Highlights

For the year ended September 30, Lucent Technologies Inc. ("Lucent" or the "Company") reported the following:

1998

- Net income of $970 million, $0.73 per share (diluted)

EXCLUDING CERTAIN ONE-TIME EVENTS:

- Net income of $2,287 million, $1.72 per share (diluted)

1997

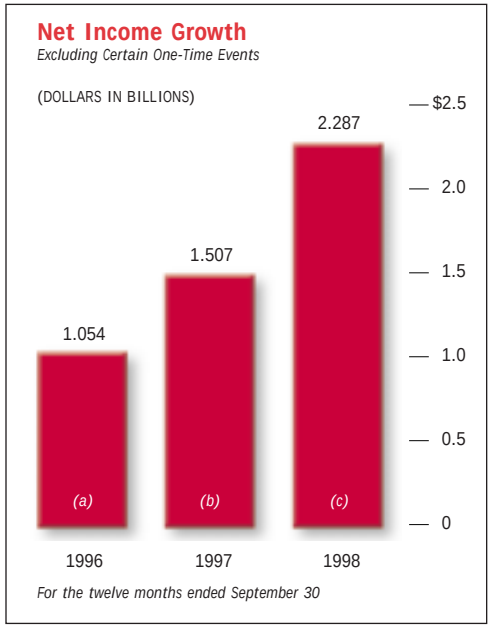
- Net income of $541 million, $0.42 per share (diluted)

EXCLUDING CERTAIN ONE-TIME EVENTS:

- Net income of $1,507 million, $1.17 per share (diluted)

ONE-TIME EVENTS in 1998 include $1,416 million ($1,412 million after tax) of purchased in-process research and development charges related to the acquisitions of Livingston Enterprises Inc., Prominet Corporation, Yurie Systems, Inc., Optimay GmBH, SDX Business Systems plc, MassMedia Communications Inc., LANNET and JNA Telecommunications Limited, as well as a $95 million after tax gain on the sale of Lucent's Advanced Technology Systems ("ATS") unit.

ONE-TIME EVENTS in 1997 include a purchased in-process research and development charge and other charges of $979 million ($966 million after tax) related to the acquisition of Octel Communications Corporation.



(a) Excludes impact of $2,801 million ($1,847 million after tax) of business restructuring and other charges incurred in December 1995.

(b) Excludes one-time charges of $979 million ($966 million after tax) related to the acquisition of Octel.

(c) Excludes one-time charges of $1,416 million ($1,412 million after tax) related to the acquisitions of Livingston, Prominet, Yurie, Optimay, SDX, MassMedia, LANNET and JNA and a gain of $95 million (after tax) on the sale of ATS.

The earnings per share data discussed above have been adjusted to reflect the two-for-one split of Lucent's common stock which became effective April 1, 1998.

Communications Revolution

The communications industry is going through a revolution, centered on rapidly growing demand by commercial and residential users for voice, data, Internet and wireless services. As a result, the industry has undergone a global consolidation of key players, including traditional telecommunications network manufacturers and data networking companies, which compete in the same markets as Lucent. This consolidation–driven by the need for key technologies, new distribution channels in untapped markets, economies of scale and global expansion–is expected to continue into the near future.

Lucent continues to evaluate its presence and product offerings in the marketplace and may use acquisitions to enhance those offerings where that makes good business sense. These acquisitions may occur through the use of cash, or the issuance of debt or common stock, or any combination of the three.

Acquisitions and Divestitures

As part of Lucent's efforts to focus on the fastest growing markets in the communications industry, the Company has acquired a number of businesses, complementing its existing product lines and its internal product development efforts.

- In September 1998, Lucent acquired JNA, an Australian telecom equipment manufacturer, reseller and system integrator.
- In August 1998, Lucent acquired LANNET, an Israeli-based supplier of Ethernet and asynchronous transfer mode ("ATM") switching solutions.
- In July 1998, Lucent acquired both SDX, a United Kingdom-based provider of business communications systems, and MassMedia, a developer of next-generation network interoperability software.
- In May 1998, Lucent acquired Yurie, a provider of ATM access technology and equipment for data, voice and video networking.
- In April 1998, Lucent acquired Optimay, a developer of software products and services for chip sets to be used for Global System for Mobile Communications ("GSM") cellular phones.
- In January 1998, Lucent acquired Prominet, a participant in the emerging Gigabit Ethernet networking industry.
- In December 1997, Lucent acquired Livingston, a global provider of equipment used by Internet service providers to connect their subscribers to the Internet.
- In September 1997, Lucent acquired Octel, a provider of voice, fax and electronic messaging technologies that complement those offered by Lucent.

Lucent has also sought to divest itself of non-core businesses.

- On October 1, 1997, Lucent contributed its Consumer Products business to a new venture formed by Lucent and Philips Electronics N.V. ("Philips") in exchange for 40% ownership of the venture. The venture, Philips Consumer Communications ("PCC"), was formed to create a worldwide provider of personal communications products. On October 22, 1998, Lucent and Philips announced their intention to end the venture in PCC. It is expected that Lucent and Philips will each regain control of the original businesses they contributed to the venture. Lucent plans to close down the wireless handset business it previously contributed to PCC and to sell the consumer product and leasing businesses.
- In October 1997, Lucent completed the sale of its ATS unit.
- In December 1996, Lucent sold its interconnect products and Custom Manufacturing Services ("CMS") businesses.
- In July 1996, Lucent completed the sale of its Paradyne subsidiary.

