

## 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 March 24, 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 four new solutions in the second quarter of fiscal 2015, including EXFO Xtract, an open analytics platform that provides mobile operators with end-to-end network and service visibility to accelerate and prioritize network optimization, and a quality of experience benchmarking platform that works in tandem with EXFO Mobile Agent, a software application converting smartphones into real-time probes. These solutions leverage technologies from the recent BysteSphere and Aito Technologies acquisitions. We also introduced common public radio interface (CPRI) software testing options for the FTB-700G and FTB-780 NetBlazer series to simplify fiber-to-the-antenna (FTTA) and distributed antenna system (DAS) deployments; and released iCERT, an added functionality on EXFO's OTDR (optical time domain reflectometry) software, which automatically certifies cable installations in data centers and enterprises. Altogether, we introduced seven new solutions or major enhancements in the first half of fiscal 2015.

We reported sales of \$51.0 million in the second quarter of fiscal 2015, stable compared to \$51.2 million for the same period last year, despite a significant headwind from a stronger US dollar versus other currencies compared to the same period last year. Bookings decreased 6.9% to \$54.7 million in the second quarter of fiscal 2015, for a book-to-bill ratio of 1.07, compared to \$58.7 million for the same period last year.

Net earnings amounted to \$931,000, or \$0.02 per diluted share, in the second quarter of fiscal 2015, compared to a net loss of \$1.3 million, or \$0.02 per share, for the same period last year. Net earnings for the second quarter of fiscal 2015 included \$1.0 million in after-tax amortization of intangible assets, \$388,000 in stock-based compensation costs and a foreign exchange gain of \$3.0 million.

Adjusted EBITDA (net earnings (loss) before interest, income taxes, depreciation and amortization, stock-based compensation costs and foreign exchange gain) reached \$1.2 million, or 2.3% of sales in the second quarter of fiscal 2015, compared to minus \$1.0 million, or 2.0% of sales for the same period last year. See page 13 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 million. On February 20, 2015, pursuant to the Offer, we purchased for cancellation 6,521,739 subordinate voting shares for an aggregate purchase price of CA\$30 million (US\$24.0 million), plus related fees of \$223,000. We used cash to fund the purchase of shares.

## 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 28,		Six months ended February 28,	
	2015	2014	2015	2014
Sales	\$ 50,990	\$ 51,179	\$ 107,714	\$ 107,182
Cost of sales <sup>(1)</sup>	19,546	20,073	40,783	41,258
Selling and administrative	20,168	21,537	41,200	43,245
Net research and development	10,506	10,973	22,164	22,254
Depreciation of property, plant and equipment	1,256	1,243	2,501	2,518
Amortization of intangible assets	1,019	1,074	2,117	2,256
Interest income	(35)	(49)	(252)	(76)
Foreign exchange gain	(2,987)	(2,292)	(4,962)	(3,094)
Earnings (loss) before income taxes	1,517	(1,380)	4,163	(1,179)
Income taxes	586	(41)	1,751	907
Net earnings (loss) for the period	\$ 931	\$ (1,339)	\$ 2,412	\$ (2,086)
Basic and diluted net earnings (loss) per share	\$ 0.02	\$ (0.02)	\$ 0.04	\$ (0.03)
<b>Other selected information:</b>				
Gross margin before depreciation and amortization <sup>(2)</sup>	\$ 31,444	\$ 31,106	\$ 66,931	\$ 65,924
Research and development:				
Gross research and development	\$ 12,176	\$ 13,046	\$ 25,485	\$ 26,355
Net research and development	\$ 10,506	\$ 10,973	\$ 22,164	\$ 22,254
Adjusted EBITDA <sup>(2)</sup>	\$ 1,158	\$ (1,002)	\$ 4,355	\$ 1,290

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

(2) Refer to page 13 for non-IFRS measures.

