# Management's Discussion and Analysis of Financial Condition and Results of Operations

*The following discussion and analysis should be read in conjunction with our consolidated financial statements and the related notes included elsewhere in this annual report. Our consolidated financial statements are reported in U.S. dollars and have been prepared in accordance with accounting principles generally accepted in Canada, or Canadian GAAP. To the extent applicable to our consolidated financial statements included elsewhere in this annual report, these principles conform in all material respects with accounting principles generally accepted in the United States, or U.S. GAAP, except as described in note 20 of our consolidated financial statements.*

## Corporate Highlights

EXFO Acquires Burleigh Instruments: Subsequent to the year-end, EXFO acquired Burleigh Instruments, Inc. for $235 million in EXFO stock and $40 million in cash. Burleigh, a privately held company in Fishers, upstate New York, is a leading supplier of DWDM wavelength measurement instruments and precision positioning equipment.

EXFO Expands into Quebec Metro High-Tech Park: Subsequent to the year-end, EXFO announced an agreement that provides it with an option to purchase 4.2 million square feet of land in the Quebec Metro High-Tech Park. A facility will be built to house administrative services, research and development, marketing and some manufacturing. The first phase of construction, which will include a 150,000 square-foot building, is expected to be completed in the fall of 2001.

EXFO Reports Record Revenues and Operating Results for Fiscal 2000: EXFO announced that it had increased its revenues by 70% to $71.6 million for the fiscal year ended August 31, 2000 from $42.2 million in 1999. Net income increased 71% to $9.9 million, or $0.25 per share, for fiscal 2000 from $5.8 million, or $0.14 per share, for 1999.

EXFO Increases Manufacturing Capacity: EXFO unveiled plans in June 2000 to increase its manufacturing capacity with the purchase of a 112,000 square-foot building, of which the company was already renting 25,000 square feet. An additional 25,000 square feet were made available in October 2000, including one-third for manufacturing, and the remaining 62,000 square feet will become available by April 2001. EXFO currently dedicates 55,000 square feet to manufacturing.

EXFO Completes Successful Initial Public Offering: EXFO announced in June 2000 that it had closed its offering of 8,050,000 subordinate voting shares at US$26.00 per share in the United States and at C$38.55 per share in Canada. Total proceeds to EXFO, including the over-allotment option exercised by the underwriters, were approximately $209 million.

EXFO Introduces More Than a Dozen Products at OFC: EXFO introduced more than a dozen new products in March 2000 at the Optical Fiber Conference in Baltimore, Maryland. Key product launches included optical spectrum analyzer test modules for field and manufacturing testing, widely tunable laser sources for DWDM testing, automated test systems for DWDM optical components and value-added optical modules, a single-slot optical time domain reflectometer platform and related test modules, as well as high-power and low-polarization sensitivity power meters.

EXFO Acquires Nortech Fibronic Inc.: EXFO announced in February 2000 that it had purchased Nortech Fibronic Inc. for $2.8 million to complement its Portable and Monitoring product line. The acquisition enabled EXFO to add more than 60 employees to its personnel.

## Industry Overview

### Optical Networking Market

The past decade has witnessed an explosive growth in the volume of data traffic largely due to the soaring popularity of the Internet and related bandwidth-intensive applications. According to the Angus Reid Group, a leading polling firm, the number of Internet users around the world is expected to increase from 300 million in 2000 to 1 billion by 2005. Ryan, Hankin & Kent, a leading telecom market research firm, forecasts that Internet traffic will increase from 350,000 terabytes, or trillions of bytes, per month at the end of 1999, to more than 15 million terabytes per month in 2003, representing a compound annual growth rate of 156%.

The dramatic increase in Internet users and traffic has created a tremendous need for high-bandwidth communications networks. To meet this increasing demand for bandwidth, many communications service providers are designing and installing new networks based on optical fiber, deploying additional fiber within their existing networks or using advances in optical technology such as Dense Wavelength Division Multiplexing, or DWDM. DWDM involves combining beams of light of slightly different wavelengths through a single fiber, with each wavelength carrying its own stream of information. This technique requires separate laser sources for each signal or channel and more complex equipment to control and amplify the signal in the network. Some DWDM systems can carry as many as 160 separate channels per optical fiber. DWDM has wide market acceptance because it incorporates technologies that greatly reduce the cost of optical transmission over long distances and because it provides network flexibility in local and metropolitan areas. According to Ryan, Hankin & Kent, the global optical transport market is expected to increase from $47 billion in 2000 to $64 billion in 2001, a 36% increase year over year.

