

LETTER TO SHAREHOLDERS



Germain Lamonde
Chairman, CEO and Founder

Dear Shareholders

In fiscal 2016, EXFO reaped the benefits of key transformations initiated over prior years, especially in the areas of high-speed optical and wireless testing, Xtract analytics software and overall operational efficiency. Our financial performance was a firm step in the right direction, demonstrating significant earnings leverage in our operating model as we scaled up our business and maintained a tight focus on profitability and execution.

For our customers: we continued to strengthen EXFO's capabilities and credentials as a genuine trusted advisor, whether addressing fixed, mobile, webscale, data center or cable operators' requirements. We delivered what EXFO does best—market-driven test and systems-based innovation to elevate our strategic relevance and to help communications service providers (CSPs) deliver on their strategic initiatives.

For our shareholders: we generated strong financial results for almost every metric, including surpassing our annual \$20 million adjusted EBITDA¹ target by reaching \$22.0 million (up 60% year-over-year), while strengthening our market position and remaining focused on expanding profitability for the long term.

Below I offer additional data points related to 2016, while providing an update on our long-term strategy.

FISCAL 2016 IN REVIEW

Revenue growth of 4.7% (bookings growth of 7.7%). As the telecom industry continued gradually moving towards an increasingly NFV and SDN-centric network architecture and despite currency headwinds, we generated revenue and bookings growth of 4.7% and 7.7%, respectively, (+6% and +9% on a constant currency basis²) while strengthening our order book (book-to-bill ratio of 1.03). These results were achieved thanks to a combination of market growth, share gains and entering new addressable markets:

- We continued building on our leading position in the growing optical and high-speed test markets, especially in metro and core networks, mobile radio access, as well as fixed broadband access;
- In the Americas and abroad, we outpaced the growth rate of the 100G optical upgrade cycle, still in its early stages, while expanding our technology and thought leadership;
- We increased penetration among web-scale and data center operators by launching specific solutions for these fast-growing end-markets;
- We leveraged our strong offering for strategic CORD or HERD (Central Offices or Head-Ends Re-Architected as Datacenters) transformations that telcos and cable operators are initiating, while positioning ourselves for the long run; and
- We achieved market success with our EXFO Xtract analytics tool with several CSPs, including a tier-1 service provider in the Americas.

These key wins benefited our Physical and Protocol-layer product groups. As expected, both generated sales growth to the height of 5.4% and 3.4%, respectively, and bookings growth of 7.4% and 8.3%. I expect both product groups will deliver growth again in 2017 based on the robust markets they address, strong benefits of our highly differentiated offering and the strengthening of our go-to-market model.

Net earnings growth of 68% (60% in adjusted EBITDA). Raising profitability is management's central focus and I am pleased we made significant strides against this objective in 2016. These results were primarily driven by:

- Key strategic transformations from prior years combined with heightened focus, relentless drive to improve efficiency, and reduced operating costs;
- Gross margin³ improvement by 90 basis points to 62.6% of sales, mostly due to higher software content within our product mix which should continue to drive our margin up over time;
- Reduction in SG&A expenses from 37.0% to 35.3%. We expect continued progress by enhancing our go-to-market efficiency, while R&D costs should remain at relatively the same percentage level; and
- Given our earnings growth, we generated \$24.4 million in cash flows from operating activities and increased our cash position by nearly \$20 million to \$47.3 million with no debt.

FISCAL 2016 FINANCIAL HIGHLIGHTS

- Revenue increased 4.7% to \$232.6 million;
- Bookings improved 7.7% to \$240.3 million (book-to-bill ratio of 1.03);
- Revenue increased 5.4% for Physical-layer product group (bookings up 7.4%);
- Revenue increased 3.4% for Protocol-layer product group (bookings up 8.3%);
- Revenue from the Americas and Asia-Pacific regions improved by 6.7% and 5.6%, while EMEA remained stable;
- Gross margin improved 90 basis points to 62.6%;
- Adjusted EBITDA surged 60% to \$22.0 million—ahead of \$20 million target;
- IFRS net earnings improved 68.0% to \$8.9 million;
- Generated \$24.4 million in cash flows from operating activities; and
- Cash position of \$47.3 million and no debt.

