



# POISED FOR PROFITABLE GROWTH

**GERMAIN LAMONDE**  
Chairman, President and Chief Executive Officer

**I believe that we continued to increase our market share as the telecom test and service assurance pie contracted more than our sales in the past year.**

Fiscal 2009 unfolded like two years in one at EXFO. At the midpoint of fiscal 2009, we had increased sales 10.1% year-over-year (or flat organically, excluding acquisitions and forward exchange contracts), while most of our peers endured double-digit declines. We had also generated strong earnings thanks, in part, to a favorable Canadian/US exchange rate.

The depressed economic environment, however, caught up with us in the second half of the fiscal year, especially in May and June, as several opportunities that we had been tracking were delayed or reduced in size. We also witnessed a significant decrease in the US dollar against multiple currencies, including the Canadian dollar, in the third quarter, which prompted us to implement a restructuring plan that will provide \$6 million in annualized pre-tax savings to help us return to better profitability levels.

We closed fiscal 2009 with a 5.9% year-over-year decrease in sales to \$172.9 million, or -13.5% on an organic basis. Given the lower sales volume caused by the economic recession, EBITDA\* dropped to \$14.5 million, or 8.4% of sales.

Obviously, these results are disappointing to me, but I believe that we continued to increase our market share as the telecom test and service assurance pie contracted more than our sales in the past year. We also made inroads in new market segments, intensified sales and marketing initiatives in targeted regions, and launched a series of ground-breaking solutions. I'm confident these actions will lead to a significant increase in sales and earnings in upcoming years.

Following is a summary of our key achievements in fiscal 2009:

- || Increased protocol sales 63.1% year-over-year to \$54.9 million;
- || Raised gross margin for a seventh consecutive year to reach 61.3%;
- || Generated a record \$22.6 million in cash flows from operations;
- || Maintained a healthy balance sheet with a cash position of \$69.7 million and no debt;
- || Returned \$26.3 million to shareholders via our share buyback programs;
- || Positioned EXFO for key market opportunities by launching 26 new products, including several game-changers; and
- || Over the last five years, increased sales by a CAGR of 18.3% and improved gross margin on average 1.3% per year – from 54.7% to 61.3%.

With the worst of the economic recession seemingly behind us, I'm optimistic that EXFO is poised to return to profitable growth, as reflected in the theme of our Annual Report. With operators shifting their fixed and mobile networks to a fully converged, IP architecture in order to meet growing bandwidth demand in a flexible and cost-effective manner, EXFO is well positioned to meet the challenge with its market-leading optical product portfolio and higher-margin, next-generation IP test and service assurance offerings.

## | OPTICAL BUSINESS

Many operators deferred capital-intensive deployments of fiber in their access networks, including fiber-to-the-home (FTTH), as well as core network expansion initiatives in 2009. Consequently, optical sales dropped 17.5% to \$95.5 million despite our continued market-share gains. Third-party research from Frost & Sullivan reported in 2009 that EXFO had made the largest market-share gains in the fiber-optic test equipment (FOTE) market for a fifth consecutive period in calendar 2008, confirming we had vaulted from third to first place in the global FOTE market with a market share of 18.0% in 2008, or an estimated 33.3% of the portable test segment. Our internal numbers indicate that the FOTE market dropped between 20 to 25% in 2009.

Continuing to build on our leadership position in 2009, we strengthened our optical product line with a number of innovative test solutions like a patent-pending, single-ended distributed PMD analyzer and a 100 Gbit/s optical modulation analyzer. We remain recognized as the partner of choice by network operators worldwide as they increase transmission rates in core and metro networks to 40 Gbit/s and even 100 Gbit/s, and deploy fiber deeper in their access networks with proven FTTH or hybrid fiber-to-the-node (FTTN) and fiber-to-the-curb (FTTC) initiatives. We expect our optical revenues to rebound in 2010 as access to capital improves among network operators.