### Optical Test, Measurement and Monitoring Equipment Market

Conventional test, measurement and monitoring instruments used by telecommunications carriers and manufacturers of communications equipment were designed for electrical transmission systems and are unsuitable for optical networking. Unlike traditional electrical transmission systems, which transmit electrical signals along copper wires, fiber-optic transmission systems use pulses of light along glass or plastic fiber, often referred to as optical fiber. When light travels along optical fiber and through the optical components and systems that link optical fibers together, it is subject to unwanted effects such as reflection, attenuation, noise and various types of dispersion, all of which degrade signal quality and reduce transmission performance. Fiber-optic test, measurement and monitoring equipment is critical for measuring these effects and helping communications carriers and manufacturers of optical components, value-added optical modules and optical networking systems ensure network performance and reliability. The main uses for fiber-optic test, measurement and monitoring equipment include research and development, manufacturing, network installation and maintenance as well as network monitoring.

## Corporate Overview

EXFO was incorporated on September 18, 1985. Our original products were focused primarily on the needs of installers and operators of fiber-optic networks. In 1996, we supplemented our product line with an extensive line of Industrial and Scientific products that are dedicated to the manufacturing and research and development markets in the fiber-optic industry. Our Industrial and Scientific products tend to be more complex and higher priced than our field-testing products. In 1999, we entered the market for Remote

Fiber Test Systems. Remote Fiber Test Systems allow carriers to deploy test equipment throughout their networks in order to monitor the status of their fiber-optic networks.

We sell our products to customers through our direct sales force and indirectly through distribution channels. We deliver products to a large number of customers. No customer accounted for more than 5.8% of total sales in fiscal 2000; in fiscal 1999, this figure was 6.8%.

Cost of sales include raw materials, salaries and related expenses for direct and indirect manufacturing personnel and manufacturing overhead.

Gross research and development expenses consist primarily of salaries and related expenses for engineers and other technical personnel and fees paid to third-party consultants. We are entitled to research and development tax credits granted by the Canadian federal government and the government of the province of Quebec. See note 2. We are also entitled to government grants resulting from agreements entered into with the government of the province of Quebec. See note 15. Research and development tax credits and certain government grants are recorded as a reduction of gross research and development expenses.

Selling and administrative expenses consist primarily of salaries and related expenses for personnel, sales commissions, travel expenses, marketing programs, professional services, management information systems, human resources and other corporate expenses. We intend to expand our sales organization by opening additional international sales offices and service centers. We expect that in support of our continued growth, the expansion of our sales efforts and our operations as a public company, selling and administrative expenses will continue to increase with sales for the foreseeable future.

Effective September 1, 1999, we adopted the U.S. dollar as the reporting currency for our consolidated financial statements. The financial statements for all periods prior to fiscal 2000 are presented in U.S. dollars in accordance with a translation of convenience method under Canadian GAAP, using the representative exchange rate as at August 31, 1999 of $1.00 = C$1.4958. The following historical results are not necessarily indicative of the results to be expected for any future period.

