the aggregate, been significantly less profitable than the fourth calendar quarter. However, Lucent has taken steps to manage the seasonality by changing its year-end and its compensation programs for employees.

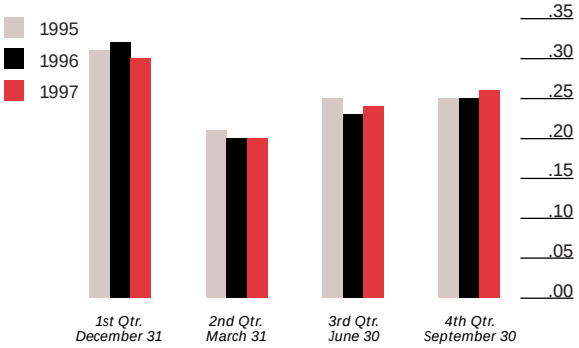
The purchasing behavior of Lucent's large customers has increasingly been characterized by the use of fewer, but larger contracts, which contributes to the variability of Lucent's results. These contracts typically involve longer negotiating cycles, require the dedication of substantial amounts of working capital and other resources, and in general require costs which may substantially precede recognition of associated revenues. Moreover, in return for larger, longer-term purchase commitments, customers often demand more stringent acceptance criteria which can also cause revenue recognition delays. Lucent has increasingly provided or arranged long-term financing for customers as a condition to obtain or bid on infrastructure projects. Certain multi-year contracts involve new technologies which may not have been previously deployed on a large-scale commercial basis. Related to these contracts, Lucent may incur significant initial cost overruns and losses which would be recognized in the quarter in which they became ascertainable. Further, profit estimates on such contracts are revised periodically over the lives of the contracts, and such revisions can have a significant impact on reported earnings in any one quarter.

To manage the fluctuation caused by the buying behaviors of large customers, Lucent continues to seek out new types of customers both in the United States and internationally, such as competitive access providers, cable television network operators and computer manufacturers.

Historically, Lucent has relied on a limited number of customers for a substantial portion of its total revenues, including AT&T which continues to be a significant customer. Lucent is seeking to diversify its customer base; nevertheless, Lucent expects that a significant portion of its future revenues will continue to be generated by a limited number of customers. The loss of any of these customers or any substantial reduction in orders by any of these customers could materially adversely affect the Company's operating results.

QUARTERLY REVENUES

(As a percentage of annual revenues)
New fiscal year basis



Lucent is taking steps to manage seasonality and moderate wide fluctuations in revenues from quarter to quarter.

FIVE YEAR SUMMARY

(dollars in millions, except per share amounts)
(unaudited)

	Year Ended September 30, (Twelve Months)		Nine Months Ended September 30,				Year Ended December 31, (Twelve Months)
	1997	**1996**[1]	**1996**[5]	**1995**	**1995**[1]	**1994**	**1993**
RESULTS OF OPERATIONS							
Revenues	$26,360	$23,286	$15,859	$13,986	$21,413	$19,765	$17,734
Gross margin	11,462	8,894	6,569	6,143	8,468	8,428	7,646
Operating income (loss)	1,631	(947)	487	434	(1,000)	971	669
Income (loss) before cumulative effects of accounting changes	541	(793)	224	150	(867)	482	430
Cumulative effects of accounting changes	–	–	–	–	–	–	(4,208)
Net income (loss)	541	(793)	224	150	(867)	482	(3,778)
Earnings (loss) per common share – Historical[2]	0.84	(1.37)	0.38	0.28	(1.65)	n/a	n/a
Earnings (loss) per common share – Pro Forma[3]	n/a	(1.25)	0.35	0.24	(1.36)	n/a	n/a
Dividends per common share	0.225	0.15	0.15	–	–	n/a	n/a
FINANCIAL POSITION							
Total assets	$23,811	$22,626	$22,626	$18,219	$19,722	$17,340	$17,109
Working capital	1,763	2,068	2,068	188	(384)	246	1,773
Total debt	4,203	3,997	3,997	4,192	4,014	3,164	3,195
Shareowners' equity	3,387	2,686	2,686	2,783	1,434	2,476	2,580
OTHER INFORMATION							
Selling, general and administrative expenses as a percentage of revenues	21.9%	31.3%	26.8%	28.9%	33.1%	27.1%	28.3%
Research and development expenses as a percentage of revenues	11.5[4]	11.0	11.6	12.0	11.1	10.6	11.1
Gross margin percentage	43.5	38.2	41.4	43.9	39.5	42.6	43.1

(1) Includes pretax restructuring and other charges of $2,801 ($1,847 after taxes) recorded as $892 of costs, $1,645 of selling, general and administrative expenses and $264 of research and development expenses.

