Dear Shareholders,

If no one ever took risks, Michelangelo would have painted the floor of the Sistine Chapel. *–Neil Simon, American playwright*

Germain Lamonde
Chairman, President and Chief Executive Officer

EXFO made significant progress with its strategic turnaround plan in fiscal 2004. The company, which from its founding had posted 16 consecutive years of growth and profitability before the onset of the telecommunications downturn in 2001, necessarily developed turnaround skills to increase sales 20.5% year-over-year, even though the marketplace remained relatively flat in 2004. We outperformed our market largely because we had made bold decisions in prior years. Despite painstaking restructuring, we maintained our R&D investments to position ourselves within growth vectors like protocol testing, Internet protocol (IP) networking and fiber-to-the-premises (FTTP) deployments. We also held onto our experienced sales team and customer support staff to increase market share and expand customer relationships, while several of our peers were forced to make more radical cuts. In short, we reached out to customers through the recognized expertise of our entire staff, strengthening the EXFO brand name in the process.

Throughout the telecom downturn, we kept all our stakeholders apprised of our long-term direction, so they would understand and support our initiatives. I often used a car-racing analogy, illustrating how we intended to navigate this sharp, hairpin curve and turn it into a lasting strategic advantage for EXFO. We also demonstrated our commitment to corporate governance by clearly spelling out four objectives in 2004 and tagging key performance indicators (KPIs) to each goal. Such transparency reflects my confidence in our management team and speaks volumes about our dedication to best disclosure practices.

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EXFO Management Team

Fiscal 2004 Corporate Objectives

Growth. Our first goal consisted of increasing sales through market-share gains. We posted our second-best sales performance in history—better than our early bubble results in 2000—growing sales 20.5% to $74.6 million in 2004, compared to our KPI of 10%. Not coincidentally, Frost and Sullivan named EXFO recipient of the 2004 Growth Strategy Excellence Award for the largest market-share increase in the global optical test and measurement (T&M) industry between 2001 and 2003 and confirmed EXFO as No. 1 in the optical test installation and maintenance space with an estimated 17% market share. Clearly, we captured market share under good and dire market conditions, which for me is the ultimate measure of corporate performance.

Corporate Performance in Fiscal 2004

Goal	Metric	Result	
Increase sales through market-share gains	10% sales growth year-over-year	20.5% sales growth year-over-year	√
Maximize profitability and growth	50% gross margin	53.7% gross margin	√
Innovate our way out of the downturn	45% of sales from new products (< two years on the market)	31.7% of sales from new products	X
Maintain a sound financial position	Positive cash flows from operations in at least one quarter	Positive cash flows from operations for the fiscal year	√

Profitability. We sought to maximize profitability with a focus on raising our gross margin above 50%. We achieved a gross margin of 53.7% in 2004 from 47.4% (excluding inventory write-offs and an unusual gain) in 2003 mainly by paying close attention to our supply chain; focusing our R&D not only on being first to market, but also on shaving points off our cost of goods; streamlining our number of manufacturing sites; and delivering superior value to customers. Our long-term objective aims to return our gross margin to the lower 60% range as sales volume increases, fixed costs are better absorbed, revenues from our software-intensive protocol solutions become more prominent, and new products with higher margins gain acceptance.

Innovation. We reported that sales from new products (on the market two years or less) represented 31.7% of total sales in 2004, while our KPI was 45%. Although we fell short on that count, I remain convinced our commitment to innovation will pay off in the long term. We have steadily invested in R&D since the telecom peak of 2001 and brought 20 new products to the market in fiscal 2004 alone. These initiatives should enable our new products to continue gaining traction and lead to further market-share gains in upcoming years.

Strong Balance Sheet. We reported positive cash flows from operations for the last three quarters of 2004 and for the entire fiscal year, while our KPI required us to generate positive cash flows in at least one quarter. We also closed a bought-deal offering of 5.2 million shares for net proceeds of $29.2 million, which raised our cash and short-term investments to $89.1 million at the end of the year. This cash position provides comfort to customers and positions EXFO as the long-term vendor of choice with strong organic and acquisition growth potential.

In early fiscal 2004, we reorganized our business under the Telecom and Photonics & Life Sciences (P&LS) divisions. This proved to be a judicious decision as it significantly contributed to our sales growth and progress towards profitability. Sales from our Telecom and P&LS divisions increased 21% and 20% year-over-year, respectively. In ongoing efforts to maximize efficiency, we merged our protocol test operations in Montreal and announced the consolidation of our P&LS Division in Toronto, thus streamlining our R&D/manufacturing sites from five to three. These latest actions will not only produce significant savings in years to come, but they will also provide a clearer focus to our respective management, R&D, sales and manufacturing teams and, more importantly, deliver greater value to our customers.

Overall, I am pleased with our team execution during fiscal 2004—we met or exceeded targets for three out of four goals—but I cannot be fully satisfied as we reported a GAAP net loss of $8.4 million, or $0.13 per share, compared to $55.0 million, or $0.87 per share, in 2003. On a pro forma* basis, we incurred a net loss of $2.0 million, or $0.03 per share, in 2004, compared to $10.9 million, or $0.17 per share, in the prior year.