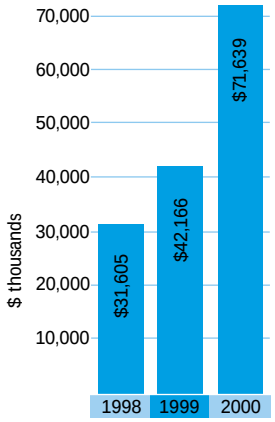
# Results of Operations

| Years Ended August 31, | 1998 | 1999 | 2000 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|
| Sales | $ 31,605 | $ 42,166 | $ 71,639 | 100.0% | 100.0% | 100.0% |
| Cost of sales | 11,345 | 14,998 | 24,712 | 35.9 | 35.6 | 34.5 |
| Gross margin | 20,260 | 27,168 | 46,927 | 64.1 | 64.4 | 65.5 |
| Operating expenses | | | | | | |
| Selling and administrative | 9,898 | 13,279 | 24,304 | 31.3 | 31.5 | 33.9 |
| Net research and development | 3,014 | 4,315 | 6,402 | 9.5 | 10.2 | 8.9 |
| Amortization of capital and other assets | 657 | 898 | 1,498 | 2.1 | 2.1 | 2.1 |
| Earnings from operations | 6,691 | 8,676 | 14,723 | 21.2 | 20.6 | 20.6 |
| Interest income, net | (40) | (136) | (1,480) | (0.1) | (0.3) | (2.1) |
| Foreign exchange loss (gain) | (126) | 506 | 684 | (0.4) | 1.2 | 1.0 |
| Earnings before income taxes and amortization of goodwill | 6,857 | 8,306 | 15,519 | 21.7 | 19.7 | 21.7 |
| Income taxes | 2,356 | 2,492 | 5,298 | 7.5 | 5.9 | 7.4 |
| Earnings before amortization of goodwill | 4,501 | 5,814 | 10,221 | 14.2 | 13.8 | 14.3 |
| Amortization of goodwill | – | – | 297 | — | — | 0.4 |
| Net earnings for the year | $ 4,501 | $ 5,814 | $ 9,924 | 14.2% | 13.8% | 13.9 |
| Research and development data: | | | | | | |
| Gross research and development | $ 4,406 | $ 6,390 | $ 9,374 | 13.9% | 15.2% | 13.1% |
| Net research and development | $ 3,014 | $ 4,315 | $ 6,402 | 9.5% | 10.2% | 8.9% |

The above table sets forth certain consolidated statements of earnings data in thousands of U.S. dollars and as a percentage of sales for the years indicated.

## Sales

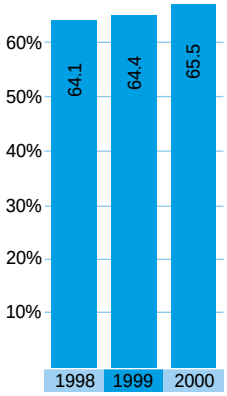
Sales totaled $71.6 million, $42.2 million and $31.6 million for fiscal 2000, 1999 and 1998, respectively. Sales increased 69.9% from fiscal 1999 to fiscal 2000 and 33.4% from fiscal 1998 to fiscal 1999 mainly due to a higher demand for our Industrial and Scientific products as well as a general sales increase in our other products. Accepted orders increased 102.3% from $42.9 million for fiscal 1999 to $86.7 million for fiscal 2000.




North American sales accounted for 61.6%, 56.3% and 50.6% of total sales for fiscal 2000, 1999 and 1998, respectively. International sales represented 38.4%, 43.7% and 49.4% of total sales for fiscal 2000, 1999 and 1998, respectively. The steady growth in North American sales during the past three years reflects a higher demand for our test, measurement and monitoring products in this region.

## Gross Margin

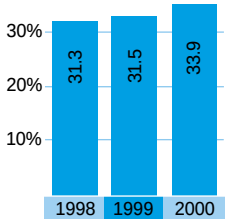
Gross margin amounted to 65.5% of sales for fiscal 2000, 64.4% for 1999 and 64.1% for 1998. The improvement in the gross margin from fiscal 1999 to 2000 is mainly due to the increase in the amount of government grants earned in fiscal 2000. However, the level of grants that will be received in future years may fluctuate based on the number of employees hired and changes in government legislation. The slight increase in gross margin from fiscal 1998 to 1999 can be attributed to increased economies of scale in our production process and increased sales of higher margin products.




Although competitive pricing pressures continue, EXFO has been able to mitigate such pricing pressures through increased sales of higher margin products and cost-reduction manufacturing programs. Gross margin can be negatively affected by increases in component costs, shifts in product mix and increases in product offerings by other suppliers in the test, measurement and monitoring market.

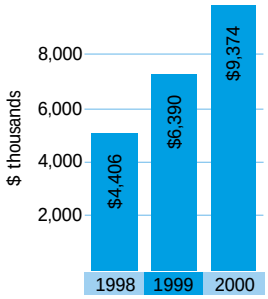
## Selling and Administrative

Selling and administrative expenses totaled $24.3 million, $13.3 million and $9.9 million for fiscal 2000, 1999 and 1998, respectively. As a percentage of sales, selling and administrative expenses amounted to 33.9%, 31.5% and 31.3% in fiscal 2000, 1999 and 1998, respectively. The $11.0 million increase in selling and administrative expenses from fiscal 1999 to 2000 reflects increased personnel expenses for sales and marketing staff, increased expenses related to customer support, increased sales commissions related to higher sales, increased promotional and product marketing expenses as well as the expenses related to operating a public company. The $3.4 million increase from fiscal 1998 to 1999 reflects the hiring of additional sales personnel, marketing and administrative personnel, the opening of offices in Asia and commissions on higher sales volume.