(2) The calculation of earnings per share on a historical basis includes the retroactive recognition to January 1, 1995 of the 524,624,894 shares owned by AT&T on April 10, 1996.

(3) The calculation of earnings per share on a pro forma basis assumes that all 636,661,931 common shares outstanding on April 10, 1996 were outstanding since January 1, 1995 and gives no effect to the use of proceeds from the IPO.

(4) Excludes one-time charges of $1,024 million of purchased in-process research and development costs from acquisitions of Octel and Agile. Including these charges, research and development expenses as a percentage of revenues were 15.4% for 1997.

(5) Beginning September 30, 1996, Lucent changed its fiscal year-end from December 31 to September 30, and reported results for the nine-month transition period ended September 30, 1996.

TWELVE MONTHS ENDED SEPTEMBER 30, 1997 VERSUS TWELVE MONTHS ENDED SEPTEMBER 30, 1996

REVENUES

Total revenues increased $3,074 million or 13.2% for 1997 compared with 1996, primarily due to gains in sales from Systems for Network Operators, Business Communications Systems and Microelectronic Products. The overall revenue growth was partially offset by the expected decline in revenue from Consumer Products and Other Systems and Products. Revenues for Lucent's three core businesses increased 17.9% for 1997 compared with 1996. Revenue growth continued to be generated from sales both in the United States and internationally (including exports). International revenues increased 11.9% compared with 1996 and represented 24.1% of total revenues in 1997. The increased international sales reflect Lucent's targeted approach toward international revenue expansion for increased profitability. The following table presents Lucent's revenues by product line, and the related percentage of total revenues for the twelve months ended September 30, 1997 and 1996:

	Twelve Months Ended September 30,			
	1997		1996	
(dollars in millions)	$	%	$	%
Systems for Network Operators	$15,614	59%	$13,192	57%
Business Communications Systems	6,411	24	5,509	24
Microelectronic Products	2,755	11	2,315	10
Consumer Products	1,013	4	1,431	6
Other Systems and Products	567	2	839	3
Total	$26,360	100%	$23,286	100%

Revenues from SYSTEMS FOR NETWORK OPERATORS increased $2,422 million or 18.4% compared with 1996. The increase resulted from higher sales of both switching and wireless systems with associated software, fiber-optic cable and professional services. Demand for second lines in businesses and residences for Internet services and data connectivity contributed to the revenue growth for 1997.

Software sales increased $414 million or 21.7% compared with the same period in 1996. The increase was primarily driven by strong demand for associated software for Lucent's new Access Interface Unit ("AIU") as well as software sales to support number portability. The AIU is used in the 5ESS switch and helps speed voice and Internet traffic.

Sales from Systems for Network Operators in the United States increased 22.2%. The revenue increase in the United States was led by sales to traditional service providers and non-traditional customers such as personal communications services ("PCS") wireless providers, competitive access providers and cable television companies. International revenues increased 8.2% compared with 1996, resulting from increased sales in the Europe/Middle East/Africa, Asia/Pacific and Caribbean/Latin America regions. International revenues represented 25.1% of Systems for Network Operators revenues for 1997.

For 1997, sales of wireless infrastructure increased significantly compared with the same period in 1996 primarily due to PCS contracts as customers accepted networks for commercial service in 1997 using various digital technologies. These technologies include Code Division Multiple Access ("CDMA"), Global System for Mobile Communications ("GSM") and Time Division Multiple Access ("TDMA"). The Lucent digital technologies continue to show acceptance in both the international and domestic markets.

Revenues from BUSINESS COMMUNICATIONS SYSTEMS increased $902 million or 16.4% compared with the same period in 1996. This increase was led by sales of DEFINITY® products, SYSTIMAX® structured cabling, messaging systems, integrated offers such as call centers and higher revenues from service contracts. This increase was partially offset by the continued erosion of the rental base. Revenues in the United States increased 17.0% compared with 1996. International revenues increased by 13.2%, reflecting growth in all international regions. The increase in the United States and internationally was primarily due to sales of DEFINITY® products, call centers and messaging systems. In addition, higher sales of SYSTIMAX® structured cabling contributed to the revenue growth in the United States. International revenues represented 15.8% of revenue for 1997.

During fiscal 1997, Lucent acquired Octel and Agile. Combined with Octel, Lucent offers a wide array of messaging products and services to reach most customer segments: wireless customers, central-office-based customers and business customers of any size, while Agile contributes technology that supports a closer integration of applications that combine voice and data. Through these acquisitions, Lucent has added new in-process and existing technologies to its voice and data networking capabilities. Utilizing these acquired in-process technologies, the development of the next generation of products will involve certain risks due to the complexity and uncertainty inherent in research and development efforts.

