Alcatel-Lucent (ALU)

Q309 Results: Is Cash No Longer King? Target To $5.89

ADR ☑
Target price change ☑
Estimate change ☑

- **Cashflow Blowout Offset By P&L "Disappointment" & Cautious Outlook** — We view the -11% stock move to ALU's Q3 results as an over-reaction to a 6% top line miss & marginally higher (in absolute terms) operating loss given the blowout FCF generation (>6% of market cap) & minimal changes to Q409/2010E EBIT ests. Although management gave cautious commentary on overall capex trends, this echoed a number of its peers (e.g. Ericsson, NSN).

- **Mix Improvements & Lower Opex Should Drive Q4 & 2010 Profitability** — Despite a lower Q3 revenue base, we believe that improving mix (e.g. recovery in U.S. CDMA, WCDMA profitability, IP, Services) will drive a 60bps QoQ GM increase. Coupled with a sequential decline in opex (cost cutting/FX), we model Q4 op. margin of 5.9%. For 2010E, we maintain our 4% op. margin estimate, supported by the likely extension of existing cost saving plans.

- **What About The Cash?** — One of the key issues in our (and investors) minds has been ALU's continual poor cash flow generation. As we highlighted in our note post Q2 results, we urged ALU to "show me the cash". That its $1,082 million of operating cashflow this quarter has gone seemingly unnoticed is in our view, unmerited.

- **Estimates Largely Unchanged, Target To $5.89** — Our underlying 2010E/11E EBIT estimates are lowered by around 3% due to lower revenue expectations. Our margin assumptions remain unchanged. We view the sell-off as a buying opportunity given our expectations on margin delivery. Target to $5.89 (from $5.74) given higher net cash position. Re-iterate Buy/High Risk (1H) rating.

Buy/High Risk	1H
Price (30 Oct 09)	US$3.69
Target price	US$5.89
Expected share price return	59.5%
Expected dividend yield	0.0%
Expected total return	**59.5%**
ADRs Outstanding	2,260M
ADR/Ord Ratio	1:1
Local Share Price	€2.57
Market Cap	US$8,768M

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Year to 31 Dec	2007A	2008A	2009E	2010E	2011E
Sales ($m)	24,390	24,989	21,771	23,678	24,822
EBITDA ($m)	5,062	8,695	747	2,296	2,855
Net Income ($m)	-787	-931	-107	734	1,211
EPADR ($)	-0.35	-0.41	0.00	0.32	0.52
EPADR (Old) ($)	-0.35	-0.41	-0.02	0.31	0.55
PE (x)	-10.57	-8.95	0.00	11.68	7.08
EV/EBITDA (x)	0.6	0.6	9.2	2.2	1.4
Dividend/ADR ($)	0.00	0.00	0.00	0.00	0.00
Dividend Yield (%)	0.0	0.0	0.0	0.0	0.0
FX Used EUR	1.37	1.47	1.39	1.47	1.47

See Appendix A-1 for Analyst Certification and important disclosures.

- **This is an excerpt from an underlying research report titled "Q309 Results: Is Cash No Longer King? Target To €4" dated October 30, 2009. Note that all the changes described in this note occurred on the 30th. For a full copy of the report, please contact your Citi sales representative.**

Results Summary & Outlook

Having followed Alcatel-Lucent in its various structures and iterations over the last decade, it seems almost ironic that the one quarter it truly delivers on cashflow that the ADR price declines by around 11%. Although Q3 revenue and operating profit were hardly inspiring, for it to overshadow ALU's stellar cash flow generation (FCF of $531 million, or > 6% of its market cap) seems excessively harsh in our opinion. Given the relatively inexpensive valuation (EV/Sales of around 0.3x), we believe that the ADR is hardly priced for perfection and see the negative reaction as a buying opportunity ahead of a likely margin recovery in Q409 and beyond.

One of the potential reasons cited for the sharp sell-off was management's increasingly cautious tone on the overall capex environment, especially in Europe and emerging markets (excluding India and China). To a large degree, this echoes recent comments from both Ericsson and Nokia Siemens regarding the late cycle macro and credit pressures that are becoming increasingly visible as operators intensify their cashflow focus given full year targets (e.g. France Telecom).

Nonetheless, with mix set to improve in Q4 as U.S. CDMA recovers from its Q2 lows (i.e. -70% YoY), WCDMA profitability continues to reverse its heavy losses given product rationalisation and improved market positioning, high margin IP momentum continues coupled with a slower pace of decline in its legacy businesses, we believe that ALU is set to at least meet current consensus expectations for Q409 and beyond.