	Three months ended February 28,		Six months ended February 28,	
	2015	2014	2015	2014
Sales	<b>100.0</b> %	100.0 %	<b>100.0</b> %	100.0 %
Cost of sales <sup>(1)</sup>	<b>38.3</b>	39.2	<b>37.9</b>	38.5
Selling and administrative	<b>39.6</b>	42.1	<b>38.2</b>	40.3
Net research and development	<b>20.6</b>	21.4	<b>20.6</b>	20.8
Depreciation of property, plant and equipment	<b>2.5</b>	2.4	<b>2.3</b>	2.3
Amortization of intangible assets	<b>2.0</b>	2.1	<b>2.0</b>	2.1
Interest income	<b>(0.1)</b>	(0.1)	<b>(0.2)</b>	(0.1)
Foreign exchange gain	<b>(5.9)</b>	(4.4)	<b>(4.6)</b>	(2.8)
Earnings (loss) before income taxes	<b>3.0</b>	(2.7)	<b>3.8</b>	(1.1)
Income taxes	<b>1.2</b>	(0.1)	<b>1.6</b>	0.8
Net earnings (loss) for the period	<b>1.8</b> %	(2.6) %	<b>2.2</b> %	(1.9) %

**Other selected information:**

Gross margin before depreciation and amortization <sup>(2)</sup>	<b>61.7</b> %	60.8 %	<b>62.1</b> %	61.5 %
Research and development:				
Gross research and development	<b>23.9</b> %	25.5 %	<b>23.7</b> %	24.6 %
Net research and development	<b>20.6</b> %	21.4 %	<b>20.6</b> %	20.8 %
Adjusted EBITDA <sup>(2)</sup>	<b>2.3</b> %	(2.0) %	<b>4.0</b> %	1.2 %

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

(2) Refer to page 13 for non-IFRS measures.

## **SALES AND BOOKINGS**

For the three months ended February 28, 2015, our sales amounted to \$51.0 million, stable compared to \$51.2 million for the same period last year, and our bookings decreased 6.9% to \$54.7 million, from \$58.7 million for the same period last year, for a book-to-bill ratio of 1.07.

For the six months ended February 28, 2015, our sales reached \$107.7 million, stable compared to \$107.2 million for the same period last year. For the first half of fiscal 2015, bookings amounted to \$108.9 million, compared to \$116.6 million for the same period last year, for a book-to-bill ratio of 1.01.

In the second quarter and the first half of fiscal 2015, we faced a significant headwind from a stronger US dollar versus other currencies compared to the same periods last year, which reduced our sales year-over-year for the second quarter and the first half respectively. Otherwise, we would have reported sales growth year-over-year.

In the second quarter and the first half of fiscal 2015, we reported year-over-year sales growth in the Americas, mainly for our Physical-layer product line, which was offset by the decrease in sales in Europe, Middle-East and Africa (EMEA) and to a lesser extent in Asia-Pacific for both our Physical- and Protocol-layer product lines. It should be noted that in the second quarter and the first half of fiscal 2014, market conditions in the Americas were challenging due to order delays and lower spending levels, especially among key customers, which mainly impacted our Physical-layer product line sales in these periods. Europe remained overall a challenging market affected by a weaker currency and macroeconomic uncertainties.

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

Booking-wise, in the second quarter and the first half of fiscal 2015, we witnessed the same factors as for our sales, but the booking decrease was more pronounced in both periods, compared to the same periods last year. More precisely, the decrease in bookings in EMEA, especially for our Protocol-layer product line, more than offset the year-over-year increase in bookings in the Americas, which resulted in year-over-year decrease in bookings.

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, multimillion dollar deals that have prolonged sales and revenue recognition cycles related to our Protocol-layer products; this also explains the year-over-year decrease in sales and bookings in the second quarter and the first half of fiscal 2015 for our Protocol-layer product line.

### ***Geographic distribution***

In the second quarter of fiscal 2015, sales to the Americas, EMEA and Asia-Pacific accounted for 53%, 25% and 22% of sales respectively, compared to 45%, 32% and 23% for the same period last year respectively. In the first half of fiscal 2015, sales to the Americas, EMEA and Asia-Pacific accounted for 51%, 28% and 21% of sales respectively, compared to 48%, 31% and 21% 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 second quarters of fiscal 2014 and 2015, no customer accounted for more than 10% of our sales, and our top three customers accounted for 13.1% and 15.2% of sales respectively. In the first halves of fiscal 2014 and 2015, no customer accounted for more than 10% of our sales, and our top three customers accounted for 11.3% and 12.2% of our sales respectively.