## Research and Development

Gross research and development expenses totaled $9.4 million, $6.4 million and $4.4 million for fiscal 2000, 1999 and 1998, respectively. As a percentage of sales, gross R&D expenses were 13.1%, 15.2% and 13.9% in fiscal 2000, 1999 and 1998, respectively. Gross R&D expenses increased $3.0 million from fiscal 1999 to 2000 and $2.0 million from fiscal 1998 to 1999. These increases are due to the hiring of additional R&D personnel in order to develop new products and enhance current ones. During fiscal 2000, we added 45 employees in our R&D Department, which reflects our continued focus on R&D activities.




Tax credits and grants from federal and provincial governments for our R&D activities amounted to $3.0 million, $2.1 million and $1.4 million in fiscal 2000, 1999 and 1998, respectively. This increase in tax credits and grants is directly related to the hiring of additional research and development personnel. As a result, net R&D expenses increased 48.4% from fiscal 1999 to 2000 and 43.2% from fiscal 1998 to 1999. Our net R&D expenses represented 8.9%, 10.2% and 9.5% of sales in fiscal 2000, 1999 and 1998, respectively.

## Interest Income

Interest income amounted to $1.5 million, $0.1 million and nil for fiscal 2000, 1999 and 1998, respectively. The increase in fiscal 2000 primarily results from the interest income derived from investment of the remaining net proceeds of the Initial Public Offering on June 29, 2000. This income is offset by interest expenses associated with borrowings under our line of credit.

## Income Taxes

Our effective income tax rates were 34.1%, 30.0% and 34.4% for fiscal 2000, 1999 and 1998, respectively. The lower effective tax rate in 1999 compared to 2000 and 1998 was the result of non-deductible expenses and other items that have reduced overall income tax expenses.

## Liquidity and Capital Resources

Prior to our Initial Public Offering, we had financed operations and met our capital expenditure requirements mainly through cash flows from our operations, research and development tax credits and government grants. Cash flows used for operating activities for fiscal 2000 were $4.0 million compared to cash flows provided by operating activities in 1999 and 1998 of $3.7 million and $3.2 million, respectively. Cash flows used for operating activities during fiscal 2000 were mainly due to the significant increase in accounts receivable, which is related to a higher volume of sales and inventories that are required to ensure minimal manufacturing and delivery lead times. As at August 31, 2000, we had cash and cash equivalents of $729,000, short-term investments of $162.7 million and working capital of $194.2 million.

Cash flows used for investing activities were $169.0 million, $1.2 million and $2.0 million for fiscal 2000, 1999 and 1998, respectively. Cash flows during fiscal 1999 and 1998 were mainly used for capital expenditures and short-term investments. The cash flows used during fiscal 2000 mainly resulted from the investment of the remaining net proceeds from the Initial Public Offering in June 2000, the acquisition of Nortech Fibronic Inc. in February 2000 and the purchase of a building located in Vanier, Quebec in June 2000.

For the year ended August 31, 2000, cash flows provided by financing activities amounted to $172.8 million compared to cash flows used in the amount of $3.3 million and $0.3 million for the years ended August 31 of 1999 and 1998, respectively. Financing from the Initial Public Offering was the main source of cash flows provided for fiscal 2000. Proceeds of the Initial Public Offering were used to pay the share issue expenses of $16.7 million, to

pay dividends of $17.6 million and to repay our debts. For fiscal 1999 and 1998, cash flows used for financing activities were mainly due to dividends paid as well as repayments of bank advances and long-term debts. We do not foresee payments of additional dividends during the next three fiscal years.

We have available credit facilities that provide for advances of up to C$10.0 million (US$6,793,000) under lines of credit and C$3.0 million (US$2,038,000) as an operating loan. These facilities, which are renewable annually, bear interest at prime rate. Accounts receivable, inventories and all tangible and intangible assets have been pledged as security against these facilities. As at August 31, 2000, C$15,000 has been drawn against the facilities. The interest rate of credit facilities drawn in Canadian dollars is the Canadian prime rate (7.5% as at August 31, 2000) and the credit facilities drawn in United States dollars is the U.S. prime rate (10.0% as at August 31, 2000).