In terms of the results this quarter, the positive surprise was the lower losses in the Carrier division despite the lower revenue and sharp decline in legacy sales (e.g. CDMA, GSM, voice switching). We believe this is a reflection of both the cost savings (e.g. fixed cost reductions, reversal of WCDMA losses) as well improving mix within its growth drivers (e.g. IP, access)

The most disappointing factor this quarter was the weaker top line, although Alcatel-Lucent's YoY constant currency decline (11%) compared favourably with Ericsson (-12%) and Nokia Siemens (-20%). The key miss relative to our expectations came in Wireless (9% revenue shortfall) primarily due to lower North American CDMA as well as emerging market 2G spend.

In terms of cost savings, ALU has completed 80% of its planned $1,098 million cost reduction program (compared to 35% at the end of Q209) which drove an 8% QoQ decline in adjusted opex – to some degree also aided by the weaker $. Management's comments that Q4 opex is expected to decline QoQ is supportive of our Q4 estimates (we had previously modelled a 3% QoQ increase).

For Q409, we now model a 20% QoQ revenue increase with adjusted operating income of $364 million (5.9% margin).

3Q09 Actual v.s. Expected

Figure 1. Alcatel-Lucent Q309 Results: Actual v.s. Expected

	3Q09A	3Q09E	Cons. ($)	Cons. (€)	2Q09A	3Q08A	QoQ	YoY
Profit & Loss								
Revenues	5,396	5,639	5,670	3,874	5,481	5,733	-5.6%	-9.3%
Gross Margin (%)	33.4%	33.3%	33.1%	33.1%	33.1%	33.0%	30 bps	38 bps
Research and Development Expenses	(891)	(903)	na	na	(918)	(937)		
R&D / sales (%)	16.5%	16.0%	na	na	16.7%	16.3%	-23 bps	18 bps
Administrative and Selling Expenses	(1,023)	(1,049)	na	na	(1,079)	(1,044)		
SG&A / sales (%)	19.0%	18.6%	na	na	19.7%	18.2%	-73 bps	75 bps
Operating Profit	(16)	13	(12)	(8)	(87)	89	-82.3%	-117.5%
Operating Margin (%)	-0.3%	0.2%	-0.2%	-0.2%	-1.6%	1.5%	129 bps	-185 bps
Restructuring costs	(56)	(1)	0	0	(1)	1,168		
IFRS Operating Profit	(16)	13	(12)	(8)	(87)	89	-82.3%	-117.5%
IFRS Operating Margin (%)	-0.3%	0.2%	(0)	(0)	-1.6%	1.5%	129 bps	-185 bps
Financial Income and Expenses	(94)	(75)	na	na	(81)	(73)		
Tax Expense	(26)	(31)	na	na	86	(97)		
Tax Rate (%)	4.3%	-10%	na	na	40.7%	-38.5%		
Net Income	(108)	(73)	na	na	279	(7)	nm	nm
Diluted ADRs (weighted average)	2,260	2,260	na	na	2,260	2,259		
Diluted EPADR ($)	(0.04)	(0.03)	na	na	0.13	-	nm	nm
Revenue Breakdown								
IP	416	*436*	*na*	*na*	400	*420*		
Optics	1,033	*1,027*	*na*	*na*	1,022	*1,125*		
Wireline	591	*609*	*na*	*na*	594	*698*	-4.5%	-18.4%
Wireless	1,257	*1,385*	*na*	*na*	1,368	*1,482*	-11.9%	-18.3%
other & eliminations	(32)	*(40)*	*na*	*na*	(38)	*(44)*	-18.5%	-29.0%
Carrier	3,265	3,418	na	na	3,346	3,683	-6.4%	-14.6%
Applications Software	419	378	na	na	365	337		
Enterprise	366	389	na	na	362	426	-3.1%	-17.2%
Service	1,272	1,366	na	na	1,225	1,196	-0.5%	2.5%
Other	75	91	na	na	182	92	nm	nm
Group	5,396	5,639	5,635	3,850	5,481	5,733		
Adjusted Operating Profit Breakdown								
Carrier	(40)	(69)	na	na	(191)	31	-80.1%	-222.7%
Applications Software	0	(12)	0		(35)	(31)		
Enterprise	6	0	na	na	(8)	30	-166.7%	-81.0%
Service	56	110	na	na	122	124	-56.3%	-56.8%
Other	(38)	(16)	na	na	25	(65)	nm	nm
Group	(16)	13	(26)	(18)	(87)	89		
Operating Margin Breakdown (%)								
Carrier	-1.2%	-2.0%	na	na	-5.7%	0.8%		
Applications Software	0.0%	-3.0%	na	na	-9.6%	-9.2%		
Enterprise	1.6%	0.0%	na	na	-2.3%	7.0%		
Service	4.4%	8.0%	na	na	10.0%	10.4%		
Group	-0.3%	0.2%	-0.5%	-0.5%	-1.6%	1.5%		
Cash Flow								
Operating Cash Flow pre working capital	40	81	na	na	(111)	38	-134.2%	0.0%
Working Capital	720	(23)	na	na	(620)	110	-211.3%	530.8%
Operating Cash Flow	760	56	na	na	(731)	148	-199.6%	394.3%
Capital Expenditure	(230)	(243)	na	na	(246)	(306)	-10.3%	-27.6%
Free Cash Flow	530	(186)	na	na	(977)	(158)	-152.0%	-423.2%
Balance Sheet								
Inventories	2,734	3,539	na	na	3,085	3,470	-15.0%	-24.1%
Accounts Receivable	4,517	5,013	na	na	4,806	5,574	-9.9%	-21.9%
Accounts Payable	5,727	5,948	na	na	5,638	6,211	-2.6%	-11.1%
Operating Working Capital	1,481	2,288	na	na	2,008	2,038	-29.3%	-30.0%
Working Capital / Sales (%)	6.3%	9.6%	na	na	6.3%	8.4%	0 bps	-210 bps
Days Sales Outstanding (Days)	70	74	na	na	76	84	-7.8%	-16.5%
Net Cash (debt) excluding Thales stake	866	(205)	na	na	39	(812)	2014.3%	nm
F/X Used ($/EUR)	1.46	1.46	1.46		1.40	1.41		

