



**Germain Lamonde** |  
Chairman, President and  
Chief Executive Officer

**“While our FTTx market penetration was excellent in 2005, we believe this is just the beginning of a long-term deployment trend.”**

## Dear Shareholders,

EXFO celebrated its 20<sup>th</sup> anniversary in a fitting manner in fiscal 2005 as reflected by most of our financial indicators. We continued our long-term, market-driven innovation strategy to tap into new, revenue-generating market opportunities. This strong positioning led to significant progress in market share, sales and profitability in 2005, even though we faced a highly competitive and changing landscape as well as considerable currency fluctuations.

### Performance Highlights

- Increased sales 30.3% to \$97.2 million in 2005, up from a 20.5% increase in 2004;
- Achieved positive GAAP net earnings in the last three quarters of 2005; net loss reduced from \$8.4 million in 2004 to \$1.6 million in 2005;
- Generated \$14.0 million in cash flows from operating activities, up from \$0.8 million in 2004;
- Reached a leadership position in the high-growth, optical FTTx test market; and
- Derived 42.4% of sales from new products on the market two years or less.

These results represent tangible evidence that we adopted the right long-term strategy to be among the first to rebound from the telecom downturn as we maintained strong investments in R&D, sales and customer support.

### Report Card for Fiscal 2005

Let's take a closer look at our quality of execution in 2005 and how we fared against the corporate performance metrics that we had established at the beginning of the fiscal year.

#### Sales growth: 30.3% vs. target of 20%

With 30.3% sales growth in 2005, we surpassed our stated goal of 20% through higher market-share gains. We delivered excellent growth results for both our Telecom Division (36.1% growth; 82% of revenues) and our Life Sciences and Industrial Division (8.6% growth, 18% of revenues), which was recently renamed to better reflect its market focus. Frost & Sullivan, a leading market research firm, reported in June 2005 that we had jumped from fifth place with a market share of 8.4% in 2003 to second place with 10.3% of the overall fiber-optic test market in 2004<sup>1</sup>. Market share in our core portable field-test instrumentation segment is estimated to have improved from 17.4% to 22.2% during the same period. Combined with stellar sales growth during our first 16 years of operation (above 25% growth every year and ~60% CAGR from 1985 to 2001), we believe that we outperformed the optical test and measurement market every single year of our existence, largely due to market-driven innovation and quality of execution. I am particularly proud of this accomplishment, since I believe it is a key measure of long-term success.

### Pro forma net earnings: \$4.5 million<sup>2</sup> vs. target of > \$0

We finished fiscal 2005 with pro forma net earnings of \$4.5 million, or \$0.06 per diluted share, while our published goal was to reach the break-even level<sup>2</sup>. This goal was achieved on the strength of higher sales volumes, richer business mix and heightened cost controls. I am also encouraged that we improved our gross margin by 100 basis points to 54.7% in fiscal 2005, despite strong pricing pressure and a 9.7% increase in the Canadian versus US dollar during that period. Although we were profitable on a GAAP basis in the last three quarters, we incurred a net loss of \$1.6 million in 2005, including \$1.3 million in foreign-exchange losses and \$1.0 million in stock-based compensation costs. In terms of earnings power, for every additional dollar of sales in 2005 over 2004, \$0.46 flowed to earnings before income taxes. Since the 2001 telecom crisis, I believe we have maintained the right balance between long-term growth and short-term profitability. Our P&L statement also reflects that we are now approaching our long-term operating model in terms of SG&A (32.7% vs. 30-32%) and net R&D (12.5% vs. 12-14%), while there's still more work required on the gross margin front (54.7% vs. ~60%).

### Sales from new products: 42.4% vs. target of 45%

Sales from new products (on the market two years or less) represented 42.4% of total sales in 2005 versus our stated goal of 45%. While we slightly missed our target, I'm pleased with the significant improvement over the prior year (31.7%). This metric speaks volumes about market focus, customer acceptance and judicious R&D investment decisions. It reveals that we're reading the market correctly, aggressively launching products worldwide and placing our customers at the top of the innovation curve. It also reflects that our R&D projects are on-scope, on-time and on-budget to maximize results. Over the years, EXFO has earned the reputation of innovation leader for good reason.

## 2006 and Beyond – Key Market Trends

Let's discuss some major drivers that will transform the telecom industry (as well as life sciences and industrial markets) in upcoming years. As a market-driven company, we try to identify the key industry trends in order to leverage technological discontinuities and convert them into value-creating market opportunities.