Sales of MICROELECTRONIC PRODUCTS increased $440 million or 19.0% compared with 1996, due to

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higher sales of customized chips for computing and communications, including components for local area networks, data networking, high-end computer workstations and wireless telephones. Higher sales of power systems and optoelectronic components also contributed to the increase for 1997. Domestic revenues increased 12.5% compared with 1996, led by sales to original equipment manufacturers ("OEMs"). The growth in international revenues of 25.9% was driven by application specific integrated circuits ("ASICs") sales in the Asia/Pacific region as well as the growth of wireless and multimedia integrated circuits and power products sold to customers in Europe for cellular applications. International revenues represented 51.3% of the Microelectronic Products sales for 1997. Microelectronic Products continues to bring to market new technologies, such as the introduction of the K56flex™ modem technology.

Revenues from CONSUMER PRODUCTS decreased $418 million or 29.2% compared with 1996. The decline in revenues was primarily due to decreased product sales related to the closing of the Phone Center Stores, the discontinuation of unprofitable product lines and the continued decrease in phone rental revenues. Lucent's Consumer Products unit was contributed to the venture between Lucent and Philips on October 1, 1997.

Revenues from OTHER SYSTEMS AND PRODUCTS decreased $272 million or 32.4% compared with 1996. The decrease is largely due to the sale of Lucent's Custom Manufacturing Services business in fiscal year 1997 and its Paradyne subsidiary in fiscal year 1996. Revenues in this product line are expected to continue to decline, reflecting the sale of Lucent's ATS unit to General Dynamics Corporation on October 1, 1997. ATS designed and manufactured custom defense systems for the United States government.

GROSS MARGIN

Gross margin percentage increased to 43.5% from 38.2% in 1996 primarily due to the restructuring charges recorded in the quarter ended December 31, 1995. Excluding restructuring charges, gross margin for 1996 was 42.0%. The increase in gross margin percentage for 1997 was due to an overall favorable mix of higher margin product revenues and the benefits associated with the business productivity improvement initiatives.

OPERATING EXPENSES

Selling, general and administrative expenses decreased $1,506 million or 20.7% compared with 1996. Excluding the $1,645 million of restructuring charges recorded in December 1995, selling, general and administrative expenses increased $139 million compared with 1996. This increase was due to expenditures associated with higher sales levels, investment in growth initiatives, and the implementation of SAP, an integrated software platform. These increases were partially offset by the reversal of $174 million of business restructuring liabilities in 1997, the lower start-up costs incurred in 1997, and business productivity improvement initiatives, including lower expenses since some businesses were exited in fiscal 1997 and 1996. Selling, general and administrative expenses as a percentage of revenue declined 2.3 percentage points to 21.9% of revenue compared with 24.2% of revenues, excluding restructuring charges in 1996.

Research and development expenses increased $472 million or 18.5% compared with 1996. Excluding the impact of restructuring charges for the quarter ended December 31, 1995, research and development expenses increased by $736 million, primarily due to expenditures in support of wireless infrastructure, microelectronic products and advanced multimedia communications systems as well as a $127 million write-down of special-purpose Bell Labs assets no longer being used. Research and development expenses represented 11.5% of revenues as compared with 11.0% of revenues in 1996. Research and development expenses as a percentage of revenues increased 1.7 percentage points from 9.8%, excluding restructuring charges in 1996.

Purchased in-process research and development for 1997 reflects one-time write-offs totaling $1,024 million of in-process research and development in connection with the acquisitions of Octel (see Note 1) and Agile.

OTHER INCOME, INTEREST EXPENSE AND PROVISION FOR INCOME TAXES

Other income – net decreased $77 million compared with 1996. This decrease was largely due to gains recognized on the sale of certain investments and insurance recoveries in 1996, offset in part by increased interest income in 1997.

Interest expense increased $12 million compared with 1996 due primarily to replacing a portion of commercial paper with long-term debt in July 1996.

The effective tax rate of 63.1% for 1997 increased from the effective tax rate of 22.4% for the same period of 1996 due to the 1997 write-offs of in-process research and development costs and the tax impact of restructuring charges incurred in 1996. Excluding charges related to the acquisition of Agile and Octel, the effective tax rate for 1997 was 37.2%, a decrease of 3.6 percentage points from the 1996 effective tax rate of 40.8% before

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considering the effects of restructuring charges incurred in 1996. This decrease is primarily attributable to the tax impact of foreign earnings.