Note: Percentage figures are calculated on local currency numbers not accounted for F/X rate.

Source: Company Reports, SME Direkt and Citigroup Investment Research

Changes To Estimates, Target To $5.89 (from $5.74)

Figure 2. Alcatel-Lucent: Summary of Changes to Estimates

				New Forecasts			% Difference		
	2009E	**2010E**	**2011E**	**2009E**	**2010E**	**2011E**	**2009E**	**2010E**	**2011E**
Group Revenue	22,359	24,332	25,508	21,771	23,678	24,822	-2.6%	-2.7%	-2.7%
Group Revenue Growth YoY (%)	-5.6%	3.1%	4.8%	-8.1%	3.0%	4.8%	-248 bps	-6 bps	0 bps
Group Gross Margin (%)	32.4%	34.8%	36.6%	33.1%	34.8%	36.6%	65 bps	0 bps	0 bps
Research and Development Expenses	(3,578)	(3,699)	(3,827)	(3,528)	(3,599)	(3,724)	-1.4%	-2.7%	-2.7%
R&D / sales (%)	16.0%	15.2%	15.0%	16.2%	15.2%	15.0%	20 bps	0 bps	0 bps
Administrative and Selling Expenses	(4,271)	(3,796)	(3,980)	(4,137)	(3,694)	(3,872)	-3.1%	-2.7%	-2.7%
SG&A / sales (%)	19.1%	15.6%	15.6%	19.0%	15.6%	15.6%	-10 bps	0 bps	0 bps
Group Operating Profit	(60)	973	1,531	(92)	948	1,489	52.9%	-2.7%	-2.7%
Group Operating Margin (%)	-0.3%	4.0%	6.0%	-0.4%	4.0%	6.0%	-15 bps	0 bps	0 bps
Diluted EPADR (Adjusted) ($)	**(0.02)**	**0.31**	**0.55**	**0.00**	**0.32**	**0.52**	**n/a**	**1%**	**-4%**
Working Capital/Sales	6.9%	6.7%	7.0%	4.2%	4.0%	3.5%	-266 bps	-268 bps	-353 bps
Free Cash Flow	(1,492)	989	1,383	(1,054)	1,114	1,021	29.3%	-12.6%	26.2%
ROIC	-9.5%	3.5%	6.2%	-6.9%	3.2%	5.5%	254 bps	-30 bps	-68 bps
F/X Used ($/EUR)	1.39	1.47	1.47	1.39	1.47	1.47			

Note: Percentage figures are calculated on local currency numbers not accounted for F/X rate.