### Broadband war leading to access investments

Intense competition between traditional telephone companies (telcos) and cable operators (cablecos) continues unabated in North America. Both parties are waging a triple-play – even quadruple-play – war to increase revenue and profitability through bundled offerings, while reducing churn. This broadband battle is prompting massive capital investments in access networks in order to increase bandwidth, flexibility and scalability, while continuing metro ring expansion. Telcos are deploying fiber-to-the-node (FTTN; ~20 Mb/s), fiber-to-the-curb (FTTC; ~40 Mb/s) or fiber-to-the-premises (FTTP; ~100 Mb/s), depending on the bets they have placed in terms of what video compression techniques will be adopted and how much bandwidth will

be required to meet the challenge from the cablecos (~40 Mb/s). The closer the fiber is to the premises and the higher the transmission rates, the better it is for EXFO, which offers the most comprehensive line of FTTx test solutions on the market. Following agreements with Verizon and SBC Communications, we are increasingly leveraging our leadership in passive optical network (PON) testing and broad portfolio of FTTx-ready technologies outside North America, given our long-established customer relationships in Europe and Asia. We are participating in several FTTx trials worldwide and recently were selected as sole-source supplier for all fiber deployment test applications by Deutsche Telekom AG – including FTTx. While our FTTx market penetration was excellent in 2005, we believe this is just the beginning of a long-term deployment trend.

### Migration towards converged, IP-based networking

Network operators around the world are migrating from public switched telephone networks (PSTN) to packet-based, Internet protocol (IP) networks in order to achieve substantial reductions in operating expenses and increased profitability. British Telecom Group, for example, announced it will spend £10 billion over five years on its 21CN initiative (21<sup>st</sup> Century Network) to reduce operating expenses by up to £1 billion per year, while enabling revenue expansion into differentiated, higher-margin new services – all thanks to a single network carrying voice, data and video signals.

Without getting too technical, legacy SONET/SDH networks were designed in the late 1970s to optimize voice traffic, but they can drop to 30% efficiency when data and video applications are added. Next-generation networks, such as those announced by British Telecom, represent a major technological improvement, since they can deliver triple-play services at almost 100% efficiency while significantly reducing operating and maintenance costs.

Anticipating this market opportunity, we shifted our focus from legacy SONET/SDH and Ethernet technologies to next-generation protocol test solutions aimed at the deployment of converged, IP-based networks. Product launches in 2005 included a next-generation SONET/SDH analyzer, featuring the latest in generic framing procedure (GFP), virtual concatenation (VCAT) and link capacity adjustment scheme (LCAS); a 10 Gigabit Ethernet (GigE) test solution, a remote Ethernet tester to ensure quality of service (QoS); and additional Ethernet test capabilities to help carriers operate their high-performance core, metro and edge networks. We also formed an alliance with ADC Telecom to provide a unique remote Ethernet test solution for first-mile applications. Subsequent to the year-end, we launched 10 GigE and Fibre Channel test solutions for the system vendor market.

Given the protocol test market is significantly larger than the optical test market, our rich product pipeline in protocol testing, and four consecutive quarters of sales growth in protocol testing with the last quarter exceeding 10% of Telecom Division revenues, we have high expectations for this product line. We expect that protocol sales will outgrow optical sales to eventually account for 50% of our Telecom Division revenues, even though our optical segment will continue to increase.

1. World Fiber Optic Test Equipment (FOTE) Markets, June 2005, Frost & Sullivan.  
2. Pro forma net earnings represent a GAAP net loss of \$1.6 million, excluding \$4.8 million in amortization of intangible assets, \$1.0 million in stock-based compensation costs and \$0.3 million in restructuring and other charges in 2005.

On the life sciences and industrial side:

Fluorescence imaging is one of the fastest-growing segments of the microscope industry. To take advantage of this market opportunity, EXFO has partnered with major microscope manufacturers in the last two years to deliver the leading fluorescence illumination system in North America. We're now seeking similar penetration in Europe and Asia through regional partnerships with microscope manufacturers.

The aging baby-boomer market is placing stringent demands on manufacturers of medical equipment for devices like in-vitro balloon catheters, hearing aids and asthma inhalers. Similarly, high-tech consumers are pushing for the continued miniaturization of devices such as digital cameras, personal digital assistants (PDAs) and cellular phones. Given the demand for higher volumes and miniature sizes, manufacturers of medical and electronic devices are requiring exceptional control and repeatability for their precision assembly applications. EXFO has responded to this dual trend by bringing to market an automated spot-curing platform that can be controlled via a personal computer.

