

ALCATEL S.A. AND LUCENT TECHNOLOGIES: THE EFFECT OF ACQUISITIONS ON NET OPERATING LOSSES

On April 26, 2006, Mariam Porter, a telecom analyst for the investment bank Nasson McDonald & Co., was sitting at her desk working on her analysis of the recently announced merger of telecom equipment giants Lucent and Alcatel. The merger agreement, which was consummated after years of informal discussions, would create a communications technology equipment behemoth in most of its product areas. With approximately \$25 billion in combined sales, the merger would create the number-one wireline, DSL, and optics equipment provider, while retaining the number-two spot in mobility and services, and third place in routing. In announcing the combination, the companies made audacious projections for cost synergies: \$1.7 billion annually, a substantial majority of which would be achieved within two years, with a net present value of \$12 billion. Geographically, the newly amalgamated company would be entrenched in the United States and Europe, with a strong presence in the fast-growing, emerging markets of Asia and Latin America.¹ “There’s practically no customer, large or small, not being reached by either Alcatel or Lucent,” boasted Steve Tchuruk, chairman and CEO of Alcatel and planned chairman of the new firm.²

While the case made by the companies for the merger seemed compelling, Porter knew Alcatel and Lucent had been hit hard by the global collapse in communications technology spending in 2000 and 2001, and both had legacies of net operating losses (NOLs). On her desk sat an article from that day’s *Wall Street Journal*, which assessed the tax consequences of the merger. The article noted that Lucent held \$3.5 billion in potential U.S. tax savings arising from NOLs plus \$2.9 billion in other tax credits, which included foreign credits of \$500 million.³ The article also predicted that the combined company could use more than \$1.4 billion in NOLs per year to offset U.S. federal taxes over the next five years, \$870 million of which was due to a

¹ All data is from Lucent or Alcatel public SEC filings, including Lucent historical 10-Ks, Alcatel historical 20-Fs, and merger-related press releases, unless otherwise noted.

² From Alcatel-Lucent joint analyst presentation during a conference call on April 3, 2006. SEC proxy filing DEF14A dated 4/3/2006.

³ Jesse Drucker and Sara Silver, “Alcatel Stands to Reap Tax Benefit on Merger.” *Wall Street Journal*, 26 April 2006, C3.

This case was prepared by Jonathan Right under the supervision of Assistant Professor Mary Margaret Frank. It was written as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation. Copyright © 2007 by the University of Virginia Darden School Foundation, Charlottesville, VA. All rights reserved. *To order copies, send an e-mail to sales@dardenbusinesspublishing.com. No part of this publication may be reproduced, stored in a retrieval system, used in a spreadsheet, or transmitted in any form or by any means—electronic, mechanical, photocopying, recording, or otherwise—without the permission of the Darden School Foundation.* ◇

relatively new IRS tax ruling.⁴ As Porter began to dive deeper into the effect of the transaction on the companies' NOLs, she wondered whether the article's assessment was correct and what impact the NOLs had on the structure and the value of the deal.

Alcatel S.A.

With a market cap of \$21.2 billion, Alcatel was one of the largest communications equipment suppliers in the world.⁵ Based in Paris, France, the company served fixed-line and wireless communications providers, ISPs, governments, and businesses in over 130 countries. The company was organized into three divisions: fixed communications, mobile communications, and private communications, and it served the telecommunications market across the spectrum of equipment needs. Products included everything from switches and routers along the backbone of communications networks to the development, manufacture, and management of undersea transmission networks to mobile communications hardware and software. Revenues grew 7.3% in 2005 to almost \$16 billion; almost 50% of the company's sales were in Europe, while 14% of revenues were found in North America (**Exhibit 1**).