Lucent's Formation

Lucent was formed from the systems and technology units that were formerly part of AT&T Corp., including the research and development capabilities of Bell Laboratories. Prior to February 1, 1996, AT&T conducted Lucent's original 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. In April 1996, Lucent completed the initial public offering of its common stock ("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. 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.

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

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 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, well-recognized brand names and a global presence. Such competitors may include Cisco Systems, Inc., Nortel Networks, Ericsson, Alcatel Alsthom and Siemens AG. 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 or investing in new businesses and ventures, partnering with existing businesses, delivering new technologies, closing and consolidating facilities, disposing of assets, reducing work force levels or withdrawing from markets.

Lucent has taken measures to manage the seasonality of its business by changing the date on which its fiscal year ends and its compensation programs for employees. As a result, Lucent has achieved a more uniform distribution of revenues–accompanied by a related redistribution of earnings–throughout the year. Revenues and earnings still remain higher in the first fiscal quarter primarily because many of Lucent's large customers historically delay a disproportionate percentage of their capital expenditures until the fourth quarter of the calendar year (Lucent's first fiscal quarter).

The purchasing behavior of Lucent's largest customers has increasingly been characterized by the use of fewer, larger contracts. These contracts typically involve longer negotiating cycles, require the dedication of substantial amounts of working capital and other resources, and in general require costs that 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 that may not have been previously deployed on a large-scale commercial basis. On its multi-year contracts, Lucent may incur significant initial cost overruns and losses that are 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.

Lucent has been successful in diversifying its customer base and seeking out new types of customers globally. These new types of customers include competitive access providers, competitive local exchange carriers, wireless service providers, cable television network operators and computer manufacturers.

Historically, a limited number of customers have provided a substantial portion of Lucent's total revenues. These customers include AT&T, which continues to be a significant customer, as well as other large carriers such as Sprint Spectrum Holdings LP ("Sprint PCS"), and the Regional Bell Operating Companies ("RBOCs"). 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.

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)	
RESULTS OF OPERATIONS	**1998**	**1997**	**1996**	**1996[1]**	**1995**	**1995**	**1994**
Revenues	**$30,147**	$26,360	$23,286	$15,859	$13,986	$21,413	$19,765
Gross margin	**13,991**	11,462	8,894	6,569	6,143	8,468	8,428
Depreciation and amortization expense	**1,334**	1,450	1,326	937	1,104	1,493	1,311
Operating income (loss)	**2,461**	1,631	(947)	487	434	(1,000)	971
Net income (loss)	**970**	541	(793)	224	150	(867)	482
Earnings (loss) per common share–basic[2] [3]	**0.74**	0.42	(0.69)	0.19	0.14	(0.83)	n/a
Earnings (loss) per common share–diluted[2] [3]	**0.73**	0.42	(0.69)	0.19	0.14	(0.83)	n/a
Earnings (loss) per common share–pro forma[3] [4]	**n/a**	n/a	(0.62)	0.18	0.12	(0.68)	n/a
Dividends per common share[3]	**0.155**	0.1125	0.075	0.075	–	–	n/a
FINANCIAL POSITION							
Total assets	**$26,720**	$23,811	$22,626	$22,626	$18,219	$19,722	$17,340
Working capital	**3,650[8]**	1,763	2,068	2,068	188	(384)	246
Total debt	**4,640**	4,203	3,997	3,997	4,192	4,014	3,164
Shareowners' equity	**5,534**	3,387	2,686	2,686	2,783	1,434	2,476
OTHER INFORMATION							
Selling, general and administrative expenses as a percentage of revenues	**21.3%**	21.9%	31.3%	26.8%	28.9%	33.1%	27.1%
Research and development expenses as a percentage of revenues	**12.2**	11.5	11.0	11.6	12.0	11.1	10.6
Gross margin percentage	**46.4**	43.5	38.2	41.4	43.9	39.5	42.6
Return on assets	**9.3[5]**	6.5[6]	5.3[7]	n/a	n/a	n/a	n/a
Ratio of total debt to total capital (debt plus equity)	**45.6**	55.4	59.8	59.8	60.1	73.7	56.1
Capital expenditures	**$ 1,626**	$ 1,635	$ 1,432	$ 939	$ 784	$ 1,277	$ 878
EXCLUDING CERTAIN ONE-TIME EVENTS							
Net income	**$ 2,287[5]**	$ 1,507[6]	$ 1,054[7]	$ 224	$ 150	$ 980[7]	$ 482
Earnings per common share–diluted[2] [3]	**1.72[5]**	1.17[6]	0.83[4,7]	0.19	0.14	0.93[7]	n/a

(1) 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.

(2) The calculation of earnings per share on a historical basis includes the retroactive recognition to January 1, 1995 of the 1,049,249,788 shares (524,624,894 shares on a pre-split basis) owned by AT&T on April 10, 1996.