TRUSTED ADVISOR FOR TEST AUTOMATION AND 3D ANALYTICS

As a leader in optical, high-speed transport and fixed/mobile broadband access network testing, EXFO is increasingly positioning itself as the trusted advisor to CSPs. Our highly differentiated test automation capabilities are becoming more and more synergistic and relevant for the high-growth, end-to-end network visibility market, where EXFO is helping CSPs maximize quality of user experience (QoE) and mitigate network investments. This, in turn, is helping CSPs accelerate revenue and profitability, while improving ARPU (average revenue per user) and customer retention. Below are more details about our strategy.



Field test automation. While it is common knowledge field testing is an integral part of EXFO's DNA and 30-plus year market leadership, fewer people realize that a large part of our success has come from bringing to market disruptive concepts that provide CSPs with test automation, productivity enhancements and reduced truck rolls. Over the years, we have introduced many innovations like our groundbreaking iOLM software for OTDR analysis, unique auto-focus, auto-center and auto-analysis connector inspection probes and many other game-changing innovations. We will continue disrupting our industry with market-driven initiatives; below are some more examples.

Taking productivity to the next level, EXFO is the pioneer of a whole new concept called TestFlow, a recently released solution that automates complex, labor-intensive tasks during fiber-to-the-home (FTTH), fiber-to-the antenna (FTTA), distributed antenna system (DAS) or small cell deployments. TestFlow greatly reduces complexity, testing time and training requirements by converting specific CSP methods and procedures (M&Ps) into automated test scripts, pushing them over the Cloud to EXFO's smart test sets – whether owned by CSPs or their contractors – to drive productivity and ensure process compliance for each test step along the way, and finally automatically storing all test results in a Cloud-based analytics tool to track completion, quality, productivity or other key performance metrics CSPs never had access to in the past.

Following the fiscal year-end, we acquired the assets of California-based Absolute Analysis, a specialist in CPRI (Common Public Radio Interface) testing for radio access networks (RANs). More specifically, their optical RFoCPRI (Radio Frequency over CPRI) technology adds to EXFO's high-growth potential as mobile network operators worldwide are in the initial stages of transforming their RAN architectures and pushing fiber deeper to the edge in order to cope with massive bandwidth demand, while preparing for 5G and IoT. With this optical RFoCPRI software capability already integrated into EXFO's instruments, we are now the only supplier of an all-in-one optical, transport and RF test solution that provides significant productivity enhancements and simplification.

Our market-leading position in optical and 100G transport testing could not be more relevant given the global investment cycle now underway. Again, EXFO continues to bring innovation to the forefront and differentiate itself with smaller form factors, simplified test procedures and heightened integration to expand revenue and market share.



Test automation and 3D analytics. EXFO's expertise in field test has been leveraged across our systems offering in which our solutions mine data from a wider range of physical and virtual sources (test instruments, active and passive test probes, and third-party network elements). As we move along this transformation path, we are enhancing EXFO's relevance to customers and their executives by strengthening long-term partnerships as well as delivering stickier products, systems and service revenue.

Leadership in Active Service Assurance: CSPs are facing mounting pressure to solve the complex and conflicting challenges of increasing network capacity, reducing costs, and gaining more agility, while accelerating revenue from the rollout of new services and improving quality of experience (QoE). On top of their historical hardware-centric investments, CSPs are now starting to mix NFV/SDN technologies in which services, capacity deployments and server loadings can be changed on the fly. All these factors are forcing CSPs to increasingly turn to real-time, full-time active service assurance solutions, spanning physical and virtual infrastructures, to solve highly complex network and service issues while assuring world-class QoE. EXFO is the technology leader in this active test/service assurance segment and is amongst the very few suppliers who have gone beyond prototyping by offering commercial solutions that simultaneously scale across physical and virtual infrastructures to deliver real-time performance assurance. Our solutions are used in several lab and field deployments, including some with a tier-1 CSP in the United States.

Unmatched End-to-End Visibility: Our solutions collect a wider range of data from various probes (active and passive, physical and virtual), test technologies and standards-based interfaces. We leverage our 30-plus years of telecom network knowledge to analyze and correlate all this big data in real time via our highly scalable Xtract analytics tool. This holistic approach allows EXFO to deliver unmatched visibility from the network, services and subscriber dimensions – thus, our “3D analytics” term. EXFO Xtract adds significant value by prioritizing the most critical issues impacting these three dimensions at any given time; pointing to the most likely root causes of these problems; and even providing predictive insights to help prevent future issues. After combining technology from the 2014 acquisitions of ByteSphere and Aito Technologies with our internal developments, I am pleased that EXFO Xtract started delivering revenue in 2016 as several deployments were completed, including a large-scale system used daily by a tier-1 CSP.

