

Dear Shareholders,



Germain Lamonde
Chairman, President and
Chief Executive Officer

Following the completion of fiscal 2006, I am pleased to report significant growth in revenue and profitability for your company. I am convinced that these results compare favorably to those of our peers, and that we're better positioned than ever to take advantage of the vibrant telecom industry offering excellent long-term market perspectives. In the following lines, I would like to comment on the state of your company, highlight some recent developments and, more importantly, provide an overview of some of our future directions.

EXFO was among the last companies to be impacted by the telecommunications downturn in 2001 and first to recover with sales growth of 20.5% in fiscal 2004, 30.3% in 2005 and 31.9% in 2006, including 12 consecutive quarters of growth. This remarkable performance was accomplished mainly through market-share gains, since our end-markets reportedly experienced negative growth in 2004 and increased in the mid-single digits in 2005 and 2006. Looking back at EXFO's history, capturing market share has not been the exception but rather the rule, as we believe that we have grown faster than our end-markets in each and every one of our 21 years in existence.

Our bottom line improved faster than our top line in the last few years with GAAP net earnings of \$8.1 million in fiscal 2006, or \$0.12 per diluted share, thus extending our sequence to seven consecutive quarters of GAAP profitability. GAAP net earnings in 2006 included \$4.4 million in amortization of intangible assets, \$1.0 million in stock-based compensation costs, \$0.6 million in impairment of long-lived assets and a government revenue grant of \$1.3 million.

Fiscal 2006 was a very productive year as demonstrated by the performance highlights listed below. These excellent results were achieved despite a strong headwind from the strengthening Canadian dollar, customers consolidating and competitors intensifying pricing pressure.

EXCELLENT PERFORMANCE

- Increased sales 31.9% to \$128.3 million in 2006 mainly through organic growth;
- Delivered sales growth of 34.0% and 22.1% year-over-year for our Telecom Division and Life Sciences & Industrial Division, respectively;
- Posted sales CAGRs of 27.5% and 20.9% over the last three and ten years, respectively, despite a major telecom crisis in 2001;
- Achieved GAAP net earnings of \$8.1 million and GAAP operating margin of 6.3%;
- Generated \$0.31 in earnings before income taxes for every additional dollar of revenue in 2006 over 2005;
- Produced \$12.3 million in cash flows from operating activities;
- Derived 37.1% of sales from new products on the market two years or less;
- Acquired Consultronics for \$19.1 million in cash, strategically positioning EXFO for the triple-play, broadband access test market;
- Consolidated leadership position in the portable optical test market with a third consecutive Growth Strategy Leadership Award from Frost & Sullivan for achieving highest organic market-share gains;
- Posted best sales and bookings year in company history for protocol business, which is growing much faster than our Telecom Division; and
- Received Product Differentiation Innovation Award from Frost & Sullivan for new portfolio of protocol test solutions dedicated to next-generation and traditional SONET/SDH networks.

WHY WE EXCEL

Given that hope is not a strategy at EXFO, our performance is not the result of good fortune. We choose our battles and win them on the strength of market-driven innovation, outstanding execution, unique modular platform design and quality people at every level of our organization.

- **Market-driven innovation.** We are first and foremost a market-driven company, highly focused on anticipating market trends and developing value-added solutions that go beyond satisfying our customers' requirements. Our aim is to deliver targeted products with just the right features to customers on a global basis.

- **Outstanding execution.** Market-driven innovation provides us with superior products and early market advantages over competitors. But paying meticulous attention to all aspects of the customer experience, combined with outstanding product quality and proficient technical expertise, enables us to expand our customer base and convert these short-term advantages into long-term market-share gains.
- **Unique modular platform design.** A decade ago, we were the first in our industry to introduce PC-based, Windows-driven modular test platforms – sharing a common series of test modules – for different end-markets. We have continued to build on our first-mover advantage with the launch of next-generation platforms and additional best-in-class test modules in order to expand our technology base. This unique platform strategy provides our customers with cost-efficient and scalable test solutions, while allowing us to leverage R&D investments across multiple end-markets.
- **Quality people.** Around the world, we have a long list of employees who share a common passion for excellence and a real dedication to serve our customers. These people, prominent within all levels of our organization, always place customers first and spare no efforts to succeed as finishing second is not an option for them. I refer to these people as “EXFO bluebloods.” Their hard work, enthusiasm and commitment are among the main reasons why EXFO is a winner in my book.

EXECUTION IN FISCAL 2006

A few years ago, the Canadian Institute of Chartered Accountants (CICA) recommended that public companies publish performance metrics to help investors better evaluate the performance of management teams. As an early adopter of this guideline, EXFO provided the following metrics for fiscal 2006:

Goal	Metric	Result
Increase sales through market-share gains	25% sales growth year-over-year*	31.9% sales growth year-over-year
Maximize profitability	GAAP operating margin of 5%	GAAP operating margin of 6.3%
Focus on innovation	40% of sales from new products	37.1% of sales from new products

* Sales growth metric was updated at the end of the second quarter in 2006 to reflect mid-year results and Consultronics acquisition.