(3) All per share data has been restated to reflect the two-for-one split of Lucent's common stock which became effective on April 1, 1998.

(4) The calculation of earnings (loss) per share on a pro forma basis assumes that all 1,273,323,862 shares (636,661,931 shares on a pre-split basis) outstanding on April 10, 1996 were outstanding since January 1, 1995 and gives no effect to the use of proceeds from the IPO.

(5) Excludes one-time charges of $1,412 (after tax) of purchased in-process research and development costs from acquisitions of Livingston, Prominet, Optimay, Yurie, SDX, MassMedia, LANNET and JNA, as well as a $95 (after tax) gain on the sale of ATS.

(6) Excludes one-time acquisition charges of $966 (after tax), including $945 of purchased in-process research and development costs, from the acquisition of Octel.

(7) Excludes pre-tax restructuring and other charges of $2,801 ($1,847 after tax) recorded as $892 of costs, $1,645 of selling, general and administrative expenses and $264 of research and development expenses.

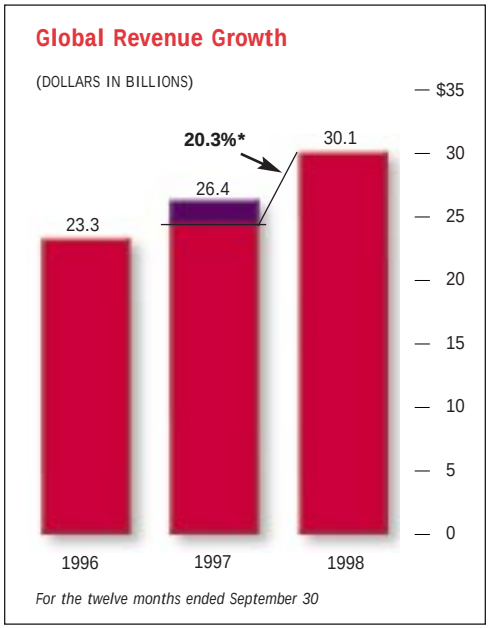
(8) Reflects the reclassification from debt maturing within one year to long-term debt as a result of the November 19, 1998 sale of $500 ($495 net of unamortized costs) of ten-year notes.

n/a Not applicable.

TWELVE MONTHS ENDED SEPTEMBER 30, 1998 VERSUS TWELVE MONTHS ENDED SEPTEMBER 30, 1997

Revenues

Total revenues increased to $30,147 million, or 14.4% compared with the same period in 1997, primarily due to increases in sales from Systems for Network Operators, Business Communications Systems and Microelectronic Products. The overall revenue growth was impacted by the elimination of the Consumer Products sales as a component of total revenue as well as lower revenues from Other Systems and Products. The decline in Other Systems and Products was due primarily to the sale of Lucent's ATS and CMS businesses in October 1997 and in December 1996, respectively. Excluding revenues from Lucent's Consumer Products, ATS and CMS businesses, total revenues increased 20.3% compared with the same period in 1997. Revenue growth was driven by sales increases globally. For fiscal year 1998, sales within the United States grew 11.9% compared with the same period in 1997. Sales outside the United States increased 22.2% compared with the same period in 1997. These sales represented 25.7% of total revenues compared with 24.1% in 1997. Excluding revenues from Lucent's Consumer Products, ATS and CMS businesses, sales within the United States increased 19.6% compared with the same period in 1997.



*Excluding the revenues from Lucent's Consumer Products, ATS and CMS businesses, total revenues increased 20.3% compared with the same period in 1997.

The following table presents Lucent's revenues by product line, and the approximate percentage of total revenues for the twelve months ended September 30, 1998 and 1997:

(DOLLARS IN MILLIONS)	Twelve Months Ended September 30, 1998	As a Percentage of Total Revenue	1997	As a Percentage of Total Revenue
Systems for Network Operators	$18,752	62%	$15,614	59%
Business Communications Systems	8,093	27	6,411	24
Microelectronic Products	3,027	10	2,755	11
Consumer Products	–	–	1,013	4
Other Systems and Products	275	1	567	2
TOTAL	$30,147	100%	$26,360	100%

Revenues from SYSTEMS FOR NETWORK OPERATORS increased $3,138 million, or 20.1% compared with the same period in 1997. The increase resulted from higher sales of switching and wireless systems with associated software, optical networking systems, communications software, and data networking systems for service providers–including those provided by recently acquired Livingston. Demand for those products was driven in part by second line subscriber growth in businesses and residences for Internet services and data traffic.

Revenues from Systems for Network Operators in the United States increased by 20.4% over the year-ago period. The revenue increase in the United States was led by sales to RBOCs, competitive local exchange carriers, wireless service providers and long distance carriers. Revenues generated outside the United States for 1998 increased 19.3% compared with the same period in 1997 due to revenue growth in the Europe/Middle East/Africa, Canada, China and Caribbean/Latin America regions. Revenues generated outside the United States represented 24.9% of revenues for 1998 compared with 25.1% in the same period of 1997.

