

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, service assurance and network visibility markets and increased competition among vendors; capacity to adapt our future product offering to future technological changes; limited visibility with regards to the timing and nature of customer orders; delay in revenue recognition due to longer sales cycles for complex systems involving customers' acceptance; 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 March 29, 2016.

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

COMPANY OVERVIEW AND RECENT DEVELOPMENTS

We provide communications service providers (CSPs) with test orchestration and performance intelligence solutions to ensure the smooth deployment, maintenance and management of next-generation, physical, virtual, fixed and mobile networks. We have also forged strong relationships with network solution vendors (NSVs) to develop deep expertise that migrates from the lab to the field and beyond. Our key differentiation comes from combining intelligent, automated and cloud-based test and monitoring solutions with real-time analytics to deliver unmatched end-to-end visibility and assurance—from a network, services and end-user level.

We launched five new solutions in the second quarter of fiscal 2016 including TestFlow, a cloud-based field test automation solution that allows network operators to automate complex, labor-intensive activities like fiber-to-the antenna (FTTA), distributed antenna system (DAS) and small cell deployments. We also introduced a whole new family of optical time domain reflectometers (OTDRs), establishing new industry standards for specifications and time savings in characterizing optical networks. Other new product introductions consist of solutions for data center and enterprise network testing; an industry-first, high-resolution, wavelength-tunable OTDR for single-ended network troubleshooting; and the telecom industry's first G.fast handheld test set for the roll out of ultra-broadband services on copper links. Following the quarter-end, we unveiled our new test strategy and platform for the lab market.

Our sales increased 5.1% to \$53.6 million in the second quarter of fiscal 2016 compared to \$51.0 million for the same period last year, despite a significant headwind from a stronger US dollar versus other currencies. In constant currency, our sales would have increased about 8% year-over-year in the second quarter of fiscal 2016. Bookings increased 9.2% to \$59.7 million in the second quarter of fiscal 2016, for a book-to-bill ratio of 1.11, from \$54.7 million for the same period last year, despite a stronger US dollar versus other currencies.

Net earnings amounted to \$4.0 million, or \$0.07 per diluted share, in the second quarter of fiscal 2016, compared to \$931,000, or \$0.02 per diluted share, for the same period last year. Net earnings for the second quarter of fiscal 2016 included \$0.3 million in after-tax amortization of intangible assets, \$0.3 million in stock-based compensation costs and a foreign exchange gain of \$1.1 million. For the same period last year, net earnings included \$1.0 million in after-tax amortization of intangible assets, \$0.4 million in stock-based compensation costs and a foreign exchange gain of \$3.0 million.

Adjusted EBITDA (net earnings before interest, income taxes, depreciation and amortization, stock-based compensation costs and foreign exchange gain) reached \$5.3 million, or 9.9% of sales, in the second quarter of fiscal 2016, compared to \$1.2 million, or 2.3% of sales for the same period last year. See page 14 in this document for a complete reconciliation of adjusted EBITDA to IFRS net earnings.

