Management's Discussion and Analysis of Financial Condition and Results of Operations

This discussion and analysis contains forward-looking statements within the meaning of the U.S. Private Securities Litigation Reform Act of 1995, and we intend that such forward-looking statements be subject to the safe harbors created thereby. Forward-looking statements are statements other than historical information or statements of current condition. Words such as may, expect, believe, plan, anticipate, intend, could, estimate, continue, or similar expressions or the negative of such expressions are intended to identify forward-looking statements. In addition, any statements that refer to expectations, projections or other characterizations of future events and circumstances are considered forward-looking statements. They are not guarantees of future performance and involve risks and uncertainties. Actual results may differ materially from those in forward-looking statements due to various factors including, but not limited to, macroeconomic uncertainty as well as capital spending and network deployment levels in the telecommunications industry (including our ability to quickly adapt cost structures with anticipated levels of business and our ability to manage inventory levels with market demand); future economic, competitive, financial and market conditions; consolidation in the global telecommunications test and service assurance industry and increased competition among vendors; capacity to adapt our future product offering to future technological changes; limited visibility with regards to timing and nature of customer orders; longer sales cycles for complex systems involving customers' acceptance delaying revenue recognition; fluctuating exchange rates; concentration of sales; timely release and market acceptance of our new products and other upcoming products; our ability to successfully expand international operations; our ability to successfully integrate businesses that we acquire; and the retention of key technical and management personnel. Assumptions relating to the foregoing involve judgments and risks, all of which are difficult or impossible to predict and many of which are beyond our control. Other risk factors that may affect our future performance and operations are detailed in our Annual Report, on Form 20-F, and our other filings with the U.S. Securities and Exchange Commission and the Canadian securities commissions. We believe that the expectations reflected in the forward-looking statements are reasonable based on information currently available to us, but we cannot assure that the expectations will prove to have been correct. Accordingly, you should not place undue reliance on these forward-looking statements. These statements speak only as of the date of this document. Unless required by law or applicable regulations, we undertake no obligation to revise or update any of them to reflect events or circumstances that occur after the date of this document. This discussion and analysis should be read in conjunction with the consolidated financial statements.

The following discussion and analysis of financial condition and results of operations is dated January 7, 2015.

All dollar amounts are expressed in US dollars, except as otherwise noted.

COMPANY OVERVIEW AND RECENT DEVELOPMENTS

We are a leading provider of next-generation test, service assurance and end-to-end quality of experience solutions for mobile and fixed network operators and equipment manufacturers in the global telecommunications industry. Our intelligent solutions with contextually relevant analytics improve end-user quality of experience, enhance network performance and drive operational efficiencies throughout the network and service delivery lifecycle. We target high-growth market opportunities related to increasing bandwidth and improving quality of experience on network infrastructures: 4G/LTE (long-term evolution), wireless backhaul, small cells and distributed antenna systems (DAS), 100G network upgrades and fiber-to-the-home (FTTH)/fiber-to-the-curb (FTTC)/fiber-to-the-node (FTTN) deployments.

We launched three new products in the first quarter of fiscal 2015, including a new version of its TravelHawk Pro, a live 4G/LTE troubleshooting tool now capturing up to 30 Gbit/s of data for deep analysis; CPRI (common public radio interface) test capabilities for the FTB-700G and FTB-800 NetBlazer series that are critical for fiber-to-the-antenna (FTTA) network deployments; and expanded testing functionalities for the Packet Blazer product family, allowing carrier labs and network equipment manufacturers to fully qualify and test 100G network elements.

We reported sales of $56.7 million in the first quarter of fiscal 2015, which represents an increase of 1.3% compared to $56.0 million for the same period last year. Bookings decreased 6.3% to $54.2 million in the first quarter of fiscal 2015, for a book-to-bill ratio of 0.96, from $57.9 million for the same period last year.

Net earnings amounted to $1.5 million, or $0.02 per diluted share, in the first quarter of fiscal 2015, compared to a net loss of $747,000, or $0.01 per share, for the same period last year. Net earnings for the first quarter of fiscal 2015 included $1.0 million in after-tax amortization of intangible assets, $400,000 in stock-based compensation costs and a foreign exchange gain of $2.0 million.