For 1998, sales of wireless infrastructure increased significantly compared with 1997 as customers accepted networks for commercial service in 1998 using various digital technologies. These technologies include Code Division Multiple Access ("CDMA"), GSM and Time Division Multiple Access ("TDMA"). The Lucent digital technologies continue to show acceptance in markets both within and outside the United States.

Revenues from BUSINESS COMMUNICATIONS SYSTEMS increased $1,682 million, or 26.2% compared with the same period in 1997. This increase was led by sales of messaging systems, including systems provided by recently acquired Octel, SYSTIMAX® structured cabling, enterprise data networking systems and services. Revenues generated outside the United States increased by 53.9% due to growth in all international regions, led by the Europe/Middle East/Africa region. Revenues generated outside the United States

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represented 19.2% of the revenues for 1998 compared with 15.8% in the same period in 1997. For 1998, sales within the United States increased 21.1% compared with the same period in 1997.

Revenues from MICROELECTRONIC PRODUCTS increased $272 million, or 9.9% for 1998 compared with the same period in 1997 due to higher sales of chips for computing and communications, including components for broadband and narrowband networks, data networking, wireless telephones and infrastructure, high-end workstations, optoelectronic components, power systems and the licensing of intellectual property. Sales within the United States increased 11.9% compared with the same period in 1997. Revenues generated outside the United States increased 8.0% compared with the same period in 1997. The increase in revenues generated outside the United States was driven by sales in all international regions, led by the Caribbean/Latin America region. Revenues generated outside the United States represented 50.5% of sales compared with 51.3% for the same period in 1997.

Despite a nearly 8.0%[a] decline in the world semiconductor market, Microelectronic Products achieved revenue growth of 9.9% for 1998.

On October 1, 1997, Lucent contributed its CONSUMER PRODUCTS unit to PCC in exchange for 40% ownership of PCC. On October 22, 1998, Lucent and Philips announced they would end their PCC venture. Lucent plans to close down the wireless handset business it previously contributed to PCC and to sell the remaining businesses. Lucent expects that these activities will be completed during the first calendar quarter of 1999.

Revenues from sales of OTHER SYSTEMS AND PRODUCTS decreased $292 million, or 51.5% compared with the same period in 1997. The reduction in revenues was primarily due to the sale of Lucent's ATS and CMS businesses. ATS designed and manufactured custom defense systems for the United States government.

Costs and Gross Margin

Total costs increased $1,258 million, or 8.4% compared with the same period in 1997 due to the increase in sales volume. Gross margin percentage increased to 46.4% from 43.5% in the year-ago period. The increase in gross margin percentage for the current period was due to an overall favorable mix of higher margin products and services sales.

Operating Expenses

Selling, general and administrative expenses as a percentage of revenues were 21.3% for 1998, a decrease of 0.6 percentage points from the same period in 1997. Excluding the amortization expense associated with goodwill and existing technology for both years, selling, general and administrative expenses as a percentage of revenues was 20.9%, a decrease of 0.9 percentage points from the same period in 1997.

Selling, general and administrative expenses increased $652 million, or 11.3% compared with the same period in 1997. This increase is attributed to the higher sales volume, investment in growth initiatives, amortization expense associated with goodwill and existing technology as well as the implementation of SAP, an integrated software platform. Amortization expense associated with goodwill and existing technology was $147 million for the year ended September 30, 1998, an increase of $115 million from the same year-ago period. These increases were offset by the reversal of $66 million of 1995 business restructuring charges. In addition, the 1997 period included a $174 million reversal of 1995 business restructuring charges.

Research and development expenses represented 12.2% of revenues for the period as compared with 11.5% of revenues from the same period in 1997.

Research and development expenses increased $655 million compared with the same period in 1997. This was primarily due to increased expenditures in support of wireless, data networking, optical networking and software as well as switching and access systems and microelectronic products.

The purchased in-process research and development expenses for 1998 were $1,416 million, reflecting the charges associated with the acquisitions of Livingston, Prominet, Yurie, Optimay, SDX, MassMedia, LANNET and JNA compared with $1,024 million related to the acquisitions of Octel and Agile Networks Inc. for the same period in 1997.

Other Income, Interest Expense and Provision for Income Taxes

Other income–net increased $22 million for 1998 compared with the same period in 1997. This increase was primarily due to gains recorded on the sale of certain business operations, including $149 million associated with the sale of Lucent's ATS business. These gains were offset by higher net losses associated with Lucent's equity investments, primarily from the PCC investment. Also, included in Other income–net for 1998 is a charge of $110 million related to a write-down associated with Lucent's investment in the PCC venture. This charge was offset by one-time gains of $103 million primarily related to the sale of an investment and the sale of certain business operations including Bell Labs Design Automation Group.

Interest expense was $318 million for the 1998 fiscal year, an increase of $13 million compared with the same period in 1997. The increase in interest expense is due to higher debt levels in 1998 as compared with the prior year.