We believe that our existing cash balances and short-term investments, together with cash flows from operations and available lines of credit, will be sufficient to meet our liquidity and capital spending requirements through the end of fiscal 2001. However, possible investments in or acquisitions of complementary businesses, products or technologies may require additional financing prior to such time. There can be no assurance that additional debt or equity financing will be available when required or, if available, can be secured on terms satisfactory to us.

### New Accounting Standards

In 1999, the Canadian Institute of Chartered Accountants issued section 3461, "Employee future benefits," which is effective for the fiscal year beginning on or after January 1, 2000. Adopting this standard will not have a significant impact on our earnings or shareholders' equity. For new U.S. accounting standards, see note 20.

## Risks and Uncertainties

### Currency Risks

We are exposed to currency risks as a result of our export of products manufactured in Canada, substantially all of which are denominated in U.S. dollars. Our exposure to foreign exchange rate fluctuations is partially hedged by operating expenses of our U.S. and European subsidiaries and the portion of our raw materials purchased in U.S. dollars. In addition, we frequently enter into forward exchange contracts to sell U.S. dollars at fixed forward rates in exchange for Canadian dollars. We enter into such contracts to manage the risk of exchange rate fluctuations between the Canadian and U.S. dollars on cash flows related to anticipated future revenue streams and firmly committed future sales transactions denominated in U.S. dollars. In the last quarter of fiscal 2000, we entered into forward exchange contracts to buy U.S. dollars at the maturity dates of certain short-term investments denominated in Canadian currency.

The following table summarizes the forward exchange contracts in effect as at August 31, 2000, classified by expected transaction dates, none of which exceed two years. The table below presents the notional amounts of such contracts (in thousands of dollars) along with the weighted average contractual forward rates under such contracts. The notional amounts of such contracts are used to calculate the contractual payments to be exchanged under these contracts.

| Years Ending August 31, | 2001 | 2002 |
|---|---|---|
| Forward exchange contracts to sell U.S. dollars in exchange for Canadian dollars | | |
| Contractual amounts | $ 5,400 | $1,200 |
| Weighted average contractual exchange rates | 1.4871 | 1.4602 |
| Forward exchange contracts to buy U.S. dollars in exchange for Canadian dollars | | |
| Contractual amount | $40,500 | – |
| Weighted average contractual exchange rates | 1.4777 | – |

The fair value of the contracts to sell U.S. dollars as at August 31, 2000, based on the prevailing exchange rate at that date of $1.00 = C$1.4722, amounted to C$9.7 million compared to a contractual value of C$9.8 million, resulting in a deferred unrealized loss of C$65,790 (approximately US$45,000).

The fair value of the contracts to buy U.S. dollars as at August 31, 2000 amounted to US$27,431,000 compared to a contractual value of US$27,407,000, resulting in an unrealized loss of US$24,000.

### Operational Risks

Gross margin has varied in the past and may continue to vary significantly in the future depending on the mix of products sold, our capacity to introduce new products with higher margins, our ability to achieve economies of scale in our production process, the impact of large orders with reduced margins, fluctuations in raw material costs, increases in personnel costs and level of government grants earned. In addition, we plan to significantly increase our operating expenses to expand our manufacturing, sales and marketing, customer support, administration and research and development activities.

### Forward-Looking Statements

This annual report contains forward-looking statements that involve risks and uncertainties. These statements relate to our future plans, objectives, expectations and intentions. We have identified these statements by the use of words such as "may," "will," "expect," "anticipate," "intend," "plan," "estimate," "believe," "continue" or other similar expressions. These forward-looking statements reflect our current expectations and assumptions as to future events that may not prove to be accurate. Our actual results are subject to a number of risks and uncertainties and could differ materially from those discussed in these statements. Factors that could contribute to these differences include, but are not limited to, our ability to adapt to current and future changes in technology; our ability to introduce new and enhanced products on a timely basis; our ability to overcome significant and increasing competition in our industry; the impact of depending on a single supplier or a limited number of suppliers for key components and materials in our products; our ability to attract and retain sufficient numbers of highly skilled technical, sales and marketing and other personnel; and our ability to sustain research and development activities. In addition, such forward-looking statements could be affected by general industry and market conditions as well as growth rates, general international economic conditions including exchange rate fluctuations, and other future factors. In light of the many risks and uncertainties surrounding our business and operations, you should keep in mind that we cannot guarantee that the forward-looking statements described in this annual report will transpire. We undertake no obligation and do not intend to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as may be required under applicable law.