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 February 29, 2016 | Three months ended February 28, 2015 | Six months ended February 29, 2016 | Six months ended February 28, 2015 |
|---|---|---|---|---|
| Sales | \$ 53,597 | \$ 50,990 | \$ 108,829 | \$ 107,714 |
| Cost of sales ⁽¹⁾ | 18,904 | 19,546 | 39,041 | 40,783 |
| Selling and administrative | 19,565 | 20,168 | 39,817 | 41,200 |
| Net research and development | 10,162 | 10,506 | 20,095 | 22,164 |
| Depreciation of property, plant and equipment | 924 | 1,256 | 1,899 | 2,501 |
| Amortization of intangible assets | 286 | 1,019 | 586 | 2,117 |
| Interest and other income | (470) | (35) | (407) | (252) |
| Foreign exchange gain | (1,101) | (2,987) | (1,411) | (4,962) |
| | | | 9,209 | |
| Earnings before income taxes | 5,327 | 1,517 | | 4,163 |
| Income taxes | 1,364 | 586 | 3,480 | 1,751 |
| Net earnings for the period | \$ 3,963 | \$ 931 | \$ 5,729 | \$ 2,412 |
| Basic net earnings per share | \$ 0.07 | \$ 0.02 | \$ 0.11 | \$ 0.04 |
| Diluted net earnings per share | \$ 0.07 | \$ 0.02 | \$ 0.10 | \$ 0.04 |
| Other selected information: | | | | |
| Gross margin before depreciation and amortization ⁽²⁾ | \$ 34,693 | \$ 31,444 | \$ 69,788 | \$ 66,931 |
| Research and development: | | | | |
| Gross research and development | \$ 11,472 | \$ 12,176 | \$ 22,751 | \$ 25,485 |
| Net research and development | \$ 10,162 | \$ 10,506 | \$ 20,095 | \$ 22,164 |
| Adjusted EBITDA ⁽²⁾ | \$ 5,280 | \$ 1,158 | \$ 10,566 | \$ 4,355 |

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

(2) Refer to page 14 for non-IFRS measures.

| | Three months ended February 29, 2016 | Three months ended February 28, 2015 | Six months ended February 29, 2016 | Six months ended February 28, 2015 |
|--|---|---|---|---|
| Sales | 100.0 % | 100.0 % | 100.0 % | 100.0 % |
| Cost of sales ⁽¹⁾ | 35.3 | 38.3 | 35.9 | 37.9 |
| Selling and administrative | 36.5 | 39.6 | 36.6 | 38.2 |
| Net research and development | 19.0 | 20.6 | 18.5 | 20.6 |
| Depreciation of property, plant and equipment | 1.7 | 2.5 | 1.7 | 2.3 |
| Amortization of intangible assets | 0.5 | 2.0 | 0.5 | 2.0 |
| Interest and other income | (0.9) | (0.1) | (0.4) | (0.2) |
| Foreign exchange gain | (2.0) | (5.9) | (1.3) | (4.6) |
| Earnings before income taxes | 9.9 | 3.0 | 8.5 | 3.8 |
| Income taxes | 2.5 | 1.2 | 3.2 | 1.6 |
| Net earnings for the period | 7.4 % | 1.8 % | 5.3 % | 2.2 % |

Other selected information:

| | | | | |
|---|---------------|--------|---------------|--------|
| Gross margin before depreciation and amortization ⁽²⁾ | 64.7 % | 61.7 % | 64.1 % | 62.1 % |
| Research and development: | | | | |
| Gross research and development | 21.4 % | 23.9 % | 20.9 % | 23.7 % |
| Net research and development | 19.0 % | 20.6 % | 18.5 % | 20.6 % |
| Adjusted EBITDA ⁽²⁾ | 9.9 % | 2.3 % | 9.7 % | 4.0 % |

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

(2) Refer to page 14 for non-IFRS measures.

RESULTS OF OPERATIONS

SALES AND BOOKINGS

The following tables summarize sales and bookings by product line in thousands of US dollars:

Sales

| | Three months ended February 29, 2016 | Three months ended February 28, 2015 | Six months ended February 29, 2016 | Six months ended February 28, 2015 |
|--|---|---|---|---|
| Physical-layer product line | \$ 32,582 | \$ 33,059 | \$ 70,059 | \$ 70,907 |
| Protocol-layer product line | 21,990 | 18,531 | 40,619 | 37,699 |
| | <u>54,572</u> | <u>51,590</u> | <u>110,678</u> | <u>108,606</u> |
| Foreign exchange losses on forward exchange contracts | (975) | (600) | (1,849) | (892) |
| Total sales | <u>\$ 53,597</u> | <u>\$ 50,990</u> | <u>\$ 108,829</u> | <u>\$ 107,714</u> |