Adjusted EBITDA (net earnings (loss) before interest, income taxes, depreciation and amortization, stock-based compensation costs and foreign exchange gain) reached $3.2 million, or 5.6% of sales, in the first quarter of fiscal 2015, compared to $2.3 million, or 4.1% of sales for the same period last year. See page 10 in this document for a complete reconciliation of adjusted EBITDA to IFRS net earnings (loss).

On January 7, 2015, we announced that our Board of Directors had authorized a substantial issuer bid (the "Offer") to purchase for cancellation up to 7,142,857 subordinate voting shares for an aggregate purchase price not to exceed CA$30,000,000. The Offer is being made by way of a "modified Dutch Auction" pursuant to which shareholders might tender all or a portion of their shares (i) at a price not less than CA$4.20 per share and not more than CA$4.60 per share, in increments of CA$0.05 per share, or (ii) without specifying a purchase price, in which case their shares would be purchased at the purchase price determined in accordance with the Offer. The Offer will expire on February 13, 2015.

RESULTS OF OPERATIONS

(in thousands of US dollars, except per share data, and as a percentage of sales for the periods indicated)

	Three months ended November 30,		Three months ended November 30,	
	2014	**2013**	**2014**	**2013**
Sales	**$ 56,724**	$ 56,003	**100.0 %**	100.0 %
Cost of sales (1)	**21,237**	21,185	**37.4**	37.8
Selling and administrative	**21,032**	21,708	**37.1**	38.8
Net research and development	**11,658**	11,281	**20.6**	20.1
Depreciation of property, plant and equipment	**1,245**	1,275	**2.2**	2.2
Amortization of intangible assets	**1,098**	1,182	**1.9**	2.1
Interest income	**(217)**	(27)	**(0.4)**	–
Foreign exchange gain	**(1,975)**	(802)	**(3.5)**	(1.4)
Earnings before income taxes	**2,646**	201	**4.7**	0.4
Income taxes	**1,165**	948	**2.1**	1.7
Net earnings (loss) for the period	**$ 1,481**	$ (747)	**2.6 %**	(1.3) %
Basic and diluted net earnings (loss) per share	**$ 0.02**	$ (0.01)		
Other selected information:				
Gross margin before depreciation and amortization (2)	**$ 35,487**	$ 34,818	**62.6 %**	62.2 %
Research and development:				
Gross research and development	**$ 13,309**	$ 13,309	**23.5 %**	23.8 %
Net research and development	**$ 11,658**	$ 11,281	**20.6 %**	20.1 %
Adjusted EBITDA (2)	**$ 3,197**	$ 2,292	**5.6 %**	4.1 %

(1) The cost of sales is exclusive of depreciation and amortization, shown separately.

(2) Refer to page 10 for non-IFRS measures.

SALES AND BOOKINGS

For the three months ended November 30, 2014, our sales slightly increased 1.3% to $56.7 million, compared to $56.0 million for the same period last year, and our bookings decreased 6.3% to $54.2 million, compared to $57.9 million for the same period last year, for a book-to-bill ratio of 0.96.

In the first quarter of fiscal 2015, despite a headwind from a stronger US dollar versus other currencies compared to 2014, which had a negative impact on our sales and bookings expressed in US dollars, our sales increased year-over-year as we benefited from a stronger backlog at the end of fiscal 2014 compared to 2013. More precisely, in the first quarter of fiscal 2015, the year-over-year increase in sales came mainly from the Europe, Middle East and Africa (EMEA) region and to a lesser extent from the Asia-Pacific region as sales to the Americas, especially in United States, decreased year-over-year due in part to orders delays.

As we gradually evolve from a supplier of dedicated test instruments to a supplier of end-to-end solutions, our quarterly sales and bookings are increasingly subject to quarterly fluctuations, as we are managing more complex, multi-million dollar deals that have prolonged sales and revenue recognition cycles related to our Protocol-layer products; this mainly explains the year-over-year decrease in total bookings in the first quarter of fiscal 2015 as we reported the highest bookings level in two years for our Physical-layer products during the quarter.

Moreover, in the first quarter of fiscal 2015, we faced increased competition and pricing pressure compared to the same period last year, which negatively affected our sales and bookings year-over-year.