CASH FLOWS

Cash provided by operating activities was $1,946 million in 1997, an increase of $967 million compared with the same period in 1996. This increase in cash was largely due to the retention of $2,000 million of customer accounts receivable by AT&T in 1996 as well as the increase in sales associated with higher cash collections. This was offset by changes in accounts payable due to the end of payments to AT&T related to the Separation and the change in other operating assets and liabilities over 1996. The change in other operating assets and liabilities was primarily due to the receipt of a $500 million cash advance made to Lucent in April 1996 by AT&T and the utilization by AT&T of that advance in 1997.

Cash payments of $483 million were charged against the December 1995 business restructuring reserves in 1997. As of September 30, 1997, the workforce had been reduced by approximately 17,900 positions in connection with business restructuring. In addition, approximately 1,000 employees left Lucent's workforce as part of the sale of Paradyne in 1996. Actual experience in employee separations, combined with redeploying employees into other areas of the business, has resulted in lower separation costs than originally anticipated.

Comparing 1997 and 1996, cash used in investing activities increased to $3,121 million from $1,638 million primarily due to the acquisition of Octel.

Capital expenditures were $1,635 million and $1,432 million for 1997 and 1996, respectively. Capital expenditures include expenditures for equipment and facilities used in manufacturing and research and development, including expansion of manufacturing capacity and international growth.

Cash provided by financing activities for 1997 was $295 million compared with $2,503 million in 1996. This decrease was primarily due to the proceeds received from the IPO in the year-ago period.

In 1995, Lucent relied on AT&T to provide financing for its operations. The cash flows from financing activities for the period ended September 30, 1996 reflect changes in the Company's assumed capital structure. These cash flows are not necessarily indicative of the cash flows that would have resulted if the Company had been a stand-alone entity.

NINE MONTHS ENDED SEPTEMBER 30, 1996 VERSUS NINE MONTHS ENDED SEPTEMBER 30, 1995

REVENUES

Total revenues increased $1,873 million or 13.4% for the nine-month period of 1996, compared with the same period of 1995, primarily due to gains in sales from Systems for Network Operators, Microelectronic Products and Business Communications Systems. The overall revenue growth was partially offset by the expected decline in revenues from Consumer Products due to the closing of the Phone Center Stores, discontinuance of unprofitable product lines and the decreased telephone rental revenues. Revenue growth continued to be generated from sales both in the United States and internationally (including exports). International revenues represented 23.1% of total revenues in 1996. The following table presents Lucent's revenues by product line, and the related percentage of total revenues for the nine months ended September 30, 1996 and 1995 (1995 has been restated to align intellectual property and other service revenues with Lucent's operating units):

	Nine Months Ended September 30,			
	1996		1995	
(dollars in millions)	$	%	$	%
Systems for Network Operators	$ 8,637	54%	$ 6,914	49%
Business Communications Systems	3,983	25	3,710	27
Microelectronic Products	1,756	11	1,420	10
Consumer Products	880	6	1,238	9
Other Systems and Products	603	4	704	5
Total	$15,859	100%	$13,986	100%

Revenues from SYSTEMS FOR NETWORK OPERATORS increased $1,723 million or 24.9% compared with the same period in 1995. The increase was driven by higher sales of switching, transmission, fiber-optic cable products and professional services. Demand for those products was driven by second-line subscriber growth and customer demand for continued network upgrades.

Software sales increased $117 million or 15.0% compared with the same period in 1995. For 1996, sales of wireless infrastructure increased $69 million or 6.4% compared with the same period in 1995.

Sales from Systems for Network Operators in the United States increased 23.4% and international

revenues increased 29.6% compared with the same period in 1995. The revenue increase in the United States was led by sales to AT&T and the Regional Bell Operating Companies, partially offset by a revenue decrease resulting from Lucent's exit from the copper cable business in 1995. Increased sales of infrastructure systems and services drove the international revenue growth in the Asia/Pacific and Europe/Middle East/Africa regions. In addition, the international revenue increase included approximately $298 million in revenue from several manufacturing and other operations of certain subsidiaries of Philips Electronics N.V. acquired in 1996 ("Philips Acquisition"). International revenues represented 24.8% of revenues from Systems for Network Operators in the nine-month period of 1996.

In 1996, Lucent focused resources on marketing CDMA technology since this technology had shown acceptance in both the international and domestic markets. In addition, Lucent made progress in the buildout of CDMA infrastructure for PrimeCo Personal Communications LP in 1996. During the first calendar quarter of 1996, Lucent was awarded a contract from Sprint Spectrum Holdings LP ("Sprint PCS") to supply equipment and services for approximately 60% of Sprint PCS's market areas for its nationwide PCS wireless network over a five-year period.