Bookings

| | Three months ended February 29, 2016 | Three months ended February 28, 2015 | Six months ended February 29, 2016 | Six months ended February 28, 2015 |
|--|---|---|---|---|
| Physical-layer product line | \$ 34,874 | \$ 33,223 | \$ 73,752 | \$ 70,617 |
| Protocol-layer product line | 25,804 | 22,027 | 46,273 | 39,169 |
| | <u>60,678</u> | <u>55,250</u> | <u>120,025</u> | <u>109,786</u> |
| Foreign exchange losses on forward exchange contracts | (975) | (600) | (1,849) | (892) |
| Total bookings | <u>\$ 59,703</u> | <u>\$ 54,650</u> | <u>\$ 118,176</u> | <u>\$ 108,894</u> |

For the three months ended February 29, 2016, our sales increased 5.1% to \$53.6 million, from \$51.0 million for the same period last year, while our bookings increased 9.2% to \$59.7 million, from \$54.7 million for the same period last year, for a book-to-bill ratio of 1.11.

For the six months ended February 29, 2016, our sales increased 1.0% to \$108.8 million, from \$107.7 million for the same period last year, while our bookings increased 8.5% to \$118.2 million, from \$108.9 million for the same period last year, for a book-to-bill ratio of 1.09.

Sales

Despite strong sales results in the second quarter and the first half of fiscal 2016, we faced a significant headwind from a stronger US dollar compared to the respective periods last year. Given that we generate a portion of our revenue in Canadian dollars (Americas) and in euros (Europe, Middle East and Africa (EMEA)) but report our results in US dollars, it had a negative impact on our total sales and bookings year-over-year, as the US dollar increased against these currencies. In fact, in the second quarter of fiscal 2016, excluding the negative currency impact, our total sales would have increased approximately 8% year-over-year and our total bookings would have increased by approximately 12% year-over-year. For the first half of fiscal 2016, our total sales would have increased approximately 5% and our total bookings would have increased by approximately 12% year-over-year.

In the second quarter and the first half of fiscal 2016, the year-over-year increase in sales comes from our Protocol-layer product line, which delivered a robust year-over-year increase in sales, despite the negative currency impact. Namely, in the second quarter and the first half of fiscal 2016, we reported year-over-year sales increases for our transport and Datacom (T&D) products, based on our new unified software architecture for 10G and 100G solutions. In addition, during the second quarter of 2016, we received and shipped a \$1.7 million order for our new analytics solution EXFO Xtract to a Tier-1 network operator.

On the other hand, in the second quarter and the first half of fiscal 2016, sales of our Physical-layer product line slightly decreased year-over-year, due to the negative currency impact. Excluding the negative currency impact, this product line's sales would have slightly increased year-over-year.

Bookings

In the second quarter and the first half of fiscal 2016, we delivered robust year-over-year increases in bookings for our Protocol-layer product line, and notable increases in bookings for our Physical-layer product line, despite the negative currency impact. The year-over-year increase in bookings was manifested through heightened penetration of mobile network operators for their fronthaul and backhaul networks, increased traction with fixed network operators for their 100G long-haul and metro links and growing business with web-scale operators for their data center interconnects. In addition, in the second quarter of 2016, we received significant orders from two network operators in the Americas for our EXFO Xtract solution, which resulted in increased bookings for our Protocol-layer product line year-over-year.

In the second quarter of fiscal 2016, we reported significant increase in bookings in the EMEA and Asia-Pacific regions for both product lines, following a modest year-over-year growth in these regions in the first quarter of 2016. Overall, for the first half of fiscal 2016, we delivered robust year-over-year growth in bookings in these two regions.

In the second quarter of fiscal 2016, we continued to make good progress in bookings in the Americas, mainly for our Physical-layer product line, and to a lesser extent for our Protocol-layer product line, compared to the same period last year, resulting in robust increase in bookings in this area for the first half of 2016.

