

# Dear Fellow Shareholders,

*Kites rise highest against the wind — not with it.*

—Sir Winston Churchill

Fiscal 2003 proved to be a transition year for EXFO, filled with challenges and opportunities that will make the company stronger in the long term. The severe two-and-a-half-year downturn in the global communications industry—compounded by economic uncertainty—has led to a very challenging environment for many test and measurement players, but a select few have moved ahead to improve their competitive position.

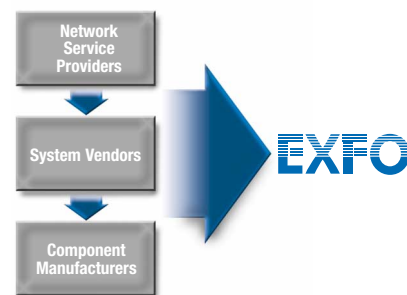


Germain Lamonde  
Chairman, President and Chief Executive Officer

I believe EXFO belongs to the latter group. Midway into fiscal 2001, we began refocusing our test and measurement business back toward network service providers (NSPs), our traditional customer segment. Our thinking was based on the premise that NSPs would continue spending moderately during the downturn and, eventually, they would be the first market segment to recover. On the other hand, we expected component vendors, with their colossal inventories and excess manufacturing capacity, to be destined for a late recovery, given that consolidation first had to occur. Accordingly, we directed our R&D efforts toward field-testing applications and acquired Avantas Networks in November 2001, thus entering the protocol-layer test market and complementing our product offering. The end result is that sales of our Portable and Monitoring product lines, which progressed from approximately 40% of total revenues at our peak in fiscal 2001 to two-thirds in 2003, increased 3% in the past year, despite depressed spending levels. Meanwhile, optical component manufacturing test solutions, which traditionally had represented the vast majority of our Industrial and Scientific sales, were no longer significant in 2003.

Secondly, we expanded our presence in the system manufacturer market by acquiring the assets of *gnubi communications* in October 2002. At the industry level, we expected system manufacturers would be the next market segment to rebound. Bandwidth demand, after all, continues to increase with new investments required to build and deploy highly efficient, IP-based networks. This ongoing trend enables the convergence of voice and data over a broadening range of consumer devices. At the company level, this acquisition not only allows us to extend our protocol-layer test portfolio to system manufacturers, but also to reuse technologies across multiple market segments.

## Communications Supply Chain



Perhaps, the one point we underestimated was the duration of the market downturn that swept across the entire communications industry. Consequently, we were forced to implement a series of restructuring plans to adjust our cost structure to existing spending levels. We froze salaries and trimmed our workforce by 15% in 2001. We reduced our staff by 30% and rationalized our operations in 2002. In 2003, we pared down our workforce by 30%, exited the optical component manufacturing automation business, and streamlined the number of our production facilities. Overall, EXFO has gone from a peak of approximately 1400 employees in 2001 to 600 in 2003, of which almost 30% remain dedicated to R&D activities.



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### **New business structure**

Although I am confident we adopted the right strategy during the downturn, I am hardly satisfied with our financial performance. We reported total sales of \$61.9 million and a pro forma net loss of \$0.18 per share, or \$0.87 per share on a GAAP basis, in fiscal 2003 compared to sales of \$68.3 million and a pro forma net loss of \$0.19 per share, or \$5.09 per share on a GAAP basis, in 2002. With that in mind, we have reorganized our business under two new reportable market segments: Telecom Division and Photonics and Life Sciences

Division. Our Telecom Division, consisting of former Portable and Monitoring and telecom-related Industrial and Scientific product lines, would have represented 79% of total sales in 2003. Our Photonics and Life Sciences Division includes previous non-telecom Industrial and Scientific product lines. This simplified business structure—with respective sales, marketing, manufacturing, R&D and management teams for each division—will enable us to better serve our diverse customer base and maximize shareholder value.

We are more than ever committed to becoming a dominant player in the global communications test and measurement industry, while leveraging our technology base toward targeted photonics and life sciences markets. To summarize our fiscal 2004 strategy, we plan to increase sales through market-share gains, maximize profitability and growth on a long-term basis, innovate our way out of this downturn, and maintain a sound financial position.

### **Increase sales through market-share gains**

In fiscal 2004, we are focusing on continued market-share gains to achieve targeted growth, since we have based our scenario on a declining communications market; hopefully, our forecast will prove to be too conservative. In 2003, we believe that we gained market share among NSPs by strengthening the leadership position of our FTB-400 field-testing platform and by extending its reach to telecom and datacom protocol-layer test applications. We also leveraged our protocol-layer acquisitions

(formerly Avantas Networks and *gnubi communications*) to enhance our strategic position and sales results in this mission-critical sector for our targeted end-markets. Evidence of this newfound traction is reflected in our protocol-layer test sales, which reached more than 10% of total revenues in each of the last three quarters of 2003. With continued quality of execution, protocol-layer activities are expected to play a larger role and contribute to our growth in 2004.