## **GROSS MARGIN BEFORE DEPRECIATION AND AMORTIZATION (non-IFRS measure — refer to page 13 of this document)**

Gross margin before depreciation and amortization (gross margin) reached 61.7% of sales for the three months ended February 28, 2015, compared to 60.8% for the same period last year.

Gross margin reached 62.1% of sales for the six months ended February 28, 2015, compared to 61.5% for the same period last year.

In the second quarter and the first half of fiscal 2015, our gross margin was favorably affected by the product mix, compared to the same periods last year.

In addition, in the second quarter and the first half of fiscal 2015, we reported lower inventory write-down compared to the same periods last year, which increased our gross margin by 0.4% for both periods year-over-year.

However, in the second quarter and the first half of fiscal 2015, foreign exchange losses on our forward exchange contracts reduced our sales and negatively impacted our gross margin by 0.2% for both periods compared to the same periods last year.

Also, in the second quarter and the first half of fiscal 2015, we faced increased competition and pricing pressure for some product lines, compared to the same period last year, which negatively impacted our gross margin year-over-year.

## **SELLING AND ADMINISTRATIVE EXPENSES**

For the three months ended February 28, 2015, selling and administrative expenses were \$20.2 million, or 39.6% of sales, compared to \$21.5 million, or 42.1% of sales for the same period last year.

For the six months ended February 28, 2015, selling and administrative expenses were \$41.2 million, or 38.2% of sales, compared to \$43.2 million, or 40.3% of sales for the same period last year.

In the second quarter and the first half 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 latter two currencies and we report our results in US dollars.

In the second quarter and the first half of fiscal 2015, our selling and administrative expenses decreased as a percentage of sales compared to the same periods last year, as these expenses decreased year-over-year, while our sales were stable.

## **RESEARCH AND DEVELOPMENT EXPENSES**

### ***Gross research and development expenses***

For the three months ended February 28, 2015, gross research and development expenses totaled \$12.2 million, or 23.9% of sales, compared to \$13.0 million, or 25.5% of sales for the same period last year.

For the six months ended February 28, 2015, gross research and development expenses totaled \$25.5 million, or 23.7% of sales, compared to \$26.4 million, or 24.6% of sales for the same period last year.

In the second quarter and the first half of fiscal 2015, 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 most of these expenses are incurred in these latter two currencies 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 second quarter and the first half 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 periods last year.

In the second quarter and the first half of fiscal 2015, our gross research and development expenses decreased as a percentage of sales compared to the same periods last year, as these expenses decreased year-over-year, while our sales were stable.

### ***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 February 28, 2015, tax credits and grants for research and development activities were \$1.7 million, or 13.7% of gross research and development expenses, compared to \$2.1 million, or 15.9% of gross research and development expenses for the same period last year.

For the six months ended February 28, 2015, tax credits and grants for research and development activities were \$3.3 million, or 13.0% of gross research and development expenses, compared to \$4.1 million, or 15.6% of gross research and development expenses for the same period last year.

The decrease in our tax credits and grants in the second quarter and the first half of fiscal 2015, compared to the same periods 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 second quarter and the first half of fiscal 2015, the decrease in tax credits and grants as a percentage of gross research and development expenses, compared to the same periods 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 February 28, 2015, we recorded a foreign exchange gain of \$3.0 million compared to \$2.3 million for the same period last year.

For the six months ended February 28, 2015, we recorded a foreign exchange gain of \$5.0 million compared to \$3.1 million for the same period last year.

During the second quarter of fiscal 2015, 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 same period last year, 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 \$2.3 million during that period. The period-end value of the Canadian dollar decreased 4.1% versus the US dollar to CA\$1.1075 = US\$1.00 in the second quarter of fiscal 2014, compared to CA\$1.0620 = US\$1.00 at the end of the previous quarter, and decreased 6.0% versus the euro to CA\$1.5291 = €1.00 in the second quarter of fiscal 2014, compared to CA\$1.4420 = €1.00 at the end of the previous quarter.

During the first half of fiscal 2015, 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.