We delivered book-to-bill ratios of 1.11 and 1.09 for the second quarter and the first half of fiscal 2016 respectively, reflecting the fact that we are becoming increasingly solution-centric, with some system orders not being yet recognized in sales, and the majority of our maintenance contracts are renewed in the first half of our fiscal year. 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.

Sales by geographic region

The following table summarizes sales by geographic region:

| | Three months ended February 29, 2016 | Three months ended February 28, 2015 | Six months ended February 29, 2016 | Six months ended February 28, 2015 |
|--------------|---|---|---|---|
| Americas | 49 % | 53 % | 52 % | 51 % |
| EMEA | 29 | 25 | 27 | 28 |
| Asia-Pacific | 22 | 22 | 21 | 21 |
| | <u>100 %</u> | <u>100 %</u> | <u>100 %</u> | <u>100 %</u> |

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 second quarters of fiscal 2015 and 2016, no customer accounted for more than 10% of our sales, and our top three customers accounted for 15.2% and 13.3% of sales respectively. In the first halves of fiscal 2015 and 2016, no customer accounted for more than 10% of our sales, and our top three customers accounted for 12.2% and 14.6% of our sales respectively.

GROSS MARGIN BEFORE DEPRECIATION AND AMORTIZATION (non-IFRS measure — refer to page 14 of this document)

Gross margin before depreciation and amortization (gross margin) increased 3.0% to 64.7% of sales for the three months ended February 29, 2016, compared to 61.7% for the same period last year.

Gross margin reached 64.1% of sales for the six months ended February 29, 2016, which represents an increase of 2.0% compared to 62.1% for the same period last year.

In the second quarter and the first half of fiscal 2016, our gross margin was favorably affected by product mix. In fact, the year-over-year increase in sales for both periods comes from our protocol-layer product line, which delivers higher margins compared to our physical-layer product line, due to their richer software content. As previously mentioned, in the second quarter of 2016, we recognized a large order with a Tier-1 network operator for our EXFO Xtract software analytics solution, which had a positive impact on our gross margin during the second quarter and the first half of fiscal 2016.

In addition, in the second quarter and the first half of fiscal 2016, we recorded lower inventory write-off compared to the same periods last year, which contributed to increase our gross margin by 0.8% and 0.5% respectively year-over-year.

Finally, in the second quarter and the first half of fiscal 2016, a stronger US dollar compared to other currencies reduced our manufacturing costs and had a positive impact on our gross margin year-over-year.

However, in the second quarter and the first half of fiscal 2016, we recorded in our sales foreign exchange losses on our forward exchange contracts of \$975,000 and \$1.8 million respectively, compared to \$600,000 and \$892,000 respectively for the same periods last year, which contributed to decrease our gross margin by 0.3% for both periods year-over-year.

SELLING AND ADMINISTRATIVE EXPENSES

For the three months ended February 29, 2016, selling and administrative expenses were \$19.6 million, or 36.5% of sales, compared to \$20.2 million, or 39.6% of sales for the same period last year.

For the six months ended February 29, 2016, selling and administrative expenses were \$39.8 million, or 36.6% of sales, compared to \$41.2 million, or 38.2% of sales for the same period last year.

In the second quarter of and the first half of fiscal 2016, our selling and administrative expenses decreased due 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 latter two currencies and we report our results in US dollars, and the positive impact of our latest restructuring plan, which more than offset inflation, salary increases, and increased commission expenses on increased sales.

RESEARCH AND DEVELOPMENT EXPENSES

Gross research and development expenses

For the three months ended February 29, 2016, gross research and development expenses totaled \$11.5 million, or 21.4% of sales, compared to \$12.2 million, or 23.9% of sales for the same period last year.

For the six months ended February 29, 2016, gross research and development expenses totaled \$22.8 million, or 20.9% of sales, compared to \$25.5 million, or 23.7% of sales for the same period last year.