Revenues from BUSINESS COMMUNICATIONS SYSTEMS increased $273 million or 7.4% compared with the same period in 1995. This increase was primarily due to higher sales in the United States and internationally, partially offset by the continued erosion of the rental base. The revenue growth in the United States was led by sales of DEFINITY® products, SYSTIMAX® structured cabling systems and INTUITY™ voice messaging products as well as higher revenue from call centers and maintenance contracts. International revenues increased by 24.7%, reflecting growth in all international regions.

Sales of MICROELECTRONIC PRODUCTS increased $336 million or 23.7% compared with the same period in 1995 due to higher sales of DSPs and ASICs to OEMs, both internationally and in the United States. Domestic revenues increased 14.7% compared with the same period in 1995, led by sales to OEMs. The growth in international revenues of 34.6% was driven by continued strength of DSPs and ASICs sales in the Asia/Pacific region. International revenues represented 49.0% of the Microelectronic Products sales for the nine-month period of 1996.

Revenues from CONSUMER PRODUCTS decreased $358 million or 28.9% compared with the same period in 1995. The expected decline in revenues was primarily due to the decrease in product sales resulting from the closing of the Phone Center Stores, the discontinuance of unprofitable product lines and the decrease in telephone rentals.

Revenues from OTHER SYSTEMS AND PRODUCTS decreased $101 million or 14.3% compared with the same period in 1995. These revenues included sales from the Paradyne subsidiary sold in July 1996 as well as the Custom Manufacturing Services business, which Lucent sold in December 1996.

GROSS MARGIN

Gross margin percent declined to 41.4% from 43.9% in the year-ago period due to changes in the mix of revenues, erosion of high margin rental revenues and lower margins on products from the Philips Acquisition. The revenue mix reflected a high proportion of hardware sales and a high proportion of revenues from contracts accounted for on a percentage of completion basis.

OPERATING EXPENSES

Selling, general and administrative expenses increased $207 million or 5.1% compared with the same period in 1995. Included are approximately $160 million due to expenditures associated with start-up related costs such as advertising and creating a new information systems infrastructure, as well as the additional expenses resulting from the Philips Acquisition.

Selling, general and administrative expenses were 26.8% of revenues for the nine-month period of 1996 compared with 28.9% of revenues for the same period in 1995.

Research and development expenses increased $166 million or 9.9% compared with the same period in 1995. Research and development expenses represented 11.6% of revenues for the nine-month period of 1996 compared with 12.0% of revenues for the same period in 1995.

OTHER INCOME AND PROVISION FOR INCOME TAXES

Other income–net increased $54 million compared with the same period in 1995. The increase was primarily due to interest income on short-term investments.

The effective income tax rate of 39.0% for the nine-month period of 1996 decreased from 40.2% in the same period of 1995, primarily due to increased federal research tax credits.

CASH FLOWS

Cash used in operating activities was $4 million compared with $505 million in the same period in 1995.

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The change was due to an increase in prepayments from customers. Additionally, inventory in 1996 remained relatively level versus the buildup reported in 1995. These activities were offset by AT&T's retention of $2,000 million of accounts receivable in 1996.

Cash payments of $456 million related to business restructuring were made during the nine months of 1996. The September 30, 1996 remaining balance will result in future cash payments over the next two years. Of the 22,000 employee separations announced as part of the 1995 business restructuring, approximately 11,400 people left the workforce as of September 30, 1996. In addition, approximately 1,000 employees left Lucent's workforce as part of the sale of Paradyne. Actual experience in employee separations, combined with redeployment of employees into other areas of the business, has resulted in lower separation costs than originally anticipated. Lucent anticipates that approximately 70% of the total expected employee separations will be complete by the end of December 1996.

Comparing the nine-month periods ended September 30, 1996 and 1995, cash used in investing activities increased to $1,066 million from $770 million. The increase in cash used in investing activities was largely the result of the Philips Acquisition and higher capital expenditures compared with the same period in 1995. Capital expenditures were $939 million and $784 million for the nine-month periods ended September 30, 1996 and 1995, respectively. These expenditures related to the expansion of manufacturing capacity of Microelectronic Products and the necessary expansion of various other facilities.

Cash provided by financing activities increased primarily due to the proceeds from the IPO in 1996 compared with the same period in 1995.

In 1995, Lucent relied on AT&T to provide financing for its operations. Cash flows from financing activities in 1995 principally reflect changes in Lucent's assumed capital structure. These cash flows are not necessarily indicative of the cash flows from financing activities that would have resulted if Lucent was a stand-alone entity.

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Total assets as of September 30, 1997, increased $1,185 million or 5.2% from September 30, 1996, due to increases in contracts in process and other assets offset by decreases in cash and inventory. The increase in contracts in process reflects the buildout for large contracts while the increase in other assets reflects the goodwill associated with the acquisition of Octel. The decrease in cash was largely due to Lucent's cash payments in connection with the acquisition of Octel offset by increased cash collections from customers.