During the same period last year, the period-end value of the Canadian dollar significantly decreased versus the US dollar and the euro, compared to the previous year end, which resulted in a foreign exchange gain of \$3.1 million during that period. The period-end value of the Canadian dollar decreased 4.9% versus the US dollar to CA\$1.1075 = US\$1.00 in the first half of fiscal 2014, compared to CA\$1.0530 = US\$1.00 at the end of the previous year, and decreased 9.7% versus the euro to CA\$1.5291 = €1.00 in the first half of fiscal 2014, compared to CA\$1.3936 = €1.00 at the end of the previous year.

Foreign-exchange-rate fluctuations also flow through the statement of earnings line items as a portion of our sales and a significant portion of our operating expenses are denominated in Canadian dollars and euros, and we report our results in US dollars. In fact, the average value of the US dollar in the second quarter of fiscal 2015 increased 9.7% and 13.7% respectively year-over-year, compared to the Canadian dollar and the euro. During the first half of fiscal 2015, it increased 8.3% and 9.8% respectively year-over-year, compared to the Canadian dollar and the euro.

## **INCOME TAXES**

For the three months ended February 28, 2015, we reported income tax expenses of \$586,000 on earnings before income taxes of \$1.5 million. For the corresponding period last year, we reported income tax recovery of \$41,000 on a loss before income taxes of \$1.4 million.

For the six months ended February 28, 2015, we reported income tax expenses of \$1.8 million on earnings before income taxes of \$4.2 million. For the corresponding period last year, we reported income tax expenses of \$907,000 on a loss before income taxes of \$1.2 million.

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 from their local currency to 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 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 February 28, 2015, cash and short-term investments totaled \$32.9 million, while our working capital was at \$71.0 million. Our cash and short-term investments decreased \$24.7 million in the second quarter of fiscal 2015, compared to the previous quarter. First, in the second quarter of fiscal 2015, we paid a cash payment of \$24.3 million for the redemption of share capital under our substantial issuer bid program (including related fees). In addition, during the quarter, we made cash payments of \$2.0 million for the purchase of capital assets. Finally, we recorded an unrealized foreign exchange loss on our cash and short-term investments of \$4.1 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, operating activities generated \$5.7 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, as well as potential acquisitions. As at February 28, 2015, cash balances included an amount of \$16.0 million that bears interest at an annual rate of 1.3%.

We believe that our cash balances and short-term investments in the amount of \$32.9 million will be sufficient to meet our liquidity and capital requirements for the foreseeable future. In addition to these assets, we have unused available lines of credit totaling \$13.6 million for working capital and other general corporate purposes, and unused lines of credit of \$15.5 million for foreign currency exposure related to forward exchange contracts. However, possible operating losses, 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 \$5.7 million for the three months ended February 28, 2015, compared to \$3.6 million for the same period last year.

Cash flows provided by operating activities were \$7.6 million for the six months ended February 28, 2015, compared to \$7.0 million for the same period last year.

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 second quarter of fiscal 2014 were attributable to the net earnings after items not affecting cash of \$1.3 million, and the positive net change in non-cash operating items of \$2.3 million; this was mainly due to the positive effect on cash of the decrease of \$6.2 million in our accounts receivable due to the timing of receipts and sales during the quarter. This positive effect on cash was offset in part by the negative effect on cash of the increase of \$1.7 million in our income tax and tax credits recoverable due to tax credits earned during the quarter not yet recovered, the negative effect on cash of the increase of \$1.2 million in our inventories to meet future demand, as well as the negative effect on cash of the increase of \$787,000 in our prepaid expenses due to timing of payments during the quarter.

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.

Cash flows provided by operating activities in the first half of fiscal 2014 were attributable to the net earnings after items not affecting cash of \$2.2 million, and the positive net change in non-cash operating items of \$4.8 million; this was mainly due to the positive effect on cash of the decrease of \$4.5 million in our accounts receivable due to the timing of receipts and sales during the period and the positive effect on cash of the increase of \$5.4 million 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 \$943,000 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 \$3.5 million in our inventories to meet future demand as well as the negative effect on cash of the increase of \$616,000 in our prepaid expenses due to timing of payments during the period.

#### *Investing activities*

Cash flows provided by investing activities were \$437,000 for the three months ended February 28, 2015, compared to cash flows used of \$1.7 million for the same period last year.