In the second quarter and the first half of fiscal 2016, the year-over-year increase in the average value of the US dollar, compared to the Canadian dollar and the euro had a positive impact on our gross research and development expenses as a large portion of these expenses are incurred in these latter two currencies and we report our results in US dollars. In addition, in the second quarter and the first half of fiscal 2016, our gross research and development expenses decreased as a result of our latest restructuring plan.

However, these positive impacts year-over-year were offset in part by inflation, salary increases, as well as a shift in the mix and timing of research and development projects, compared to the same periods 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 for grants issued by a Finnish technology organization on certain research and development projects conducted in Finland.

For the three months ended February 29, 2016, tax credits and grants for research and development activities were \$1.3 million, or 11.4% of gross research and development expenses, compared to \$1.7 million, or 13.7% of gross research and development expenses for the same period last year.

For the six months ended February 29, 2016, tax credits and grants for research and development activities were \$2.7 million, or 11.7% of gross research and development expenses, compared to \$3.3 million, or 13.0% of gross research and development expenses for the same period last year.

In the second quarter and the first half of fiscal 2016, the year-over-year decrease in our tax credits and grants mainly results 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.

DEPRECIATION OF PROPERTY, PLANT AND EQUIPMENT

For the three months ended February 29, 2016, depreciation of property, plant and equipment amounted to \$924,000 compared to \$1.3 million for the same period last year.

For the six months ended February 29, 2016, depreciation of property, plant and equipment amounted to \$1.9 million compared to \$2.5 million for the same period last year.

In the second quarter and the first half of fiscal 2016, the year-over-year increase in the average value of the US dollar, compared to the Canadian dollar had a positive impact on our depreciation expenses as these expenses are incurred in Canadian dollars and we report our results in US dollars.

AMORTIZATION OF INTANGIBLE ASSETS

For the three months ended February 29, 2016, amortization of intangible assets amounted to \$286,000 compared to \$1.0 million for the same period last year.

For the six months ended February 29, 2016, amortization of intangible assets amounted to \$586,000 compared to \$2.1 million for the same period last year.

The decrease in our amortization expenses in the second quarter and the first half of fiscal 2016, compared to the same period last years, is mainly due to the fact that core technology related to the acquisition of NetHawk Oyj (acquired in fiscal 2010) became fully amortized in the third quarter of fiscal 2015, and that the average value of the US dollar increased compared to the Canadian dollar year-over-year, as our amortization expenses is incurred in this currency and we report our results in US dollars.

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 February 29, 2016, we recorded a foreign exchange gain of \$1.1 million compared to \$3.0 million for the same period last year.

For the six months ended February 29, 2016, foreign exchange gain amounted to \$1.4 million compared to \$5.0 million for the same period last year.

During the second quarter of fiscal 2016, the period-end value of the Canadian dollar decreased versus the US dollar and the euro, compared to the previous quarter, which resulted in a foreign exchange gain of \$1.1 million during the quarter. In fact, the period-end value of the Canadian dollar decreased 1.3% versus the US dollar to CA\$1.3531 = US\$1.00 in the second quarter of fiscal 2016, compared to CA\$1.3353 = US\$1.00 at the end of the previous quarter, and decreased 4.4% to CA\$1.4696 = €1.00 in the second quarter of fiscal 2016, compared to CA\$1.4081 = €1.00 at the end of the previous quarter.

During the same period last year, the period-end value of the Canadian dollar significantly decreased versus the US dollar compared to the previous quarter, which resulted in a foreign exchange gain of \$3.0 million during that period. The period-end value of the Canadian dollar decreased 8.5% versus the US dollar to CA\$1.2503= US\$1.00 in the second quarter of fiscal 2015, compared to CA\$1.1440 = US\$1.00 at the end of the previous quarter.