Geographic distribution

In the first quarter of fiscal 2015, sales to the Americas, EMEA and Asia-Pacific accounted for 48%, 32% and 20% of sales respectively, compared to 51%, 29% and 20% for the same period last year respectively.

Customer concentration

We sell our products to a broad range of customers, including network service providers, network equipment manufacturers, wireless operators and cable TV operators. In the first quarter of fiscal 2014 and 2015, no customer accounted for more than 10% of our sales, and our top three customers accounted for 12.5% and 11.1% of our sales respectively.

GROSS MARGIN BEFORE DEPRECIATION AND AMORTIZATION (non-IFRS measure — refer to page 10 of this document)

Gross margin before depreciation and amortization (gross margin) reached 62.6% of sales for the three months ended November 30, 2014, compared to 62.2% for the same period last year.

In the first quarter of fiscal 2015, our gross margin was favorably affected by our product mix, including some software-intensive products with higher margins, compared to the same period last year.

In addition, in the first quarter of fiscal 2015, we recorded an inventory write-down of $933,000, compared to $1.2 million for the same period last year. This write-off had less of a negative impact on our gross margin (0.4%) when compared with the same period last year.

However, in the first quarter of fiscal 2015, we face increased pricing pressure compared to the same period last year, which had a negative impact on our gross margin year-over-year.

In addition, in the first quarter of fiscal 2015, we recorded in our sales foreign exchange losses of $292,000 on our forward exchange contracts, compared to $84,000 for the same period last year, which contributed to decreasing our gross margin by 0.2% year-over-year.

SELLING AND ADMINISTRATIVE EXPENSES

For the three months ended November 30, 2014, selling and administrative expenses were $21.0 million, or 37.1% of sales, compared to $21.7 million, or 38.8% of sales for the same period last year.

In the first quarter of fiscal 2015, our selling and administrative expenses decreased due to tight control on expenses and to the increase in the average value of the US dollar compared to the Canadian dollar and the euro year-over-year, as a portion of our selling and administrative expenses are incurred in these currency and we report our results in US dollars.

RESEARCH AND DEVELOPMENT EXPENSES

Gross research and development expenses

For the three months ended November 30, 2014, gross research and development expenses totaled $13.3 million, or 23.5% of sales, flat compared to $13.3 million, or 23.8% of sales for the same period last year.

In the first quarter of fiscal 2015, the year-over-year increase in the average value of the US dollar compared to the Canadian dollar had a positive impact on our gross research and development expenses as a significant portion of these expenses are incurred in this currency and we report our results in US dollars.

Excluding the positive impact of the year-over-year increase of the average value of the US dollar compared to the Canadian dollar in the first quarter of fiscal 2015, inflation, salary increases, as well as a shift in the mix and timing of research and development projects slightly increased our gross research and development expenses compared to the same period last year.

Tax credits and grants

We are entitled to tax credits from the Canadian federal and provincial governments for eligible research and development activities conducted in Canada. We are also eligible to grants by a Finnish technology organization on certain research and development projects conducted in Finland.

For the three months ended November 30, 2014, tax credits and grants for research and development activities were $1.7 million, or 12.4% of gross research and development expenses, compared to $2.0 million, or 15.2% of gross research and development expenses for the same period last year.

The decrease in our tax credits and grants in the first quarter of fiscal 2015, compared to the same period last year, results from the decrease in the statutory Canadian federal and provincial research and development tax credit rates, as well as from the increase in the average value of the US dollar, compared to the Canadian dollar year-over-year, as our tax credits are denominated in Canadian dollars and we report our results in US dollars.

In the first quarter of fiscal 2015, the decrease in tax credits and grants as percentage of gross research and development expenses, compared to the same period last year, mainly comes from the decrease in the statutory Canadian federal and provincial research and development tax credit rates.

FOREIGN EXCHANGE GAIN

Foreign exchange gains and losses are mainly the result of the translation of operating activities denominated in currencies other than our functional currency, which is the Canadian dollar. A portion of our foreign exchange gains or losses result from the translation of cash balances and deferred income taxes denominated in US dollars. We manage our exposure to currency risk in part with forward exchange contracts. In addition, some of our entities' operating activities are denominated in US dollars, euros and British pounds, which further hedges this risk. However, we remain exposed to a currency risk; namely, any increase in the value of the Canadian dollar, compared to the US dollar, would have a negative impact on our operating results.