Cash flows used by investing activities were \$242,000 for the six months ended February 28, 2015, compared to \$2.4 million for the same period last year.

In the second quarter of fiscal 2015, 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.

For the corresponding last year, we paid \$1.7 million for the purchase of capital assets.

In the first half of fiscal 2015, 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.

For the corresponding period last year, we paid \$2.4 million for the purchase of capital assets.

#### *Financing activities*

Cash flows used by financing activities were \$24.3 million for the three months ended February 28, 2015, compared to \$1.2 million for the same period last year.

Cash flows used by financing activities were \$25.1 million for the six months ended February 28, 2015, compared to \$1.0 million for the same period last year.

In the second quarter of fiscal 2015, we redeemed share capital under our substantial issuer bid for a cash consideration of \$24.3 million.

For the corresponding period last year, we redeemed share capital for a cash consideration of \$937,000 and we made a repayment of \$307,000 of our long-term debt. However, we received \$89,000 from the exercise of stock options.

In the first half of fiscal 2015, we redeemed share capital under our share repurchase programs (namely our substantial issuer bid) for a cash consideration of \$25.1 million.

For the corresponding period last year, we redeemed share capital for a cash consideration of \$937,000 and we made a repayment of \$307,000 of our long-term debt. However, we received \$195,000 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 February 28, 2015, 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 2015 to August 2015	\$ 15,600,000	1.1027
September 2015 to August 2016	20,200,000	1.1180
September 2016 to August 2017	8,000,000	1.1530
September 2017 to December 2017	1,600,000	1.2135
Total	\$ 45,400,000	1.1223

##### *US dollars – Indian rupees*

Expiry dates	Contractual amounts	Weighted average contractual forward rates
March 2015 to August 2015	\$ 2,400,000	64.00
September 2015 to February 2016	1,200,000	65.32
Total	\$ 3,600,000	64.44

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 \$4.5 million as at February 28, 2015, mainly for our US/Canadian dollars forward exchange contracts. The quarter-end exchange rate was CA\$1.2503 = US\$1.00 as at February 28, 2015.

## **SHARE CAPITAL**

### ***Share capital***

As at March 24, 2015, EXFO had 31,643,000 multiple voting shares outstanding, entitling to 10 votes each and 22,221,590 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 28, 2015, our off-balance sheet arrangements consisted of letters of guarantee amounting to \$358,000 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 February 28, 2015, 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 AND AMENDMENTS**

Refer to note 2 to our condensed unaudited interim consolidated financial statements for the three and six months ended February 28, 2015 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 half 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 to plan and forecast future periods as well as to 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		Six months ended	
	February 28,		February 28,	
	2015	2014	2015	2014
IFRS net earnings (loss) for the period	\$ 931	\$ (1,339)	\$ 2,412	\$ (2,086)
Add (deduct):				
Depreciation of property, plant and equipment	1,256	1,243	2,501	2,518
Amortization of intangible assets	1,019	1,074	2,117	2,256
Interest income	(35)	(49)	(252)	(76)
Income taxes	586	(41)	1,751	907
Stock-based compensation costs	388	402	788	865
Foreign exchange gain	(2,987)	(2,292)	(4,962)	(3,094)
Adjusted EBITDA for the period	<u>\$ 1,158</u>	<u>\$ (1,002)</u>	<u>\$ 4,355</u>	<u>\$ 1,290</u>
Adjusted EBITDA in percentage of sales	<u>2.3%</u>	<u>(2.0)%</u>	<u>4.0%</u>	<u>1.2%</u>

**QUARTERLY SUMMARY FINANCIAL INFORMATION (unaudited)**

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

	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 <sup>(1)</sup>	\$ 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

	Quarters ended			
	February 28, 2014	November 30, 2013	August 31, 2013	May 31, 2013
Sales	\$ 51,179	\$ 56,003	\$ 60,888	\$ 58,865
Cost of sales <sup>(1)</sup>	\$ 20,073	\$ 21,185	\$ 22,574	\$ 22,574
Net earnings (loss)	\$ (1,339)	\$ (747)	\$ 3,802	\$ (862)
Basic and diluted net earnings (loss) per share	\$ (0.02)	\$ (0.01)	\$ 0.06	\$ (0.01)

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