During the first half of fiscal 2016, the period-end value of the Canadian dollar decreased versus the US dollar, compared to the previous year end, which resulted in a foreign exchange gain of \$1.4 million during that period. In fact, the period-end value of the Canadian dollar decreased 2.8% versus the US dollar to CA\$1.3531 = US\$1.00 in the half of fiscal 2016, compared to CA\$1.3157 = US\$1.00 at the end of the previous year.

During the same period last year, the period-end value of the Canadian dollar significantly decreased versus the US dollar, compared to the previous year end, which resulted in a foreign exchange gain of \$5.0 million during that period. The period-end value of the Canadian dollar decreased 13.2% versus the US dollar to CA\$1.2503 = US\$1.00 in the first half of fiscal 2015, compared to CA\$1.0858 = US\$1.00 at the end of the previous year.

Foreign exchange rate fluctuations also flow through the P&L line items as a portion of our sales are dominated in Canadian dollars and euros and a significant portion of cost of sales and 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 second quarter and the first half of fiscal 2016, 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 second quarter of fiscal 2016 increased 13.5% and 7.3% respectively year-over-year, compared to the Canadian dollar and the euro. During the first half of fiscal 2016, it increased 14.4% and 10.1% respectively year-over-year, compared to the Canadian dollar and the euro.

INCOME TAXES

For the three months ended February 29, 2016, we reported income tax expenses of \$1.4 million on earnings before income taxes of \$5.3 million. For the corresponding period last year, we reported income tax expenses of \$586,000 on earnings before income taxes of \$1.5 million.

For the six months ended February 29, 2016, we reported income tax expenses of \$3.5 million on earnings before income taxes of \$9.2 million. For the corresponding period last year, we reported income tax expenses of \$1.8 million on earnings before income taxes of \$4.2 million.

These distorted tax rates 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 in the functional currency, 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 7 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 February 29, 2016, cash and short-term investments totaled \$44.4 million, while our working capital was at \$77.8 million. Our cash and short-term investments increased by \$15.0 million in the second quarter of fiscal 2016, compared to the previous quarter, mainly due to cash flows from operating activities of \$15.3 million.

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 program. As at February 29, 2016, cash balances included an amount of \$24.4 million that bears interest at an annual rate of 1.2%

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 normal course issuer bid. In addition to these assets, we have unused available lines of credit totaling \$14.6 million for working capital and other general corporate purposes and unused lines of credit of \$17.7 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 \$15.3 million for the three months ended February 29, 2016, compared to \$5.7 million for the same period last year.

Cash flows provided by operating activities were \$18.6 million for the six months ended February 29, 2016, compared to \$7.6 million for the same period last year.

Cash flows provided by operating activities in the second quarter of fiscal 2016 were attributable to the net earnings after items not affecting cash of \$7.1 million, and the positive net change in non-cash operating items of \$8.2 million; this was mainly due to the positive effect on cash of the decrease of \$11.3 million in our accounts receivable due to the timing of receipts and sales during the quarter and the \$1.2 million decrease in our income tax and tax credits recoverable due to tax credits earned in previous periods recovered during the current quarter. These positive effects on cash were offset in part by the negative effect on cash of the \$2.6 million increase in our inventories to meet future demand and the \$1.6 million decrease in our accounts payable, accrued liabilities and provisions due to the timing of purchases and payments during the quarter.

Cash flows provided by operating activities in the second quarter of fiscal 2015 were attributable to the net earnings after items not affecting cash of \$3.3 million, 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 decrease of \$3.7 million in our accounts receivable due to the sequential decrease in sales as well as the timing of receipts and sales during the quarter, and the positive effect on cash of the increase of \$824,000 in our accounts payable and accrued liabilities due to timing of purchases and payments during the period. These positive effects on cash were offset in part by the negative effect on cash of the increase of \$1.2 million in our income tax and tax credits recoverable due to tax credits earned during the quarter not yet recovered, and the negative effect on cash of the increase of \$752,000 in our inventories to meet future demand.