For the year ended September 30, 1997, Lucent's inventory turnover ratio was 4.0 times compared with 3.3 times for the twelve months ended September 30, 1996. The increase was primarily due to improved inventory management at the factories and in the distribution channels. Inventory turnover is defined as cost of sales (excluding costs related to long-term contracts) divided by average inventory during the year.

Accounts receivable were outstanding an average of 64 days for the period ended September 30, 1997 compared with 68 days for the same period in 1996. The decrease in days outstanding was due to a faster level of cash collections in 1997 compared with 1996.

Working capital, defined as current assets less current liabilities, decreased $305 million from September 30, 1996 largely due to the decrease in cash.

The fair value of Lucent's pension plan assets is greater than the projected pension obligations. Lucent records pension income when the expected return on plan assets plus amortization of the transition asset is greater than the interest cost on the projected benefit obligation plus service cost for the year. Consequently, Lucent continued to have a net pension credit that added to prepaid pension costs in 1997 and beyond.

Lucent expects that, from time to time, outstanding commercial paper balances may be replaced with short- or long-term borrowings as market conditions permit. At September 30, 1997, Lucent maintained approximately $5,200 million in credit facilities of which a portion is used to support Lucent's commercial paper program. At September 30, 1997, approximately $5,000 million of these credit facilities were unused. Future financings will be arranged to meet Lucent's requirements with the timing, amount and form of issue depending on prevailing market and general economic conditions. Lucent anticipates that borrowings under its bank credit facilities, the issuance of additional commercial paper, cash generated from operations and short- and long-term debt financings will be adequate to satisfy its future cash requirements, although there can be no assurance that this will be the case.

Network operators, domestically and internationally, increasingly have required their suppliers to arrange or provide long-term financing for them as a condition to obtaining or bidding on infrastructure projects. These projects may require financing in amounts ranging from modest sums to over a billion dollars. In this regard, Lucent entered into a credit agreement in October 1996 to provide Sprint PCS long-term financing of $1,800 million for purchasing equipment and services for its PCS network.

In May 1997, under the $1,800 million credit facility provided by Lucent to Sprint PCS, Lucent closed transactions to lay off $500 million of loans and undrawn commitments and $300 million of undrawn commit-

ments to a group of institutional investors and Sprint Corporation (a partner in Sprint PCS), respectively. As of September 30, 1997, $146 million of these commitments were not yet drawn down by Sprint PCS.

As part of the revenue recognition process, Lucent has assessed the collectibility of the accounts receivable relating to the Sprint PCS purchase contract in light of its financing commitment to Sprint PCS. Lucent has determined that the receivables under the contract are reasonably assured of collection based on various factors among which was the ability of Lucent to sell the loans and commitments without recourse. Lucent intends to continue pursuing opportunities for the sale of future loans and commitments.

Lucent has also entered into agreements to extend credit of up to an aggregate of approximately $850 million to three other PCS operators for possible future sales. As of September 30, 1997, no amounts had been advanced under these agreements. On October 1, 1997, a commitment for $300 million included in the $850 million expired and was not extended. The agreement relating to about $200 million of credit is subject to fulfillment of certain conditions and completion of final contract documentation. Lucent is continuing to propose, and commit to provide, financing where appropriate for its business, in addition to the above arrangements. The ability of Lucent to arrange or provide financing for network operators will depend on a number of factors, including Lucent's capital structure and level of available credit.

Lucent believes that it will be able to access the capital markets on terms and in amounts that will be satisfactory, and that it will be able to obtain bid and performance bonds, to arrange or provide customer financing as necessary, and to engage in hedging transactions on commercially acceptable terms, although there can be no assurance that this will be the case.

The ratio of total debt to total capital (debt plus equity) was 55.4% at September 30, 1997 compared with 59.8% at September 30, 1996. Excluding the one-time charges related to the acquisition of Octel for the twelve months ended September 30, 1997, the return on assets was 6.5% compared with 5.3% for the twelve months ended September 30, 1996, excluding business restructuring and other charges.

RISK MANAGEMENT

Lucent is exposed to market risk from changes in foreign currency exchange rates and interest rates, which could impact its results of operations and financial condition. Lucent manages its exposure to these market risks through its regular operating and financing activities and, when deemed appropriate, through the use of derivative financial instruments. Derivative financial instruments are viewed as risk management tools and are not used for speculative or trading purposes. In addition, derivative financial instruments are entered into with a diversified group of major financial institutions in order to manage Lucent's exposure to nonperformance on such instruments.