Looking ahead, we intend to further expand our presence with NSPs, who are increasingly focusing on reducing operating expenditures (OPEX) as capital expenditures (CAPEX) draw nearer to maintenance-level run rates. The unique value proposition inherent to our FTB-400 platform and related suite of test technologies reduces both CAPEX and OPEX, aptly matching the priorities of NSPs and installation teams of system vendors. Speaking of system vendors, we also started to target their R&D and manufacturing teams in 2003—as evidenced by the acquisition of *gnubi communications*. Following significant balance sheet restructuring, system vendors are gradually recovering with positive cash flow and even profits. We believe they will continue to improve their financial position in 2004, resume their role as innovation drivers and become a major end-market for EXFO in the long term. In addition, we intend to leverage synergies across our entire protocol R&D activities to accelerate the development of innovative, advanced and differentiated test solutions that maximize the reuse of technologies over multiple market segments. The design, manufacturing and deployment of next-generation SONET/SDH networks, coupled with the convergence of multiple applications on simplified architectures, represent a significant market opportunity for our Telecom Division as we continue to expand our addressable markets.

As indicated by the realignment of our operations, we also intend to maximize revenue streams by leveraging our core telecom expertise into select adjacent markets. For example, we recently launched the X-Cite™ 120 Fluorescence Illumination System that was based on our adhesive curing technology for optical component manufacturing. Through joint development and reseller agreements with market-leading microscope manufacturers, we plan to take advantage of their large sales organizations and established base of microscopes to grow revenues in our Photonics and Life Sciences Division.

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## Letter to Shareholders (continued)

### Maximize profitability and growth on a long-term basis

Returning to profitability represents another top priority. We plan to keep a tight control on operating costs with a leaner and more flexible workforce. We will also continue to design differentiated, higher-margin products in our R&D labs, streamline our manufacturing operations and review our supply chain to reduce our cost of goods. As well, we will keep fine-tuning our sales process to offset ongoing pricing pressure from some competitors. These initiatives should help us improve our gross margin—which fell to 47.4% (excluding inventory write-offs and a non-recurring gain) in 2003 versus our historical level of about 60%—and accelerate our return to profitability, but not at the expense of sacrificing long-term growth. Maximizing profitability and growth on a long-term basis is critical to ensure the success of our company.

### Innovate our way out of the downturn

Ever since we founded EXFO in 1985, innovation strategies were focused on being first to market with unique solutions that anticipate and better address customer requirements. Our market-driven approach can be demonstrated through a long history of industry firsts—first modular optical test platform, first all-in-one field-testing platform, first portable polarization mode dispersion (PMD) analyzer, etc. This focus on delivering a unique value proposition to the marketplace is of strategic importance to improve our gross margin in the upcoming year. Despite reductions in 2003, we maintained gross R&D spending at \$17.1 million compared to \$17.0 million in 2002 and \$17.6 million in 2001. As a result, our strong product pipeline delivered 15 new solutions to the marketplace, including the next-generation PMD Analyzer that can characterize PMD levels in high-speed optical networks, the 2.5+ Gigabit Multi-Rate Transceiver for protocol-layer test applications, and the Packet Blazer™ Fibre Channel test module for installation and commissioning of storage area networks. Sales of new products (on the market two years or less) accounted for 49% of total sales in 2003. These numbers reflect our commitment to the future and indicate that our innovation strategy is working at EXFO. We intend to keep innovating our way out of this downturn in 2004. As NSPs and system manufacturers turn their attention to metro, access and fiber-to-the-home networks and as systems converge toward data-centric, Internet Protocol-based technologies, we are developing the sophisticated test solutions required to match heightened network complexity.

### Maintain a sound financial position

For more than 18 years, we have maintained a solid balance sheet and, as of August 31, 2003, we had a cash position of approximately \$57.4 million and practically no debt. This fiscal responsibility, in turn, provides our customers with the assurance that they can count on EXFO as a solid, long-term partner.

### Conclusion

I would like to thank our employees for their dedication and hard work during what can best be described as a challenging year; our customers, for the confidence they have demonstrated in our products and services; our Board of Directors, for its diligent governance and wise counsel; and our shareholders, for supporting our long-term vision and profitable growth strategy. With the continued support of everyone, I am more than ever committed to the long-term success of the company and am confident we will soar to new heights.

Sincerely,



Germain Lamonde  
Chairman, President and Chief Executive Officer  
October 27, 2003