**With operators shifting their fixed and mobile networks to a fully converged, IP architecture... EXFO is well positioned to meet the challenge with its market-leading optical product portfolio and higher-margin, next-generation IP test and service assurance offerings.**

## PROTOCOL BUSINESS

Sales of our protocol business increased 63.1% year-over-year to \$54.9 million in 2009 as we continued gaining market share in next-generation transport and datacom testing, IMS/VoIP testing (Navtel acquisition) and IP service assurance (Brix acquisition). These latter two segments made full-year contributions to our protocol sales in 2009 compared to five and four months, respectively, in 2008. Our five-year CAGR for protocol sales is a remarkable 51.9%.

We made headway in 2009 not only with wireline operators, but also with their wireless counterparts. Among our numerous contract wins, let's mention two multi-million dollar contracts with Tier-1 wireless operators: one for mobile backhaul testing and another for a nation-wide service assurance deployment. Wireless is increasingly becoming an attractive end-market for EXFO as both fixed and mobile networks are converging to a common IP-based communications infrastructure supported by IMS for seamless network interoperability. Wireless operators are aggressively investing in 3G networks and preparing for 4G/LTE deployments to cope with the explosion in bandwidth demand generated by smart phones and notebooks.

To accommodate soaring mobile data traffic, wireless operators will be massively deploying optical fiber to their transmission towers in order to ratchet transmission rates up to 1 Gbit/s. This represents a major opportunity for EXFO to combine leading optical, protocol and service assurance solutions in a comprehensive end-to-end offering.

## BRIX ACQUISITION

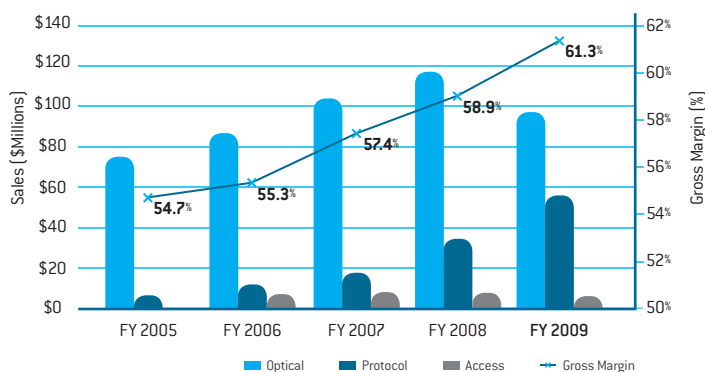
Our bold move to acquire Brix Networks in April 2008 is just starting to pay off as we begin to leverage the technical and commercial synergies with the rest of our business. Brix brought to EXFO the most advanced and scalable service assurance solution for voice, data and video applications on fixed and mobile IP networks. As an integral part of our protocol business, it was negative to earnings (excluding amortization of intangible assets and stock-based compensation costs) for the remainder of fiscal 2008 and slightly positive in 2009—ahead of what we had initially communicated. It should increasingly contribute to earnings as we ramp up sales volume in a segment that carries our highest margins. IP service assurance is a high-growth market opportunity for EXFO. Network operators must increasingly measure quality of experience to assure customer satisfaction and retention, given the less predictable nature of IP networks with applications competing for bandwidth as they travel through the "Internet cloud."

Looking at the chart on this page, our consolidated gross margin has grown in tandem with sales of our protocol solutions, which have elevated margins due to their inherently high software content. As mentioned in previous years, I anticipate this business will surpass optical revenues in the not-too-distant future despite expectations that our optical business will resume its growth trajectory. Consequently, I'm confident that our consolidated gross margin profile will continue its ascent in upcoming years as we focus on carrying over the impact to our earnings.

## ACCESS BUSINESS

This smaller unit is taking longer than planned to deliver on its promise. It was affected by difficult market conditions in 2009, along with the fact that our new offering targeting high-speed bandwidth to the home is just starting to win product approvals with large accounts. Sales in access testing decreased 21.8% to \$5.8 million in 2009, but should return to a growth mode in 2010.