Lucent uses foreign currency derivative instruments to reduce its exposure to the risk that the eventual net cash inflows and outflows resulting from the sale of products to foreign customers and purchases from foreign suppliers will be adversely affected by changes in exchange rates. The foreign currency exchange contracts are designated for firmly committed or forecasted purchases and sales. The use of these derivative financial instruments allows Lucent to reduce its overall exposure to exchange rate movements, since the gains and losses on these contracts substantially offset losses and gains on the assets, liabilities and transactions being hedged. As of September 30, 1997 and 1996, Lucent's primary foreign currency market exposures include Deutsche marks, Japanese yen and Dutch guilders. There have been no changes in how such exposures are managed since the nine-month period ended September 30, 1996. Management does not foresee or expect any significant changes in foreign currency exposure or in the strategies it employs to manage such exposures in the near future.

Foreign currency exchange contracts are sensitive to changes in foreign currency exchange rates. As of September 30, 1997, 10% appreciations from the prevailing market rates of Deutsche marks, Japanese yen and Dutch guilders would increase the related unrealized gain by $16 million. Conversely, 10% depreciations of these currencies from the prevailing market rates would decrease the related unrealized gain by $20 million. Unrealized gains/losses in foreign currency exchange contracts are defined as the difference between the hypothetical rates and the current market exchange rates. Consistent with the nature of the economic hedge of such foreign currency exchange contracts, such unrealized gains or losses would be offset by corresponding decreases or increases, respectively, of the underlying instrument or transaction being hedged.

While Lucent hedges actual and anticipated transactions with customers, the decline in value of the Asia/Pacific currencies may, if not reversed, adversely affect future product sales because Lucent products may become more expensive for customers to purchase in their local currency.

Lucent manages its ratio of fixed to floating rate debt with the objective of achieving a mix that management believes is appropriate. To manage this mix in a cost effective manner, Lucent, from time to time, enters into interest rate swap agreements, in which it agrees to exchange various combinations of fixed and/or

variable interest rates based on agreed upon notional amounts. Lucent had no material interest rate swap agreements in effect as of September 30, 1997 and 1996. The strategy employed by Lucent to manage its exposure to interest rate fluctuations is unchanged from that date. Management does not foresee or expect any significant changes in its exposure to interest rate fluctuations or in how such exposure is managed in the near future.

Various financial instruments held or issued by Lucent are sensitive to changes in interest rates. Interest rate changes would result in gains/losses in the market value of Lucent's term debt, commercial paper and investments due to differences between the market interest rates and rates at the inception of these financial instruments. Based on Lucent's term debt and commercial paper outstanding at September 30, 1997 and current market perception, a 100 basis point increase in the interest rates as of September 30, 1997 would result in a net reduction of the market value of these instruments of $80 million. Conversely, a 100 basis point decrease in the interest rates would result in an $86 million net increase in the market value of Lucent's term debt and commercial paper outstanding at September 30, 1997. Neither a 100 basis point increase nor decrease from current interest rates would have a material impact on the market value of Lucent's investments.

OTHER

Lucent's current and historical operations are subject to a wide range of environmental protection laws. In the United States, these laws often require parties to fund remedial action regardless of fault. Lucent has remedial and investigatory activities underway at about 40 current and former facilities. In addition, Lucent was named a successor to AT&T as a potentially responsible party ("PRP") at numerous "Superfund" sites pursuant to the Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA") or comparable state statutes. Under the Separation and Distribution Agreement, among AT&T, Lucent and NCR Corporation ("NCR") dated as of February 1, 1996, and amended and restated as of March 29, 1996 ("Separation and Distribution Agreement"), Lucent is responsible for all liabilities primarily resulting from or related to the operation of Lucent's business as conducted at any time prior to or after the Separation including related businesses discontinued or disposed of prior to the Separation, and Lucent's assets including, without limitation, those associated with these sites. In addition, under the Separation and Distribution Agreement, Lucent is required to pay a portion of contingent liabilities paid out in excess of certain amounts by AT&T and NCR, including environmental liabilities.