The collapse in technology spending that followed the rapid decline in the stock market in 2000 and 2001 had a dramatic effect on the profits of tech equipment providers, and Alcatel was no exception. After earning (euros) EUR449 million in 1999, the company's net income dipped dramatically, falling to a EUR481 million loss in 2000 before losing EUR4.9 billion in 2001. The company did not break even again until 2004, when it earned a net income of EUR550 million. **Exhibit 2** provides Alcatel's 2005 and 2004 income statements, balance sheets, and excerpts from its income tax footnotes reported using *U.S. GAAP*.

Exhibit 3 shows the deterioration and recovery of Alcatel's total *operating* earnings under *French GAAP*, along with the portions that it earned in and out of the United States.⁶ In 2005, Alcatel yielded total operating earnings of EUR1189 million, EUR406 million of which came from the United States.

Lucent Technologies

Lucent began its storied history as the telecommunications equipment arm of AT&T. In a 1982 antitrust settlement, the Department of Justice sought to loosen AT&T's monopoly in both the long distance and local telephone markets. Therefore, AT&T separated into a long distance and equipment company, which retained the AT&T name, and seven regional local telephone

⁴ Internal Revenue Service Notice 2003-65, 2003-2 C.B. 747.

⁵ Dennis Berman, et al., "Lucent, Alcatel Are Far Along in Merger Talks." *Wall Street Journal*, 24 March 2006, A1.

⁶ Until 2001, U.S. earnings were reported as from the United States. After 2001, earnings from the United States were grouped with earnings from all of North America.

service providers, called Regional Bell Operating Companies (RBOCs), which became known as the “Baby Bells.” Nonetheless, AT&T still held an almost exclusive grip on equipment sales to the RBOCs through Lucent. When the 1990s’ deregulation opened the doors for the Baby Bells to enter the long distance market, these emerging titans balked at purchasing their equipment from a direct competitor in long distance, instead looking to other providers such as Alcatel. To alleviate the concerns of its customers (i.e., the Baby Bells), AT&T spun off Lucent in 1996.⁷

The resulting company became a powerful provider of equipment, systems, software, and services to the telecommunications market, with a market cap of approximately \$12.6 billion before the proposed transaction with Alcatel.⁸ With products that essentially paralleled Alcatel’s, the company primarily served large, established service providers in the wireless, wireline telecom, and optical networking spaces, as well as the U.S. government. Its R&D arm, Bell Laboratories, became one of the world’s largest research and development organizations focused on communications. In 2005, Lucent employed 30,500 workers, with over 18,500 in the United States. Sixty-six percent of the company’s FY2005 sales of \$9.4 billion were located in the United States. (**Exhibit 1**)

Lucent’s earnings history paralleled Alcatel’s during the 2000 telecom bust and 2001 recession. Net income fell from \$4.8 billion for the fiscal year ending September 30, 1999, to a net loss of \$16.2 billion in 2001; net income did not reach positive territory again until 2004.

Exhibit 4 shows the rise, fall, and recovery of Lucent’s total, U.S., and non-U.S. *pre-tax* earnings under U.S. GAAP.

Exhibit 5 reports estimates of Lucent’s federal taxable income from 1998 to 2005.

Exhibit 6 provides Lucent’s 2005 and 2004 income statements, balance sheets, and excerpts from its income tax footnotes.

The Merger

The transaction was structured as a reverse triangular A reorganization, approximately 40% owned by Lucent shareholders post-transaction. Based in Paris, Alcatel-Lucent would be helmed by Lucent’s CEO Patricia Russo. Alcatel’s CEO Steve Tchuruk would serve as the non-executive chairman. The fourteen board positions would be divided equally: six directors from Alcatel (including Tchuruk), six from Lucent (including Russo), and two outside appointees. The parties expected 34% of combined revenues of \$25 billion to come from North America (**Exhibit 1**). While some analysts thought the companies were compatible, the deal failed to garner much

⁷ <http://www.corp.att.com/history/milestones.html>.

⁸ Dennis Berman, et al., “Lucent, Alcatel Are Far Along in Merger Talks.” *Wall Street Journal*, 24 March 2006, A1.