For the three months ended November 30, 2014, we recorded a foreign exchange gain of $2.0 million compared to $802,000 for the same period last year.

During the first quarter of fiscal 2015, the period-end value of the Canadian dollar decreased significantly versus the US dollar, compared to the previous quarter, which resulted in a foreign exchange gain of $2.0 million during that period. In fact, the period-end value of the Canadian dollar decreased 5.1% versus the US dollar to CA$1.1440 = US$1.00 in the first quarter of fiscal 2015, compared to CA$1.0858 = US$1.00 at the end of the previous quarter.

During the same period last year, the period-end value of the Canadian dollar decreased versus the US dollar, the euro and the British pound, compared to the previous quarter, which resulted in a foreign exchange gain of $802,000 during that period. In fact, the period-end value of the Canadian dollar decreased 0.9% versus the US dollar to CA$1.0620 = US$1.00 in the first quarter of fiscal 2014, compared to CA$1.0530 = US$1.00 at the end of the previous quarter, decreased 3.3% versus the euro to CA$1.4420 = €1.00 in the first quarter of fiscal 2014, compared to CA$1.3936 = €1.00 at the end of the previous quarter, and decreased 5.9% versus the British pound to CA$1.7353 = £1.00 in the first quarter of fiscal 2014, compared to CA$1.6323 = £1.00 at the end of the previous quarter.

Foreign-exchange-rate fluctuations also flow through the statement of earnings line items as a significant portion of our operating items are denominated in Canadian dollars, euros and Indian rupees, and we report our results in US dollars. Consequently, the increase in the average value of the US dollar in the first quarter of fiscal 2015, compared to Canadian dollar and the euro year-over-year, resulted in a positive impact on our financial results. In fact, the average value of the US dollar in the first quarter of fiscal 2015 increased 6.9% and 5.9% respectively year-over-year, compared to the Canadian dollar and the euro.

INCOME TAXES

For the three months ended November 30, 2014, we reported income tax expenses of $1.2 million on earnings before income taxes of $2.6 million. For the three months ended November 30, 2013, we reported income tax expenses of $948,000 on earnings before income taxes of $201,000. These situations mainly resulted from the fact that we did not recognize deferred income tax assets for some of our subsidiaries at loss and had some non-deductible losses and expenses, such as stock-based compensation costs. However, a significant portion of our foreign exchange gain was created by the translation of financial statements of our foreign subsidiaries, and was therefore non-taxable. Otherwise, our effective tax rate would have been closer to the combined Canadian and provincial statutory tax rate of 27% for both periods.

Please refer to note 6 to our condensed unaudited interim consolidated financial statements for a full reconciliation of our income tax provision.

LIQUIDITY AND CAPITAL RESOURCES

Cash requirements and capital resources

As at November 30, 2014, cash and short-term investments totaled $57.6 million, while our working capital was at $105.1 million. Our cash and short-term investments decreased $2.2 million in the first quarter of fiscal 2015, compared to the previous quarter. During the first quarter of fiscal 2015, we made cash payments of $754,000 for the purchase of capital assets and $853,000 for the redemption of share capital under our share repurchase program. In addition, we recorded an unrealized foreign exchange loss on our cash and short-term investments of $2.5 million. This unrealized foreign exchange loss resulted from the translation, in US dollars, of our Canadian-dollar-denominated cash and short-term investments and was included in the accumulated other comprehensive income in the balance sheet. However, during the first quarter of fiscal 2015, operating activities generated $1.9 million in cash.

Our short-term investments consist of debt instruments issued by high-credit quality corporations; therefore, we consider the risk of non-performance of these financial instruments to be limited. These debt instruments are not expected to be affected by a significant liquidity risk. For the purpose of managing our cash position, we have established a cash management policy, which we follow and monitor on a regular basis. Our cash and short-term investments will be used for working capital and other general corporate purposes, potential acquisitions as well as our share repurchase programs, namely our substantial issuer bid. As at November 30, 2014, cash balances included an amount of $37.8 million that bears interest at an annual rate of 1.5%.