Segmented Telecom Sales/Consolidated Gross Margin



## LIFE SCIENCES AND INDUSTRIAL DIVISION

Sales in our Life Sciences and Industrial Division dropped 13.2% year-over-year to \$19.8 million in 2009 mainly due to reduced demand for consumer goods, such as cellular phones and cameras, which affected sales of our opto-electronics assembly product lines. This division remains, however, quite profitable.

## SHARE BUYBACK PROGRAMS

Through a substantial issuer bid (SIB) in December 2008, we bought back 7.7 million shares for \$25.5 million. The SIB re-affirmed management's belief in the long-term success of the company, reduced pressure on our share price created by some shareholders' need for liquidity during the financial crisis, and efficiently disposed of excess cash on our balance sheet. We also maintained our normal course issuer bid (NCIB) and altogether returned \$26.3 million to shareholders in fiscal 2009.

## FOCUS ON REVENUE AND EARNINGS GROWTH

As we enter our 25<sup>th</sup> year of operation, we're better positioned than ever to benefit from an economic recovery, key market trends and earnings leverage. In a nutshell:

- || We expect all our telecom segments to resume sales growth in 2010. As access to capital improves for network operators, our market-leading optical business should rebound thanks to FTTH rollouts and overall network expansion. Our protocol business is expected to continue its strong growth trajectory as operators migrate their wireline and wireless networks to an all-IP network architecture. Finally, our access segment should benefit from increased product approvals among a larger base of network operators, who are delivering higher speeds to homes through their existing fiber and copper plants.
- || We're confident that we will continue to raise our gross margin based on increased sales from our higher-margin protocol business, which will eventually surpass our optical unit in terms of revenues. In addition, several strategic initiatives in procurement, product development and manufacturing operations should continue to sustain this trend.
- || As we ramp up sales volume, we expect to better absorb the costs of our global R&D, sales and support teams, and reduce their relative weight in our P&L statement. It should be noted that our R&D software center in India will begin its third year of operation, resulting in enhanced productivity and better innovation results for EXFO.
- || We will focus on increasing the differentiation and added value in our various product lines in order to deliver end-to-end test and service assurance solutions that very few players in our field can match. We will further leverage our technical and sales forces to maximize our return on investment as network operators increasingly turn up triple-play IP services and reduce customer churn.

- || We've made significant moves in recent years, such as establishing our telecom manufacturing plant in China and R&D software center in India, to better position ourselves for strong revenue growth and even faster earnings growth. We're committed to finding the right balance between sales and profitability growth, as well as organic versus acquisition-related development. It's essential that our earnings, measured in EBITDA\*, progress at a high rate in upcoming years, since as a significant shareholder of the company I want to create value for all shareholders.

## CORPORATE PERFORMANCE METRICS

We have maintained our best practice of establishing corporate metrics by which management's performance can be measured by shareholders. Given the economic recession in 2009, however, we've adjusted them for a new three-year period extending from fiscal 2010 to 2012. We're retaining our minimum target of 20% sales CAGR as we intend to grow sales faster than our end-markets. We're raising our gross margin metric to a minimum of 64% based on an increased contribution from higher-margin protocol solutions. Finally, we plan to at least double EBITDA\* in dollars over the newly defined three-year period.

### CORPORATE PERFORMANCE OBJECTIVES FOR FY 2010-2012

**Increase sales by a CAGR of 20% or more**

**Raise gross margin to 64%**

**Double EBITDA\* in dollars**

## WRAP-UP

A final word of thanks goes out to the three pillars of our company: customers, employees and shareholders. Without your ongoing trust, commitment and belief in EXFO, we would not be as well positioned today to grow on a profitable basis. I would also like to extend my gratitude to our Board of Directors, whose wise counsel and staunch support have proven to be invaluable over the years.

Sincerely,



**Germain Lamonde**

Chairman, President and Chief Executive Officer  
October 13, 2009

*\*EBITDA is defined as net earnings (loss) before interest, income taxes, amortization of property, plant and equipment, amortization of intangible assets, impairment of goodwill and extraordinary gain. Please see page 64 for a reconciliation of EBITDA to GAAP net earnings (loss).*