Sales growth. Given strong sales growth in our two divisions and the Consultronics acquisition in January 2006, we raised our performance metric from 15% to 25% midway through the fiscal year. We still surpassed the revised goal with 31.9% growth in 2006, largely due to market-share gains. Frost & Sullivan, a leading market research firm in the test and measurement industry, confirmed our market-share gains by naming EXFO recipient of its Growth Strategy Leadership Award for the third consecutive year. According to Frost & Sullivan, EXFO increased its market share from 10.3% in 2004 to 11.0% in 2005 for third place overall in the global fiber-optic test equipment market and was the only supplier among the top five to deliver significant organic growth. Based on the June 2006 report, EXFO also increased its leadership position in the portable field instrumentation market segment from an estimated 22.2% to 23.0% during the same period.

Profitability. We completed fiscal 2006 with a GAAP operating margin of 6.3% versus our published metric of 5%. I am particularly pleased by the improvement in our gross margin for a third consecutive year, reaching 55.3% in 2006 despite pricing pressure and the strengthening of the Canadian dollar versus the US dollar (29.1% over last three years and 7.3% in FY 2006). I remain confident that our gross margin will attain 60% in the not-too-distant future as higher-margin protocol revenues, better absorption of fixed costs on higher

sales volumes, specific internal initiatives, and currency stability come into play. For every additional sales dollar in 2006 over 2005, \$0.31 flowed to earnings before income taxes, demonstrating excellent leverage in our operating model.

Innovation. Sales from new products (on the market two years or less) accounted for 37.1% of total sales in 2006 versus our stated goal of 40%. Despite missing this aggressive innovation target, I am proud of our accomplishments, since new products with their built-in superior performance and lower cost of goods contributed significantly to raising revenues, gross margin and operating margin in 2006. I am also pleased that several of our successful FTTx products, moving down to the denominator part of the ratio as they've been on the market for more than two years, still strongly contributed to our sales performance. I firmly believe that our innovation mark is well above the industry average.

EXCITING MARKET DRIVERS FOR 2007 AND BEYOND

Global market demand for telecom test and measurement equipment should remain strong in the years to come as most network service providers (NSPs) are increasing capital expenditures to upgrade their networks for converged IP services and triple-play offerings. These market forces create needs for differentiated test solutions to help NSPs accelerate deployment and ensure service quality in their network build-outs.

EXPECTING IPTV TO DRIVE IP MIGRATION

With the ongoing globalization of the world's economy and the emergence of new consumer markets, NSPs are poised to capitalize on growing demand for communications and entertainment services. Early in 2006, some smaller telecom operators launched broadcast-quality video services based on IP communications. This technology, better known as IPTV, allows telephone companies (telcos) to efficiently offer TV, HDTV and interactive TV services to their broadband subscribers. Tier-1 and Tier-2 telcos are expected to launch similar IPTV services on a large-scale basis later in 2007. While Web-based streaming video is offered for free on a best-effort basis, IPTV, whom many regard as the broadband “killer application,” will require a high level of performance to ensure a quality user experience. NSPs, after all, don't want customer churn to prevent a meaningful return on their massive investments.

To deliver a wide range of differentiated IP services, NSPs will continue transforming their legacy, circuit-switched networks into highly efficient, flexible and scalable packet-based IP architectures. NSPs have already proven they can generate significant revenues from higher-margin services on hybrid networks, while reducing operating costs. IPTV should only accelerate the migration towards fully converged, IP-based networks, since it typically allows NSPs to nearly double average revenue per user (ARPU).

EXPANDING BANDWIDTH IN ACCESS NETWORKS

The increasing reliance on telecom and IP-related services will continue driving bandwidth consumption, thus pushing the deployment of fiber deeper into access networks. Competition between telcos and cable TV operators (cablecos) has intensified as triple-play offerings are announced almost daily. Hybrid architectures combining copper and fiber (FTTC and FTTN) will keep expanding worldwide, since this is the quickest and least expensive method to increase bandwidth. To remain competitive with cablecos, telcos are migrating from former ADSL, to current ADSL2+, and onto future VDSL2+ technologies as interoperability becomes a reality. Telcos, however, will increasingly opt for all-fiber, PON-based architectures (FTTP) to meet heightened bandwidth requirements and to future-proof their networks. These decisions will apply not only to green-field deployments and high-rise buildings, but also to larger-scale rollouts as operating costs are less than FTTC and FTTN architectures and costs of deployments are falling. We are still in the early stages of building access networks around the world.