Source: Citi Investment Research and Analysis

Alcatel-Lucent

Company description

Alcatel-Lucent supplies communication networks to carriers, governments and enterprises. Broadband access, optics, IP routing, CDMA/GSM networks & integration services make up most of its sales. By revenues, ALU is No1 in carrier fixed line & No3 in mobile. It employs 77k staff (pre-synergies but post Space).

Investment strategy

We rate Alcatel-Lucent as Buy/High Risk (1H). We believe that despite significant portfolio and end-market challenges, the company's cost savings initiatives, and focus on profitability will drive a margin recovery over the medium term. In our view, this will be primarily driven by improvements in its key Carrier division given its legacy of multiple platforms, bloated cost base, and poor mix. In fixed, we believe the company is the industry leader in broadband/video deployments with telcos, which will drive optical network upgrades. Services is likely to be a key revenue and margin driver over the medium term given operators' needs to lower opex and outsource non-core competencies. Finally, we see an improvement in cash generation over the medium term given improving profitability and working capital progress. Although balance sheet & pension concerns dominate investor fears, we believe this is overdone.

Valuation

Our Alcatel-Lucent target price is $5.89. We apply a 14x multiple to our estimate of 2010E "normalised" net earnings excluding net interest. This is based on a group operating margin of 6% (post restructuring, share-based payments and merger synergies) and a 8% tax rate. We also adjust for the ceiling of its pension liabilities, net cash, and subtract the 50% minority interest of the Alcatel Shanghai Bell JV. We note the increasing valuation sensitivity to quarterly fluctuations in the funded status of the pension fund.

Risks

We rate Alcatel-Lucent as High Risk, based on our assessment of industry and company-specific risk factors. The following risks that could impede the ADR price from reaching our target price:

(1) Additional near-term capex cuts from operators (U.S. CDMA/wireline, EU wireline, emerging market GSM) following financial market turmoil/macro weakness. The company has already cited the potential impact of fixed access spending in Europe.

(2) Additional cash injection into its U.S. management pension plan should fall below its 94% funded threshold. Should this arise, we note that the company has up to three years to make this payment.

(3) Market share losses/pricing pressure from the transition to 4G standards given its incumbent CDMA position.

(4) Emerging market GSM may suffer prolonged price pressure as other larger vendors exploit their scale advantages.

(5) Data services uptake (particularly IPTV in the case of ALU) is a critical driver of long-term telecom capex growth.

Appendix A-1

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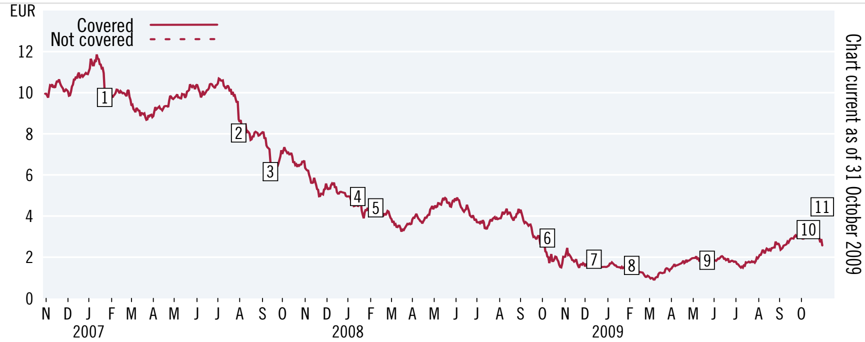
Analyst: Sherief Bakr
Covered since August 21 2007



	Date	Rating	Target Price	Closing Price
1	23-Jan-07	1H	*13.00	10.02
2	31-Jul-07	1H	*11.00	8.70
3	13-Sep-07	1H	*10.00	6.62
4	15-Jan-08	1H	*8.00	4.46
5	8-Feb-08	1H	*7.00	4.14
6	8-Oct-08	1H	*3.50	2.03
7	12-Dec-08	1H	*2.50	1.64
8	4-Feb-09	1H	*2.00	1.50
9	21-May-09	1H	*2.50	1.76
10	12-Oct-09	1H	*3.90	3.34
11	30-Oct-09	1H	*4.00	2.57

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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