The effective income tax rate of 57.9% for 1998 decreased from the effective income tax rate of 63.1% in the same year-ago period. Excluding the impact of the purchased in-process research and development expenses associated with Livingston, Prominet, Yurie, Optimay, SDX, LANNET and JNA acquisitions, as well as the similar impact of the Octel and Agile acquisitions in 1997, the effective income tax rate was 36.0% for 1998, a decrease from the year-ago rate of 37.2%. This decrease was primarily due to a reduced state effective tax rate and increased research tax credits.

Cash Flows

Cash provided by operating activities was $1,366 million in 1998, a decrease of $580 million compared with the same period in 1997. This decrease in cash was largely due to the increase in accounts receivable, partially offset by the increase in payroll and benefit-related liabilities.

[a] *Source: World Semiconductor Trade Statistics, Inc.*

Cash payments of $176 million were charged against the December 1995 business restructuring reserves in 1998 compared with $483 million in 1997. Of the 23,000 positions that Lucent announced it would eliminate in connection with the 1995 restructuring charges, approximately 19,900 positions had been eliminated through September 30, 1998. Actual experience in employee separations, combined with redeploying employees into other areas of the business, resulted in lower separation costs than originally anticipated. Lucent expects employee reductions in positions to be substantially complete by September 1999.

Comparing 1998 and 1997, cash used in investing activities decreased to $2,808 million from $3,121 million primarily due to a decrease in cash used for acquisitions, as well as an increase in cash received from dispositions. In 1998, cash was used in the acquisitions of Yurie, Optimay, SDX, LANNET and JNA. The acquisitions of Livingston and Prominet in 1998 were completed through the issuance of stock and options and did not require the use of cash. The use of cash in 1998 was partially offset by proceeds from the sale of ATS. In 1997, Lucent acquired Octel and Agile and disposed of its interconnect products and CMS businesses.

Capital expenditures were $1,626 million and $1,635 million for 1998 and 1997, 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 1998 was $838 million compared with $295 million in 1997. The increase in cash provided by financing activities was due to higher debt levels and increased issuances of common stock when compared with the prior period.

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 within and outside the United States. Sales outside the United States increased 11.9% compared with 1996 and represented 24.1% of total revenues in 1997. The increased sales outside of the United States reflected Lucent's targeted approach toward revenue expansion outside the United States 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:

(DOLLARS IN MILLIONS)	Twelve Months Ended September 30, 1997	As a Percentage of Total Revenue	Twelve Months Ended September 30, 1996	As a Percentage of Total Revenue
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.

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. Sales outside the United States increased 8.2% compared with 1996, resulting from increased sales in the Europe/Middle East/Africa, Asia/Pacific and Caribbean/Latin America regions. Sales outside the United States 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 CDMA, GSM and TDMA. The Lucent digital technologies continue to show acceptance in markets both within and outside the United States.

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. Revenues outside the United States increased by 13.2%, reflecting growth in all international regions. The increases both within and outside the United States were 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. Sales outside the United States represented 15.8% of revenue for 1997.

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Sales of MICROELECTRONIC PRODUCTS increased $440 million or 19.0% compared with 1996, due to 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. Sales within the United States increased 12.5% compared with 1996, led by sales to original equipment manufacturers ("OEMs"). The 25.9% growth in revenues outside the United States 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. Sales outside the United States represented 51.3% of the Microelectronic Products sales for 1997. Microelectronic Products continued 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 CMS business in fiscal year 1997 and its Paradyne subsidiary in fiscal year 1996.

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 Lucent's 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 revenues 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 recorded in 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 and Agile. Agile is a provider of advanced intelligent data switching products acquired by Lucent in October 1996.

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 purchased in-process research and development costs and the tax impact of restructuring charges incurred in 1996. Excluding charges related to the acquisitions 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 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 cash collections associated with higher sales. 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.

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Cash payments of $483 million were charged against the December 1995 business restructuring reserves in 1997. As of September 30, 1997, the work force had been reduced by approximately 17,900 positions in connection with business restructuring. In addition, approximately 1,000 employees left Lucent's work force 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 year 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 Lucent had been a stand-alone entity.

Financial Condition, Liquidity and Capital Resources

Total assets as of September 30, 1998 increased $2,909 million, or 12.2%, from September 30, 1997. This increase was primarily due to increases in accounts receivable and other assets of $1,566 million and $1,001 million, respectively. The increase in accounts receivable was primarily due to higher sales. The increase in other assets was largely due to the increase in goodwill and existing technology associated with the Livingston, Prominet, Yurie, Optimay, SDX, LANNET and JNA acquisitions, and an increase in equity investments as a result of Lucent's contribution of its Consumer Products business to PCC.

Total liabilities increased $762 million, or 3.7%, from September 30, 1997. This increase was largely due to the increases in payroll and benefit-related liabilities and postretirement and postemployment benefit liabilities. These increases are primarily related to the increase in employee headcount as a result of Lucent's recent acquisitions as well as year end payroll and benefit accruals.

Working capital, defined as current assets less current liabilities, increased $1,887 million from fiscal year end 1997 primarily resulting from the increase in accounts receivable and the following reclassification of $500 million ($495 million net of unamortized costs) from short-term debt to long-term debt. On November 19, 1998, Lucent sold $500 million of ten-year notes and reclassified the amount from debt maturing within one year to long-term debt. The proceeds were used to pay down a portion of Lucent's commercial paper during the first quarter of fiscal 1999.