EXPLOITING METRO AND LONG-HAUL NETWORKS

Metro network deployments, taking advantage of carrier-grade Ethernet and metro-Ethernet technologies, are moving ahead to handle large increases in bandwidth consumption in access networks. These network upgrades, in turn, will eventually place a strain on long-haul networks, where excess capacity created by massive overspending in the late-90s is gradually being consumed. NSPs are more than ever committed to deploying next-generation SONET/SDH transport technologies, while 40 Gb/s deployments are not far behind.

EXCELLENT POSITIONING IN TELECOM MARKETS

We anticipated these market trends and directed a significant part of our R&D efforts to bring NSPs the distinctive product offering they have come to expect from EXFO for installation and maintenance applications and, increasingly, for network quality assurance. In addition, we have increased interaction with system vendors, both in terms of partnerships and product offerings, since they are the key players defining and designing the networks of the future. Consequently, we have widened our competitive advantage, based on our FTB-200, FTB-400 and IQS-500 modular platforms and extensive line of test modules, and developed new test solutions for converged, IP networking. I am confident that we will commercially leverage our technological leadership in installation and maintenance applications – up to 10 Gb/s Ethernet and 10 Gb/s next-generation SONET/SDH testing. I also maintain that protocol sales, substantially above 10% of optical sales in 2006 and growing significantly faster than the company overall, will equal optical revenues in the next three to five years.

On the optical testing front, we have strengthened our dominant market position for access networks both in terms of new network architectures (FTTH, FTTC, FTTN) and technologies (BPON, GPON, EPON). Look for us to enhance our presence with an expanded offering for twisted-copper-pair testing of IPTV and VoIP services in the last mile now that Consultronics has been fully integrated. As well, we will take advantage of our technical expertise in optical testing for upcoming deployments of 40 Gb/s systems in long-haul networks. In a nutshell, we will expand our product offering from access to core, touching on various levels of the network to fuel our long-term growth.

EXPERTISE IN LIFE SCIENCES AND INDUSTRIAL MARKETS

On the life sciences and industrial side, we will continue leveraging technologies developed or acquired for optical component manufacturing applications into non-telecom markets. Overall, I am satisfied with the results delivered by this division.

- Our OmniCure product line, focused on UV spot-curing applications, has enjoyed significant growth within the medical and optoelectronics industries. These diverse markets, largely influenced by the miniaturization trend, are expanding worldwide with Asia showing the largest year-over-year growth.

- Our X-Cite series, an add-on illumination system for high-end microscopes, has entrenched itself as a market leader in various research areas. The global fluorescence microscopy market is growing in mid-single digits, while live cell and quantitative imaging are increasingly gaining traction.
- Our Burleigh nanomanipulation product line, mainly designed for cellular micromanipulation, continues to demonstrate strong brand-name recognition and loyal following with electrophysiologists. It targets a stable growth market focused on fundamental neuroscience and drug discovery.

LOOKING TO EXCEED OUR OBJECTIVES IN 2007

EXFO remains committed to best practices in corporate governance and, as such, I am pleased to provide the following performance metrics for fiscal 2007. Please note that these management goals should not be confused with guidance.

- Grow revenues by at least 20% year-over-year;
- Generate a GAAP operating margin of more than 7%; and
- Derive at least 35% of sales from new products (on the market two years or less).

Looking ahead to 2007, we will strengthen our competitive position by leveraging the aforementioned market drivers, both organically and through strategic acquisitions if stringent criteria are met. Our strong balance sheet, including \$111.3 million in cash, combined with superior execution and disciplined management, should enable us to sustain growth. On the operations side, we will increasingly take advantage of talent pools around the world to cost-effectively design and manufacture innovative test solutions. These initiatives will improve our ability to face pricing pressure, account consolidation and market expansion on a global basis, while accelerating product innovation as we privilege long-term advantages over short-term gains. In doing so, we will continue to build one of the most respected brand names in the telecom test and measurement industry, while bolstering shareholder value.

I would be remiss if I did not mention the efforts deployed internally to be compliant with Section 404 of Sarbanes-Oxley. It has proven to be a major undertaking during the last two years to ensure that our internal processes meet the highest standards, but it also has enabled us to review how and why we do things at EXFO. Ultimately, it has improved our overall efficiency.

A final word of thanks to the three pillars of our company, namely customers, employees and shareholders. Without your unwavering belief, support and commitment to our long-term vision, EXFO would not be as well-positioned as it is today to keep growing on a profitable basis. I would also like to extend my appreciation to our Board of Directors, whose wise counsel and staunch support represent invaluable assets to the company.

Sincerely,



Germain Lamonde
Chairman, President and Chief Executive Officer
October 25, 2006