It is often difficult to estimate the future impact of environmental matters, including potential liabilities. Lucent records an environmental reserve when it is probable that a liability has been incurred and the amount of the liability is reasonably estimable. This practice is followed whether the claims are asserted or unasserted. Management expects that the amounts reserved will be paid out over the period of remediation for the applicable site which ranges from 5 to 30 years. Reserves for estimated losses from environmental remediation are, depending on the site, based primarily upon internal or third party environmental studies, and estimates as to the number, participation level and financial viability of any other PRPs, the extent of the contamination and the nature of required remedial actions. Accruals are adjusted as further information develops or circumstances change. The amounts provided for in Lucent's consolidated financial statements in respect to environmental reserves are the gross undiscounted amount of such reserves, without deductions for insurance or third party indemnity claims. In those cases where insurance carriers or third party indemnitors have agreed to pay any amounts and management believes that collectibility of such amounts is probable, the amounts are reflected as receivables in the financial statements. Although Lucent believes that its reserves are adequate, there can be no assurance that the amount of capital and other expenditures that will be required relating to remedial actions and compliance with applicable environmental laws will not exceed the amounts reflected in Lucent's reserves or will not have a material adverse effect on Lucent's financial condition, results of operations or cash flows.

FORWARD-LOOKING STATEMENTS

This Management's Discussion and Analysis of financial condition and results of operations and other sections of this Annual Report contain forward-looking statements that are based on current expectations, estimates and projections about the industries in which Lucent operates, management's beliefs and assumptions made by management. In addition, other written or oral statements which constitute forward-looking statements may be made by or on behalf of the Company. Words such as "expects," "anticipates," "intends," "plans," "believes," "seeks," "estimates," or variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions ("Future Factors") which are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements. The Company undertakes no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

Future Factors include increasing price and product/services competition by foreign and domestic competitors, including new entrants; rapid technological developments and changes and the Company's ability to continue to introduce competitive new products and services on a timely, cost effective basis; the mix of products/services; the achievement of lower costs and expenses; domestic and foreign governmental and public policy changes which may affect the level of new investments and purchases made by customers; changes in environmental and other domestic and foreign governmental regulations; protection and validity of patent and other intellectual property rights; reliance on large customers; technological, implementation and cost/financial risks in increasing use of large, multi-year contracts; the cyclical nature of the Company's business; the outcome of pending and future litigation and governmental proceedings and continued availability of financing, financial instruments and financial resources in the amounts, at the times and on the terms required to support the Company's future business. These are representative of the Future Factors that could affect the outcome of the forward-looking statements. In addition, such statements could be affected by general industry and market conditions and growth rates, general domestic and international economic conditions including interest rate and currency exchange rate fluctuations and other Future Factors.

For a further description of Future Factors that could cause actual results to differ materially from such forward-looking statements, see below in this Annual Report and also see the discussion in the Company's Form 10-K for the year ended September 30, 1997 in Item 1 under the section entitled "OUTLOOK-Forward Looking Statements" and the remainder of the OUTLOOK section.

Competition:
See discussion above under KEY BUSINESS CHALLENGES.

Dependence on New Product Development:
The markets for the Company's principal products are characterized by rapidly changing technology, evolving industry standards, frequent new product introductions and evolving methods of building and operating communications systems for network operators and business customers. The Company's operating results will depend to a significant extent on its ability to continue to introduce new systems, products, software and services successfully on a timely basis and to reduce costs of existing systems, software and services. The success of these and other new offerings is dependent on several factors, including proper identification of customer needs, cost, timely completion and introduction, differentiation from offerings of the Company's competitors and market acceptance. In addition, new technological innovations generally require a substantial investment before any assurance is available as to their commercial viability, including, in some cases, certification by international and domestic standards-setting bodies.

Reliance on Major Customers:
See discussion above under KEY BUSINESS CHALLENGES.

Readiness for Year 2000:
Lucent has taken actions to understand the nature and extent of the work required to make its systems, products and infrastructure Year 2000 compliant. Lucent began work several years ago to prepare its products and its financial, information and other computer-based systems for the Year 2000, including replacing and/or updating existing legacy systems. Lucent continues to evaluate the estimated costs associated with these efforts based on actual experience. While these efforts will involve additional costs, Lucent believes, based on available information, that it will be able to manage its total Year 2000 transition without any material adverse effect on its business operations, products or financial prospects.

Multi-Year Contracts:
See discussion above under FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES, AND KEY BUSINESS CHALLENGES.

Seasonality:
See discussion above under KEY BUSINESS CHALLENGES.

Future Capital Requirements:
See discussion above under FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES.

International Growth:
Lucent intends to continue to pursue growth opportunities in international markets. In many international markets, long-standing relationships between potential customers of the Company and their local providers, and protective regulations, including local content requirements and type approvals, create barriers to entry. In addition, pursuit of such international growth opportunities may require significant investments for an extended period before returns on such investments, if any, are realized. Such projects and investments could be adversely affected by reversals or delays in the opening of foreign markets to new competitors, exchange controls, currency fluctuations, investment policies, repatriation of cash, nationalization, social and political risks, taxation, and other factors, depending on the country in which such opportunity arises.

Foreign Exchange:
See discussion above under RISK MANAGEMENT.