Cash flows provided by operating activities in the first half of fiscal 2016 were attributable to the net earnings after items not affecting cash of \$12.3 million, and the positive net change in non-cash operating items of \$6.3 million; this was mainly due to the positive effect on cash of the decrease of \$9.3 million in our accounts receivable due to the timing of receipts and sales during the period, the \$933,000 decrease in our income tax and tax credits recoverable due to tax credits earned in previous periods recovered during the current period, and the \$1.7 million increase in our accounts payable, accrued liabilities and provisions due to the timing of purchases and payments during the period. These positive effects on cash were offset in part by the negative effect on cash of the \$5.9 million increase in our inventories to meet future demand.

Cash flows provided by operating activities in the first half of fiscal 2015 were attributable to the net earnings after items not affecting cash of \$5.2 million, 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 increase of \$7.7 million in our accounts payable and accrued liabilities due to timing of purchases and payments during the period. This positive effect on cash was offset in part by the negative effect on cash of the increase of \$1.3 million in our accounts receivable due to the timing of receipts and sales during the period, the negative effect on cash of the increase of \$1.4 million in our income tax and tax credits recoverable due to tax credits earned during the period not yet recovered, the negative effect on cash of the increase of \$1.9 million in our inventories to meet future demand, and the negative effect on cash of the increase of \$501,000 in our prepaid expenses due to timing of payments during the period.

Investing activities

Cash flows used by investing activities were \$426,000 for the three months ended February 29, 2016, compared to cash flows provided of \$437,000 for the same period last year.

Cash flows used by investing activities were \$1.8 million for the six months ended February 29, 2016, compared to \$242,000 for the same period last year.

In the second quarter of fiscal 2016, we paid \$927,000 for the purchase of capital assets, but we disposed of \$501,000 worth of short-term investments.

For the corresponding period last year, we disposed (net of acquisitions) of \$2.5 million worth of short-term investments, but we paid \$2.0 million for the purchase of capital assets.

In the first half of fiscal 2016, we paid \$2.2 million for the purchase of capital assets, but we disposed (net of acquisitions) of \$480,000 worth of short-term investments.

For the corresponding period last year, we paid \$2.8 million for the purchase of capital assets, but we disposed (net of acquisitions) of \$2.6 million worth of short-term investments.

Financing activities

Cash flows used by financing activities were \$33,000 for the three months ended February 29, 2016, compared to \$24.3 million for the same period last year.

Cash flows provided by financing activities were \$281,000 for the six months ended February 29, 2016, compared to cash flows used of \$25.1 million for the same period last year.

In the second quarter of fiscal 2016, we redeemed share capital under our share repurchase program for a cash consideration of \$186,000, but our bank loan increased \$153,000.

For the corresponding period last year, we redeemed share capital under our substantial issuer bid program for a cash consideration of \$24.3 million.

In the first half of fiscal 2016, our bank loan increased \$468,000, but we redeemed share capital under our share repurchase program for a cash consideration of \$187,000.

For the corresponding period last year, we redeemed share capital under our share repurchase programs (namely our substantial issuer bid) for a cash consideration of \$25.1 million.

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 February 29, 2016, 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 |
|---------------------------------|----------------------------|---|
| March 2016 to August 2016 | \$ 12,600,000 | 1.1976 |
| September 2016 to August 2017 | 19,800,000 | 1.2779 |
| September 2017 to August 2018 | 9,300,000 | 1.3402 |
| September 2018 to December 2018 | 1,900,000 | 1.3639 |
| Total | <u>\$ 43,600,000</u> | <u>1.2717</u> |

US dollars – Indian rupees

| Expiry dates | Contractual amounts | Weighted average contractual forward rates |
|---------------------------------|----------------------------|---|
| March 2016 to August 2016 | \$ 3,100,000 | 67.92 |
| September 2016 to February 2017 | 1,400,000 | 71.12 |
| | <u>\$ 4,500,000</u> | <u>68.91</u> |

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 \$4.2 million as at August 31, 2015 and \$2.5 million as at February 29, 2016, mainly for our US/Canadian dollars forward exchange contracts. The quarter-end exchange rate was CA\$1.3531 = US\$1.00 as at February 29, 2016.