Long-Term Value Creation

TRANSFORMATION



As unveiled during our Investor Day in 2016, our unique test instrument and systems expertise is part of our strategy to gradually transform EXFO from a box supplier to a “trusted advisor” that CSP executives can rely upon to assure a sound test and service assurance solution is an integral part of their plans from Day 1.

Thanks to closer relationships with chief technology officers, VPs of network planning and other telecom executives, we are getting involved earlier in their strategic initiatives to design smarter networks aimed at delivering a plethora of new services at an unprecedented scale. We can thus bring a greater contribution to their initiatives like deployments of hybrid networks (physical and virtual) offering best-in-class performance and QoE, or while they are steering capital investments toward 100G/200G/400G, 4G/5G, NFV/SDN, IoT, Cloud/datacenters or fixed/mobile broadband access. We have come a long way along this journey by transforming our global sales organization and go-to-market strategy, and we have already cumulated significant wins for our systems and solutions business that we intend to leverage and replicate globally to drive market share gains and revenue growth.

LEADERSHIP

About one year ago, Philippe Morin, whom I have known for more than 15 years, joined EXFO as Chief Operating Officer. I had several objectives in mind when making this well-thought out decision: accelerate the transformation of our sales organization, especially at the executive level; improve our go-to-market efficiency to drive more revenue per head and thus reduce SG&A margin; increase market penetration in the high-growth, 100G+ optical test market with both CSPs and network equipment manufacturers; and strengthen EXFO's management bench.

I am very pleased with Philippe's contributions so far and my plan remains intact to elevate him to the CEO position some time during 2017, while I will then assume the Executive Chairman role on a full-time basis. I am convinced the combination of new ideas from Philippe with my long-term industry experience will create long-term value for EXFO, while securing a strong succession plan. We are jointly committed to keep building EXFO into the uncontested leader in the markets we serve, while accelerating growth and value creation.

ACQUISITION STRATEGY

EXFO had a solid balance sheet with a cash position of \$47.3 million and no debt at the end of fiscal 2016. While organic growth remains our No. 1 priority, we intend to increase our focus on partnerships and acquisitions to accelerate leadership in strategic, high-growth markets. On the acquisition front, we typically target companies that fit into our “3S” acquisition strategy, namely Small, Synergistic and Strategic to maximize value creation. The asset acquisition of Absolute Analysis in late October perfectly reflects this thinking. This relatively small acquisition brings a highly strategic optical RF test technology that has already been synergistically integrated into the industry's only all-in-one optical, transport and RF tester for the high-growth, smart-RAN deployment market. As EXFO's largest shareholder, I will remain highly focused on maximizing value creation with the right mix of organic growth, partnerships and acquisitions, while staying on the sidelines for large-scale share buybacks or paying out dividends.



Financial Target for Fiscal 2017



We remain fully committed to driving adjusted EBITDA faster than revenue until we get closer to our medium-term target of 15% adjusted EBITDA margin. I am continuing last year's practice of providing a single annual financial objective as a demonstration of our resolve to increase earnings. In 2016, I am pleased we exceeded our adjusted EBITDA target of \$20 million to achieve \$22.0 million, or 9.5% of revenue. For 2017, we intend to expand adjusted EBITDA to reach at least \$26 million (+18% year-over-year), while remaining steadfastly focused on our medium-term target.

In closing, I am thankful to our shareholders for their confidence, our Board members for their guidance and the entire EXFO team for its great contribution. Altogether, I trust we will keep pushing EXFO to the next level.

Sincerely,

Germain Lamonde
Chairman, CEO and Founder

A handwritten signature in black ink, appearing to read 'G. Lamonde'.

November 28, 2016

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- 1 Adjusted EBITDA represents net earnings before interest, income taxes, depreciation and amortization, stock-based compensation costs and foreign exchange gain or loss.
 - 2 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 previous year.
 - 3 Gross margin before depreciation and amortization represents sales less cost of sales, excluding depreciation and amortization.