We believe that our cash balances and short-term investments will be sufficient to meet our liquidity and capital requirements for the foreseeable future, including the effect of our substantial issuer bid and our normal course issuer bid. In addition to these assets, we have unused available lines of credit totaling $14.7 million for working capital and other general corporate purposes and unused lines of credit of $20.7 million for foreign currency exposure related to forward exchange contracts. However, possible operating losses, additional restructuring costs and/or possible investments in or acquisitions of complementary businesses, products or technologies may require additional financing. There can be no assurance that additional debt or equity financing will be available when required or, if available, that it can be secured on satisfactory terms.

Sources and uses of cash

We finance our operations and meet our capital expenditure requirements mainly through cash flows from operating activities, the use of our cash and short-term investments as well as the issuance of subordinate voting shares.

Operating activities

Cash flows provided by operating activities were $1.9 million for the three months ended November 30, 2014, compared to $3.3 million for the same period last year.

Cash flows provided by operating activities in the first quarter of fiscal 2015 were attributable to the net earnings after items not affecting cash of $1.8 million, and the positive net change in non-cash operating items of $0.1 million; this was mainly due to the positive effect on cash of the $6.8 million increase in our accounts payable, accrued liabilities and provisions due to the timing of purchases and payments during the quarter. This positive effect on cash was mostly offset by the negative effect on cash of the $5.0 million increase in our accounts receivable due to the timing of sales during the quarter, the $1.2 million increase in our inventories to meet future demand, the $212,000 increase in our income tax and tax credits recoverable due to tax credits earned during the quarter not yet recovered, as well as the $336,000 increase in our prepaid expenses due to time of payments during the quarter.

Cash flows provided by operating activities in the first quarter of fiscal 2014 were attributable to the net earnings after items not affecting cash of $938,000, and the positive net change in non-cash operating items of $2.4 million; this was mainly due to the positive effect on cash of the $5.5 million increase in our accounts payable, accrued liabilities and provisions due to the timing of purchases and payments during the quarter, as well as the $743,000 decrease in our income tax and tax credits recoverable due to tax credits recovered during the quarter. These positive effects on cash were offset in part by the negative effect on cash of the $1.7 million increase in our accounts receivable due to the timing of sales during the quarter as well as the $2.3 million increase in our inventories to meet future demand.

Investing activities

Cash flows used by investing activities were $679,000 for the three months ended November 30, 2014, compared to $710,000 for the same period last year.

In the first quarter of fiscal 2014 and 2015, we paid $701,000 and $754,000 respectively for the purchase of capital assets.

Financing activities

Cash flows used by financing activities were $853,000 for the three months ended November 30, 2014, compared to cash flows provided of $106,000 for the same period last year.

In the first quarter of fiscal 2015, we redeemed share capital for a cash consideration of $853,000.

For the corresponding period last year, we received $106,000 from the exercise of stock options.

FORWARD EXCHANGE CONTRACTS

We are exposed to a currency risk as a result of our export sales of products manufactured in Canada, China and Finland, the majority of which are denominated in US dollars and euros. In addition, we are exposed to a currency risk as a result of our research and development activities in India (Indian rupees). These risks are partially hedged by forward exchange contracts. Forward exchange contracts, which are designated as cash flow hedging instruments, qualify for hedge accounting.

As at November 30, 2014, we held forward exchange contracts to sell US dollars for Canadian dollars and Indian rupees at various forward rates, which are summarized as follows:

US dollars – Canadian dollars

Expiry dates	**Contractual amounts**	**Weighted average contractual forward rates**
December 2014 to August 2015	$ 18,300,000	1.0748
September 2015 to August 2016	16,200,000	1.1001
September 2016 to August 2017	5,400,000	1.1160
September 2017	200,000	1.1306
Total	$ 40,100,000	1.0908

US dollars – Indian rupees

Expiry dates	**Contractual amounts**	**Weighted average contractual forward rate**
December 2014 to August 2015	$ 3,600,000	63.49

The carrying amount of forward exchange contracts is equal to fair value, which is based on the amount at which they could be settled based on estimated current market rates. The fair value of forward exchange contracts amounted to net losses of $497,000 as at August 31, 2014 and $2.0 million as at November 30, 2014, mainly for our US/Canadian dollars forward exchange contracts. The quarter-end exchange rate was CA$1.144 = US$1.00 as at November 30, 2014.