Back to the Future

Before moving on to our plans for 2005, I would like to paint for you a picture of the major trends and technologies shaping the global telecom industry. The telecom space is currently undergoing major transformations with technological discontinuities and market shifts serving as important drivers for market-driven companies like EXFO. We intend to leverage these new requirements and opportunities to generate value in upcoming years. We have conscientiously been preparing for this industry upheaval through a steady level of R&D investments, well-defined product roadmaps and selected strategic acquisitions over the last few years. Let's examine some of these key market trends:

- Globally, **bandwidth demand** will continue instigating backbone construction in developing countries, further Internet penetration in other parts of the world and facilitate rapid applications evolution in the most advanced nations. Accessing the Web directly through wireline (or its wireless extension) has become an essential part of our online lives for business travel, home entertainment and schoolwork. Consumers just cannot get enough bandwidth. Carriers in advanced countries like South Korea and Japan, for example, are on the verge of offering 100 Mb/s to homes, enabling the delivery of multiple high-definition television (HDTV) channels, online gaming and a host of other bandwidth-intensive applications.

** GAAP net loss excluding stock-based compensation costs, amortization and write-down of goodwill, unusual tax recovery, future income tax assets valuation allowance and the after-tax effect of amortization of intangible assets, restructuring and other charges, inventory and tax credit write-offs, unusual grants recovery and impairment of long-lived assets. This information may not be comparable to similarly titled measures reported by other companies because it is non-GAAP information.*

- As long-haul utilization increases and metro-ring construction progresses in most advanced countries, the **access network**, or so-called “last mile”, will be the cornerstone of the network service providers’ (NSPs) strategy to increase or maintain their consumer base. This market reality will inevitably lead to much deeper and richer fiber penetration into the network, whether NSPs intend to leverage their existing copper plant or deploy **fiber-to-the-home (FTTH)**.
- **IP networking**. SONET/SDH telecom transport standards were defined almost 30 years ago to optimize voice traffic, but they are largely inefficient in today’s data-centric world. A highly flexible and scalable, next-generation SONET/SDH platform is required for the efficient and high-quality delivery of several new applications like VoIP and IP video, while achieving significant OPEX reductions through the management of a single network architecture. NSPs will be streamlining their operations, deployment and maintenance processes as well as moving to higher-margin service revenues.
- **System vendors** are back driving the telecom innovation curve in this post-DWDM era, whereby data networking is a primary catalyst. As a result, these vendors are heightening their focus on delivering ubiquitous, consumer-friendly networking solutions and highly differentiated product offerings in order to partner with public and private network operators. System vendors are focusing more than ever on shortening their innovation cycle and improving operating performance—from the design phase all the way to network deployment.
- Competition between incumbent telecom carriers and cable multiple-system operators (MSOs), especially in North America, is intensifying as they race to increase revenue streams. Both groups are deploying **triple-play services** (voice, data and video) as a pre-emptive measure to retain customers and as an offensive means to secure new ones.

On the photonics and life sciences side:

- Industrial manufacturing sectors like microelectronics, optoelectronics and medical devices remain strong. The distinct trend of moving high-tech manufacturing to Asia continues, while the global market is driven by innovative new products and stronger customer intimacy. The life sciences market trend is towards application-based, total-solution selling and taking advantage of new, disruptive technologies.

Customer Intimacy as a Motto

On top of offering best-in-class solutions that surpass highest expectations in this changing environment, all EXFO employees are committed to enhancing customer intimacy, since customer satisfaction represents our true *raison d’être*. As part of our strategic direction, we intend to raise our business relationships to the next level—from mere supplier to partner of choice. This customer-first mindset will enable us to expand market share to a dominant position in optical testing and extend it to protocol testing, which represents a major growth vehicle for our company.

To reach our ultimate goal of becoming the leading player in the telecom T&M space, we will intensify our sales and marketing efforts, both domestic and international, in 2005 to further leverage our strong technology base and innovation pipeline. We will also focus on strengthening and expanding our business relationships with major accounts. Finally, we will continue building EXFO into one of the most respected brand names in the industry by allowing our recognized expertise to reach out to customers where and when it is needed. In an increasingly competitive landscape, I am counting on these actions, combined with our strategies related to the aforementioned industry trends, to provide our shareholders with long-term growth and profitability.

Measuring Up

As we did in fiscal 2004, I would like to communicate the key performance indicators against which management’s performance should be measured in 2005. It should be specified that these are metrics, not guidance, for fiscal 2005. Not surprisingly, our goals reflect continuity from last year with a renewed focus on profitable growth.

- **Sales growth of 20% year-over-year.** As we have since our founding in 1985, we intend to grow sales faster than the market by leveraging our sustained R&D investments in areas such as next-generation IP and FTTP testing, as well as increase our sales and marketing footprint worldwide.
- **Profitability on a pro forma basis.** Higher sales volumes, richer business mix, improved manufacturing efficiency and consolidation efforts will support our return to profitability on a pro forma basis in 2005.
- **At least 45% of revenues from new products.** Our relentless focus on product differentiation, time-to-market and astute product portfolio management—combined with a heightened sales focus and product traction—should increase this result in 2005.

Wrap-Up

As we embark on our 20th year of operation, I would like to thank all our employees for their unwavering commitment and passion in returning the company to growth; our customers for their extraordinary confidence in our products and services and for sharing their outlook on the future—they are, after all, the reason why EXFO is in business; our Board of Directors for its constant availability and sage counsel; and our shareholders for their staunch belief in our long-term vision. With the continued support of everyone, in 2005 and beyond, I am confident that we will continue progressing towards increased revenue, profitability and market-share gains.

Sincerely,

Germain Lamonde
Chairman, President and Chief Executive Officer
October 26, 2004