For the year ended September 30, 1998, Lucent's inventory turnover ratio was 4.6 times compared with 4.0 times for the year ended September 30, 1997. 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 years ended September 30, 1998 and 1997.

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 1998 and which is expected to continue in the near term.

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, 1998, 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, 1998, approximately $4,850 million was unused. Future financings will be arranged to meet Lucent's requirements, with the timing, amount and form of issue depending on the 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, inside and outside the United States, 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. Lucent has increasingly provided or arranged long-term financing for customers. As market conditions permit, Lucent's intention is to lay off these long-term financing arrangements, which may include both commitments and drawn down borrowings, to other financial institutions and investors. This enables Lucent to reduce the amount of its commitments and free up additional financing capacity.

As of September 30, 1998, Lucent had made commitments or entered into an agreement to extend credit to certain customers, including Sprint PCS up to an aggregate of approximately $2,300 million. As of September 30, 1998, approximately $400 million had been advanced and was outstanding. Included in the $2,300 million is approximately $1,230 million to six other PCS or wireless network operators (including fixed wireless) for possible future sales. As of September 30, 1998, approximately $130 million had been

advanced under four of these arrangements. In addition, Lucent had made commitments or entered into agreements to extend credit up to an aggregate of approximately $370 million for two network operators other than PCS or wireless network operators. As of September 30, 1998, no amount was advanced under either of these agreements. In November 1998, a commitment for $110 million, included in the $370 million, was terminated.

In October 1996, Lucent entered into a credit agreement to provide Sprint PCS long-term financing of $1,800 million for purchasing Lucent's 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 commitments to a group of institutional investors and Sprint Corporation (a partner in Sprint PCS), respectively. As of September 30, 1998, all of these commitments were drawn down by Sprint PCS. On June 8, 1998, Lucent sold $645 million of loans in a private sale. As of September 30, 1998, Lucent has $253 million of undrawn commitments and $226 million of drawn loans outstanding.

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 the $226 million of loans outstanding, and the future loans and commitments to Sprint PCS.

On October 22, 1998, Lucent announced that it had entered into a five-year agreement with WinStar Communications, Inc. to provide WinStar with a fixed wireless broadband telecommunications network in major domestic and international markets. In connection with this agreement, Lucent entered into a credit agreement with WinStar to provide up to $2,000 million in equipment financing to fund the buildout of this network. The maximum amount of credit that Lucent is obligated to extend to WinStar at any one time is $500 million.

In addition to the above arrangements, Lucent will continue to provide or commit to financing where appropriate for its business. The ability of Lucent to arrange or provide financing for its customers will depend on a number of factors, including Lucent's capital structure and level of available credit, and its continued ability to lay off commitments and drawn down borrowings on acceptable terms.

Lucent believes that it will be able to access the capital markets on terms and in amounts that will be satisfactory to Lucent 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 45.6% at September 30, 1998 compared with 55.4% at September 30, 1997. The decrease in the ratio was primarily due to the increase in shareowners' equity, which resulted from net income and the issuance of common stock, partially offset by the increase in debt.

Excluding the one-time charges related to the acquisitions of Livingston, Prominet, Optimay, Yurie, SDX, MassMedia, LANNET and JNA as well as the gain on the sale of ATS in 1998, the return on assets was 9.3%. This represents a 2.8 percentage point increase over the prior year return on assets of 6.5%, excluding the Octel acquisition charges in 1997.

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. Lucent uses derivative financial instruments as risk management tools and not 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 exchange contracts, and to a lesser extent, foreign currency purchased options 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. 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, 1998, Lucent's primary net foreign currency market exposures include Deutsche marks and British pounds. As of September 30, 1997, Lucent's primary net foreign currency market exposures included Deutsche marks, Japanese yen and Dutch guilders. Lucent has not changed its policy regarding how such exposures are managed since the year ended September 30, 1997. Management does not foresee or expect any significant changes in foreign currency exposure in the near future.

The fair value of foreign currency exchange contracts is sensitive to changes in foreign currency exchange rates. As of September 30, 1998 and 1997, a 10% appreciation in foreign currency exchange rates from the prevailing market rates would increase the related net unrealized gain by $11 million and $27 million, respectively. Conversely, a 10%

depreciation in these currencies from the prevailing market rates would decrease the related net unrealized gain by $18 million and $35 million, as of September 30, 1998 and 1997, respectively. Unrealized gains/losses in foreign currency exchange contracts are defined as the difference between the contract rate at the inception date of the foreign currency exchange contract 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 or currencies in other regions 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, 1998 and 1997. The strategy employed by Lucent to manage its exposure to interest rate fluctuations is unchanged from September 30, 1997. 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.