SHARE CAPITAL

Share capital

As at January 7, 2015, EXFO had 31,643,000 multiple voting shares outstanding, entitling to 10 votes each and 28,582,933 subordinate voting shares outstanding. The multiple voting shares and the subordinate voting shares are unlimited as to number and without par value.

OFF-BALANCE SHEET ARRANGEMENTS

As at November 30, 2014, our off-balance sheet arrangements consisted of letters of guarantee amounting to $400,000 for our own selling and purchasing requirements, which were reserved from our lines of credit; these letters of guarantee expire at various dates through fiscal 2017.

STRUCTURED ENTITIES

As at November 30, 2014, we did not have interests in any structured entities.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

For a description of the critical accounting policies, judgments in applying accounting policies as well as estimates and assumptions used in the preparation of our consolidated financial statements, refer to our Annual Report on Form 20-F for the year ended August 31, 2014, filed with the U.S. Securities and Exchange Commission and the Canadian securities commissions.

NEW IFRS PRONOUNCEMENTS

Refer to note 2 to our condensed unaudited interim consolidated financial statements for the three months ended November 30, 2014 and to our consolidated financial statements for the year ended August 31, 2014 for the effect of certain recent accounting pronouncements on our consolidated financial statements.

RISKS AND UNCERTAINTIES

For the first quarter of fiscal 2015, there have been no material changes from the risk factors disclosed in our Annual Report on Form 20-F for the year ended August 31, 2014.

NON-IFRS MEASURES

We provide non-IFRS measures (gross margin before depreciation and amortization* and adjusted EBITDA**) as supplemental information regarding our operational performance. We use these measures for the purpose of evaluating our historical and prospective financial performance, as well as our performance relative to our competitors. These measures also help us plan and forecast future periods as well as make operational and strategic decisions. We believe that providing this information to our investors, in addition to the IFRS measures, allows them to see the company's results through the eyes of management, and to better understand our historical and future financial performance.

The presentation of this additional information is not prepared in accordance with IFRS. Therefore, the information may not necessarily be comparable to that of other companies and should be considered as a supplement to, not a substitute for, the corresponding measures calculated in accordance with IFRS.

* Gross margin before depreciation and amortization represents sales, less cost of sales, excluding depreciation and amortization.

** Adjusted EBITDA represents net earnings (loss) before interest, income taxes, depreciation and amortization, stock-based compensation costs and foreign exchange gain.

The following table summarizes the reconciliation of adjusted EBITDA to IFRS net earnings (loss), in thousands of US dollars:

Adjusted EBITDA (unaudited)

	Three months ended November 30,	
	2014	**2013**
IFRS net earnings (loss) for the period	$ 1,481	$ (747)
Add (deduct):		
Depreciation of property, plant and equipment	1,245	1,275
Amortization of intangible assets	1,098	1,182
Interest income	(217)	(27)
Income taxes	1,165	948
Stock-based compensation costs	400	463
Foreign exchange gain	(1,975)	(802)
Adjusted EBITDA for the period	$ 3,197	$ 2,292
Adjusted EBITDA in percentage of sales	5.6%	4.1%

QUARTERLY SUMMARY FINANCIAL INFORMATION (unaudited)
(tabular amounts in thousands of US dollars, except per share data)

	Quarters ended			
	November 30, 2014	**August 31, 2014**	**May 31, 2014**	**February 28, 2014**
Sales	$ 56,724	$ 59,742	$ 63,882	$ 51,179
Cost of sales [(1)]	$ 21,237	$ 22,109	$ 23,469	$ 20,073
Net earnings (loss)	$ 1,481	$ 1,204	$ 1,665	$ (1,339)
Basic and diluted net earnings (loss) per share	$ 0.02	$ 0.02	$ 0.03	$ (0.02)

	Quarters ended			
	November 30, 2013	**August 31, 2013**	**May 31, 2013**	**February 28, 2013**
Sales	$ 56,003	$ 60,888	$ 58,865	$ 62,576
Cost of sales [(1)]	$ 21,185	$ 22,574	$ 22,574	$ 23,664
Net earnings (loss)	$ (747)	$ 3,802	$ (862)	$ 39
Basic and diluted net earnings (loss) per share	$ (0.01)	$ 0.06	$ (0.01)	$ 0.00

(1) The cost of sales is exclusive of depreciation and amortization.