

**Management discussion and analysis of  
operating results and  
financial position**



**Quarter ended September 29, 2006**



## MANAGEMENT DISCUSSION AND ANALYSIS

### For the third quarter ended September 29, 2006

The purpose of this Management Discussion & Analysis (“MD&A”) is to help the reader understand our development strategy, our future expectations, evaluate our performance in relation to our objectives and the manner in which we manage risks and dispose of available financial resources. The MD&A should be read in conjunction with the interim consolidated financial statements for the quarter ended September 29, 2006, the annual MD&A and the audited consolidated financial statements and related notes for the year ended December 30, 2005 which are included in the Company’s annual report. The Company’s quarterly and annual reports as well as other information documents are available on SEDAR

(www.sedar.com) and on the Company’s website (www.roctest.com).

In order to facilitate different business processes and maintain a comparable basis with previous years, the Company adopted, in 2005, a new fiscal calendar consisting of four quarters of 13 weeks each.

In the present document, unless otherwise indicated, all financial information is prepared in accordance with Canadian Generally Accepted Accounting principles (GAAP). All amounts are in Canadian dollars. To facilitate reading of this MD&A, the terms “Company” “we” “our” “us” all refer to Roctest Ltd.

### Company activity, profile and strategy

Roctest designs, manufactures and markets sensors and high-precision measuring instruments for the civil engineering, energy, healthcare and industrial control markets. The Company is recognized for its leading-edge technology, the quality of its technical expertise and its product development capabilities for challenging and demanding environments.

The Company’s products are mainly sold internationally. A commercial development network consisting of agents and distributors

allows the Company to seize business opportunities throughout the world. During the last fiscal year, Roctest generated more than 80% of its revenues outside of Canada.

The Company is comprised of two distinct sectors, industrial and civil engineering. The industrial sector is mainly based on fiber optics technology and is an emerging sector offering numerous growth opportunities. With regards to the civil engineering sector, with approximately 10% of the world’s market for measuring

instruments, we will continue to deploy significant efforts in order to capitalize on the many opportunities available to innovative firms such as Roctest.

Since the acquisition of Smartec, we offer to our clients distributed fiber sensing technology in addition to our traditional instruments based on vibrating wire technology.

On a general basis, the Company will maintain its strategic focus on developing markets in China, the USA, Europe and South America for its products both for the civil engineering and the industrial sectors.

More specifically, the strategy for FISO Technologies Inc., a subsidiary of the Roctest Group specialized in the manufacturing and commercialization of fiber optic sensors, is to stimulate organic growth of its revenues by concluding agreements that will allow it to position itself as a preferred supplier to original equipment manufacturers (OEM).

As for the civil engineering sector, its strategy will be to position itself as a consolidator in a highly fragmented and competitive market and by offering innovative products

We continue to focus on concluding new OEM agreements in our industrial sector thereby increasing the importance of OEM clients in this sector's sales. These agreements provide numerous advantages on an operational level. Sales from OEM agreements are recurring,

thereby enabling us to reduce production costs and facilitate production planning and product improvements.

On the downside, these agreements require more development and customization of our products in order to answer to specific needs. Consequently, these developments cause delays between product qualification and the reception of high volume orders.

Furthermore, the development and launch of new products during the last months of 2006 will allow this sector to open new potential markets in the future.

In the civil engineering sector, integrating technologies based on fiber optics, such as distributed sensing, will allow us to offer complete and attractive global solutions for our clients' various needs.

During the quarter ended on September 29, 2006, the consolidated results include Smartec's results. For the quarter, Smartec's revenues amounted to 0.84 million dollars and net earnings of 0.11 million dollars were registered.

During the quarter terminated on September 29, 2006, the Company recorded a charge amounting to \$300,000 for costs related to a cost reduction plan. The cost reduction plan implemented will generate recurring savings of \$ 1.1 million on an annual basis. These savings will come mainly from a reduction in the number of employees in

the sales and administration departments as well as in the operations department.

The Company will rationalize certain operations in order to increase its margins while maintaining its capacity to efficiently satisfy its clients' demands. Also, subcontracting some activities will allow Roctest to be more competitive.