The fair value of Lucent's fixed rate long-term debt is sensitive to changes in interest rates. Interest rate changes would result in gains/losses in the market value of this debt due to differences between the market interest rates and rates at the inception of the debt obligation. Based on a hypothetical immediate 150 basis point increase in interest rates at September 30, 1998 and 1997, the market value of Lucent's fixed rate long-term debt would be impacted by a net decrease of $209 million and $113 million, respectively. Conversely, a 150 basis point decrease in interest rates would result in a net increase in the market value of Lucent's fixed rate long-term debt outstanding at September 30, 1998 and 1997 of $247 million and $121 million, respectively. As a result of the change in market conditions in 1998, Lucent used a hypothetical 150 basis point change, versus 100 basis points used in the fiscal year 1997 presentation, to determine the change in market value of this debt.

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 numerous 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 dated as of February 1, 1996, as amended and restated, 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 follwed 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. Any amounts of environmental costs that may be incurred in excess of those provided for at September 30, 1998 cannot be determined.

Forward-Looking Statements

This Management's Discussion and Analysis of Results of Operations and Financial Condition and other sections of this report contain forward-looking statements that are based on current expectations, estimates, forecasts 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," 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; the outcome and impact of Year 2000; 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 the 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.

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, products, 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 is engaged in a major effort to minimize the impact of the Year 2000 date change on Lucent's products, information technology systems, facilities and production infrastructure. Lucent has targeted June 30, 1999 for completion of these efforts.

The Year 2000 challenge is a priority within Lucent at every level of the Company. Primary Year 2000 preparedness responsibility rests with program offices which have been established within each of Lucent's product groups and corporate centers. A corporate-wide Lucent Year 2000 Program Office ("LYPO") monitors and reports on the progress of these offices. Each program office has a core of full-time individuals augmented by a much larger group who have been assigned specific Year 2000 responsibilities in addition to their regular assignments. Further, Lucent has engaged third parties to assist in its readiness efforts in certain cases. LYPO has established a methodology to measure, track and report Year 2000 readiness status consisting of five steps: inventory; assessment; remediation; testing and deployment.

Lucent is completing programs to make its new commercially available products Year 2000 ready and has developed evolution strategies for customers who own non-Year 2000 ready Lucent products. The majority of the upgrades and new products needed to support customer migration are already generally available. By the end of 1998, all but a few of these products are targeted for general availability.

Lucent has launched extensive efforts to alert customers who have non-Year 2000 ready products, including direct mailings, phone contacts and participation in user and industry groups. Recently, Lucent has set up a Year 2000 website www.lucent.com/y2k that provides Year 2000 product information. Lucent continues to cooperate in the Year 2000 information sharing efforts of the Federal Communications Commission and other governmental bodies.

Lucent believes it has sufficient resources to provide timely support to its customers that require product migrations or upgrades. However, because this effort is heavily dependent on customer cooperation, Lucent continues to monitor customer response and will take steps to improve customer responsiveness, as necessary. Also, Lucent has begun contingency planning to address potential spikes in demand for customer support resulting from the Year 2000 date change. These plans are targeted for completion by April 30, 1999.

Lucent has largely completed the inventory and assessment phases of the program with respect to its factories, information systems, and facilities. Approximately, two-thirds of the production elements included in the factory inventory were found to be Year 2000

ready. The factories have commenced the remediation phase of their effort through a combination of product upgrades and replacement. Plans have been developed to facilitate the completion of this work, as well as the related testing and deployment, by June 30, 1999.

Currently, approximately 60% of Lucent's information technology infrastructure has been determined to be Year 2000 ready and is deployed for use. Approximately, 45% of the applications requiring Year 2000 remediation that are supported by Lucent's information technology group are now Year 2000 ready and have been deployed or are awaiting deployment. LYPO is monitoring the progress of readiness efforts across the Company, with a special emphasis on the early identification of any areas where progress to-date could indicate difficulty in meeting the Company's June 1999 internal readiness target date. Lucent is developing specific contingency plans, as appropriate.

Lucent is also assessing the Year 2000 readiness of the large number of facilities that it owns or leases world-wide. Priority is being placed on Lucent-owned facilities, leased facilities that Lucent manages and other critical facilities that house large numbers of employees or significant operations. Based on the results of these assessment activities, Lucent plans to complete remediation efforts by March 31, 1999 and complete development of applicable contingency plans by May 31, 1999.

To ensure the continued delivery of third party products and services, Lucent's procurement organization has analyzed Lucent's supplier base and has sent surveys to approximately 5,000 suppliers. Follow-up efforts have commenced to obtain feedback from critical suppliers. To supplement this effort, Lucent plans to conduct readiness reviews of the Year 2000 status of the suppliers ranked as most critical based on the nature of their relationship with Lucent, the product/service provided and/or the content of their survey responses. Almost all of Lucent's suppliers are still deeply engaged in executing their Year 2000 readiness efforts and, as a result, Lucent cannot, at this time, fully evaluate the Year 2000 risks to its supply chain. Lucent will continue to monitor the Year 2000 status of its suppliers to minimize this risk and will develop appropriate contingent responses as the risks become clearer.