### Fiscal 2006 Corporate Objectives

During meetings with investors in the past year, I often asked myself whether they are growing tired of hearing the same story, but I have come to realize that most investors are comforted by the consistency and coherence in our long-term strategy. Consequently, our corporate objectives for 2006 bear a strong resemblance to those of previous years. We intend to:

**Increase sales more than 15% year-over-year mainly through market-share gains.** It's hardly surprising that "market-share gains" is a mantra constantly repeated at EXFO, since we strive to grow faster than our industry year-in and year-out. To achieve this goal, we intend to exploit the aforementioned market opportunities and concentrate on solid execution.

**Generate more than 5% in earnings from operations.** Higher sales volumes, increased contribution from higher-margin protocol test solutions, improved operating efficiencies and continued cost controls should help us reach our objective. This metric assumes no significant currency fluctuations nor closed acquisitions in fiscal 2006. If an acquisition is completed in 2006, this metric will be revised accordingly.

**Derive at least 40% of sales from products on the market two years or less.** At EXFO, we remain attuned to customer and market requirements, not to technology for the sake of it. This ambitious innovation target is fully aligned with our fundamental goals of differentiating ourselves from the competition, increasing market share and revenue, as well as improving gross margin and profitability. Stay tuned for several new product introductions in 2006.

Clearly, EXFO is one of the best-positioned companies in the global test and measurement industry. We generated \$14.0 million in cash flows from operating activities in 2005 to increase our cash and short-term investments to \$112.0 million, or \$1.62 per diluted share. This strong cash position provides comfort to our customers, while offering us the flexibility to accelerate our long-term growth strategy through select acquisitions. Typically, we target companies with leading-edge technologies that are deemed strategic to our long-term success. As a disciplined acquirer, we will only complete a transaction if we firmly believe there are real synergies leading to long-term value creation.

## Corporate Highlights – Fiscal 2005



PPM-350B | PON Power Meter

### October 2004

- | PON power meter selected by a Tier-1 NSP in the US
- | Launches next-generation SONET/SDH analyzer
- | Releases software suite for Ethernet testing
- | Introduces OmniCure Series 2000 Spot-Curing System

### September 2004

- | Consolidates Photonics and Life Sciences Division in Toronto

### November 2004

- | Introduces optical spectrum analyzer (OSA) for metro and access networks

### January 2005

- | Receives sole-source approval for a line of FTTx test solutions from another Tier-1 NSP in the US
- | PMD measurement method approved by International Telecommunication Union (ITU)

### December 2004

- | Forms alliance with ADC Telecom to offer integrated remote Ethernet test solution
- | Expands line of handheld testers with 600 series

600 Series | Line of handheld FTTx products



In terms of corporate governance, we put in place a number of charters and policies in 2005 (see the Investors section of our Web site) in compliance with regulatory authorities. We also implemented a "Whistleblower" mechanism on our Web site, which enables any interested party with significant concerns to send an anonymous e-mail to our Board's independent Lead Director. Finally, we continued to work diligently towards compliance with Section 404 of Sarbanes-Oxley, even though foreign issuers were given an extra year's grace by the Securities and Exchange Commission in the US. These initiatives demonstrate EXFO's commitment to best-in-class corporate governance practices.

### Wrap-Up

We have reached an important milestone at EXFO. Closing my 20<sup>th</sup> year at the helm, I feel privileged to lead such an accomplished team of professionals. Most members of our senior management team have worked with me for more than 10 years and all have over a decade of industry-specific experience. Through the years, we have found that excellent results can only be achieved through disciplined, long-term strategic planning and a strong focus on execution at all levels.

I'd like to sincerely thank our employees for their hard work, excellence-driven attitude and strong commitment to growing their company – this is no small feat given our high expectations! Similarly, I appreciate the strong vote of confidence our increasing customer base has demonstrated in our products and services on a daily basis. By sharing their expectations and future requirements, they are providing us with an opportunity to showcase what we do best at EXFO: enabling our innovations and expertise to reach out. All of us are highly committed to making the "EXFO Experience" one that will provide customers with unparalleled satisfaction.

**"Through the years, we have found that excellent results can only be achieved through disciplined, long-term strategic planning and a strong focus on execution at all levels."**

Many thanks as well to our Board of Directors for its wise counsel, availability, unwavering support and for sharing its industry-wide experience, as well as to our shareholders for believing in our long-term vision. With the continued support of everyone, I am looking forward to the challenges of the new year with a large measure of confidence.

Sincerely,



**Germain Lamonde**  
Chairman, President  
and Chief Executive Officer  
October 20, 2005