SHARE CAPITAL

As at March 29, 2016, EXFO had 31,643,000 multiple voting shares outstanding, entitling to 10 votes each and 22,305,802 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 February 29, 2016, our off-balance sheet arrangements consisted of letters of guarantee amounting to \$605,000 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 2020.

STRUCTURED ENTITIES

As at February 29, 2016, 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, 2015, 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 and six months ended February 29, 2016 and to our consolidated financial statements for the year ended August 31, 2015, for the effect of certain recent accounting pronouncements on our consolidated financial statements.

RISKS AND UNCERTAINTIES

For the first half of fiscal 2016, 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, 2015.

NON-IFRS MEASURES

We provide non-IFRS measures (constant currency data, 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.

Constant currency data represents data before foreign currency impact. Data for the current period is translated using foreign exchange rates of the corresponding period from the preceding year.

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

Adjusted EBITDA represents net earnings 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, in thousands of US dollars:

Adjusted EBITDA

| | Three months ended February 29, 2016 | Three months ended February 28, 2015 | Six months ended February 29, 2016 | Six months ended February 28, 2015 |
|---|---|---|---|---|
| IFRS net earnings for the period | \$ 3,963 | \$ 931 | \$ 5,729 | \$ 2,412 |
| Add (deduct): | | | | |
| Depreciation of property, plant and equipment | 924 | 1,256 | 1,899 | 2,501 |
| Amortization of intangible assets | 286 | 1,019 | 586 | 2,117 |
| Interest and other income | (470) | (35) | (407) | (252) |
| Income taxes | 1,364 | 586 | 3,480 | 1,751 |
| Stock-based compensation costs | 314 | 388 | 690 | 788 |
| Foreign exchange gain | (1,101) | (2,987) | (1,411) | (4,962) |
| Adjusted EBITDA for the period | <u>\$ 5,280</u> | <u>\$ 1,158</u> | <u>\$ 10,566</u> | <u>\$ 4,355</u> |
| Adjusted EBITDA in percentage of sales | <u>9.9%</u> | <u>2.3%</u> | <u>9.7%</u> | <u>4.0%</u> |

QUARTERLY SUMMARY FINANCIAL INFORMATION

(tabular amounts in thousands of US dollars, except per share data)

| | Quarters ended | | | |
|--|----------------------|----------------------|--------------------|-----------------|
| | February 29, 2016 | November 30, 2015 | August 31, 2015 | May 31, 2015 |
| Sales | \$ 53,597 | \$ 55,232 | \$ 56,594 | \$ 57,781 |
| Cost of sales ⁽¹⁾ | \$ 18,904 | \$ 20,137 | \$ 21,975 | \$ 22,281 |
| Net earnings | \$ 3,963 | \$ 1,766 | \$ 2,323 | \$ 563 |
| Basic and diluted net earnings per share | \$ 0.07 | \$ 0.03 | \$ 0.04 | \$ 0.01 |

| | Quarters ended | | | |
|--|----------------------|----------------------|--------------------|-----------------|
| | February 28, 2015 | November 30, 2014 | August 31, 2014 | May 31, 2014 |
| Sales | \$ 50,990 | \$ 56,724 | \$ 59,742 | \$ 63,882 |
| Cost of sales ⁽¹⁾ | \$ 19,546 | \$ 21,237 | \$ 22,109 | \$ 23,469 |
| Net earnings | \$ 931 | \$ 1,481 | \$ 1,204 | \$ 1,665 |
| Basic and diluted net earnings per share | \$ 0.02 | \$ 0.02 | \$ 0.02 | \$ 0.03 |

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