The risk to Lucent resulting from the failure of third parties in the public and private sector to attain Year 2000 readiness is the same as other firms in Lucent's industry or other business enterprises generally. The following are representative of the types of risks that could result in the event of one or more major failures of Lucent's information systems, factories or facilities to be Year 2000 ready, or similar major failures by one or more major third party suppliers to Lucent: (1) information systems–could include interruptions or disruptions of business and transaction processing such as customer billing, payroll, accounts payable and other operating and information processes, until systems can be remedied or replaced; (2) factories and facilities–could include interruptions or disruptions of manufacturing processes and facilities with delays in delivery of products, until non-compliant conditions or components can be remedied or replaced; and (3) major suppliers to Lucent–could include interruptions or disruptions of the supply of raw materials, supplies and Year 2000 ready components which could cause interruptions or disruptions of manufacturing and delays in delivery of products, until the third party supplier remedied the problem or contingency measures were implemented. Risks of major failures of Lucent's principal products could include adverse functional impacts experienced by customers, the costs and resources for Lucent to remedy problems or replace products where Lucent is obligated or undertakes to take such action, and delays in delivery of new products.

Lucent believes it is taking the necessary steps to resolve Year 2000 issues; however, given the possible consequences of failure to resolve significant Year 2000 issues, there can be no assurance that any one or more such failures would not have a material adverse effect on Lucent. Lucent estimates that the costs of efforts to prepare for Year 2000 from calendar year 1997 through 2000 is about $535 million, of which an estimated $210 million has been spent as of September 30, 1998. Lucent has been able to reprioritize work projects to largely address Year 2000 readiness needs within its existing organizations. As a result, most of these costs represent costs that would have been incurred in any event. These amounts cover costs of the Year 2000 readiness work for inventory, assessment, remediation, testing and deployment including fees and charges of contractors for outsourced work and consultant fees. Costs for previously contemplated updates and replacements of Lucent's internal systems and information systems infrastructure have been excluded without attempting to establish whether the timing of non-Year 2000 replacement or upgrading was accelerated.

While the Year 2000 cost estimates above include 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.

The actual outcomes and results could be affected by Future Factors including, but not limited to, the continued availability of skilled personnel, cost control, the ability to locate and remediate software code problems, critical suppliers and subcontractors meeting their commitments to be Year 2000 ready and provide Year 2000 ready products, and timely actions by customers.

European Monetary Union–Euro:

On January 1, 1999, several member countries of the European Union will establish fixed conversion rates between their existing sovereign currencies, and adopt the Euro as their new common legal currency. As of that date, the Euro will trade on currency exchanges and the legacy currencies will remain legal tender in the participating countries for a transition period between January 1, 1999 and January 1, 2002.

During the transition period, cash-less payments can be made in the Euro, and parties can elect to pay for goods and services and transact business using either the Euro or a legacy currency. Between January 1, 2002 and July 1, 2002, the participating countries will introduce Euro notes and coins and withdraw all legacy currencies so that they will no longer be available.

Lucent has begun planning for the Euro's introduction. For this purpose, Lucent has in place a joint European-United States team representing affected functions within the Company.

The Euro conversion may affect cross-border competition by creating cross-border price transparency. Lucent is assessing its pricing/marketing strategy in order to insure that it remains competitive in a broader European market. Lucent is also assessing its information technology systems to allow for transactions to take place in both the legacy currencies and the Euro and the eventual elimination of the legacy currencies, and reviewing whether certain existing contracts will need to be modified. Lucent's currency risk and risk management for operations in participating countries may be reduced as the legacy currencies are converted to the Euro. Final accounting, tax and governmental legal and regulatory guidance generally has not been provided in final form. Lucent will continue to evaluate issues involving introduction of the Euro. Based on current information and Lucent's current assessment, Lucent does not expect that the Euro conversion will have a material adverse effect on its business, results of operations, cash flows or financial condition.

Employee Relations:
On September 30, 1998, Lucent employed approximately 141,600 persons, including 78.9% located in the United States. Of these domestic employees, about 40% are represented by unions, primarily the Communications Workers of America ("CWA") and the International Brotherhood of Electrical Workers ("IBEW"). Lucent signed new five-year agreements with the CWA and IBEW expiring May 31, 2003.

Multi-Year Contracts:
Lucent has significant contracts for the sale of infrastructure systems to network operators which extend over a multi-year period, and expects to enter into similar contracts in the future, with uncertainties affecting recognition of revenues, stringent acceptance criteria, implementation of new technologies and possible significant initial cost overruns and losses. See also 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.

Growth Outside the United States, Foreign Exchange and Interest Rates:
Lucent intends to continue to pursue growth opportunities in markets outside the United States. In many markets outside the United States, long-standing relationships between potential customers of Lucent and their local providers, and protective regulations, including local content requirements and type approvals, create barriers to entry. In addition, pursuit of such growth opportunities outside the United States 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. Difficulties in foreign financial markets and economies, and of foreign financial institutions, could adversely affect demand from customers in the affected countries.

See discussion above under RISK MANAGEMENT with respect to foreign exchange and interest rates. A significant change in the value of the dollar against the currency of one or more countries where Lucent sells products to local customers or makes purchases from local suppliers may materially adversely affect Lucent's results. Lucent attempts to mitigate any such effects through the use of foreign currency contracts, although there can be no assurances that such attempts will be successful.

Legal Proceedings and Environmental:
See discussion above under OTHER.