## Results of Operations and Financial Position

	For the three-month periods ended				For the nine-month periods ended			
	September 29, 2006		September 30, 2005		September 29, 2006		September 30, 2005	
	\$	% of sales	\$	% of sales	\$	% of sales	\$	% of sales
<b>Consolidated earnings data</b>								
Sales	<b>5,194,348</b>	<b>100.0</b>	4,928,858	100.0	<b>14,889,911</b>	<b>100.0</b>	15,587,448	100.0
Cost of sales	<b>3,396,576</b>	<b>65.4</b>	2,549,158	51.7	<b>9,248,159</b>	<b>62.1</b>	8,918,506	57.2
Gross profit	<b>1,797,772</b>	<b>34.6</b>	2,379,700	48.3	<b>5,641,752</b>	<b>37.9</b>	6,668,942	42.8
Sales and administration expenses	<b>1,676,852</b>	<b>32.3</b>	1,492,605	30.3	<b>5,004,559</b>	<b>33.6</b>	4,577,700	29.4
Other administration, research and development and amortization expenses	<b>729,615</b>	<b>14.1</b>	586,076	11.9	<b>2,105,649</b>	<b>14.1</b>	1,920,206	12.3
Cost reduction plan	<b>300,000</b>	<b>5.7</b>	-	-	<b>300,000</b>	<b>2.0</b>	-	-
Foreign exchange loss (gain)	<b>(695)</b>	<b>-</b>	265,284	5.4	<b>184,700</b>	<b>1.3</b>	292,441	1.9
Earnings (loss) before income taxes	<b>(908,000)</b>	<b>(17.5)</b>	35,735	0.7	<b>(1,953,156)</b>	<b>(13.1)</b>	(121,405)	(0.8)
Provision for (recovery of) income taxes	<b>(330,653)</b>	<b>(6.4)</b>	(92,581)	(1.9)	<b>(694,004)</b>	<b>(4.7)</b>	(209,552)	(1.4)
Net earnings (loss)	<b>(577,347)</b>	<b>(11.1)</b>	128,316	2.6	<b>(1,259,152)</b>	<b>(8.4)</b>	88,147	0.6
Earnings (loss) per share								
Diluted and Basic	<b>(0.11)</b>		0.03		<b>(0.24)</b>		0.02	
Weighted average number of shares outstanding on a fully diluted basis	<b>5,344,461</b>		4,447,886		<b>5,344,461</b>		4,447,886	

	September 29, 2006	December 30, 2005
	\$	\$
<b>Balance sheet data</b>		
Working capital <sup>(1)</sup>	<b>8,082,160</b>	9,734,270
Property, plant and equipment	<b>5,366,888</b>	5,126,273
Total assets	<b>26,312,344</b>	24,401,305
Total debt	<b>4,868,682</b>	2,436,935

(1) Working capital is defined as current assets minus current liabilities.

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## **ANALYSIS OF FINANCIAL RESULTS OF THE THIRD QUARTER 2006**

During the third quarter ended September 29, 2006, earnings before interest, income taxes and amortization (“EBITDA”) were a loss of (\$536,598) compared to a gain of \$329,406 in the third quarter of 2005. For the nine-month period ended September 29, 2006, EBITDA was a loss of (\$889,887) while it amounted to a gain of \$862,594 in 2005.

The third quarter decrease in EBITDA results mainly from a decrease of \$0.58 million in gross margin mostly related to lower sales prices due to increased competition in certain markets and lower volume, an increase in sales and administration cost of \$0.18 million compared to the same quarter in 2005 notwithstanding a marginal foreign exchange gain compared with a foreign exchange loss of \$0.26 million in 2005. In addition, a provision for a cost reduction plan in the amount of \$0.30 million was recorded during the third quarter of 2006. This provision is mainly comprised of expenses related to severance benefits for terminated employees.

The gross margin as a percentage of sales decreased by 13.7% in comparison to the same period in 2005. The average exchange rates for the quarter, for the US dollar and Euro, have decreased by 6.7% and 2.5% respectively in comparison to 2005 which also had a negative impact on gross margins.

Had the average foreign exchange rates remained at the same level as in 2005, the gross margin of 2006 would have increased by \$0.16 million, representing a 3% gain.

Furthermore, the decrease in gross margins for the period as a percentage of sales resulted from lower revenues from the industrial sector in the amount of \$0.18 million compared to the same period in 2005, combined with lower revenues in the amount of \$0.39 million from the civil engineering sector, excluding revenues from Smartec for that period which stood at \$0.89 million.

Revenues from the industrial sector come from products with higher margins. However, since the beginning of the year, stronger competition in many markets puts a negative pressure on margins by lowering prices and is only partially offset by efforts to reduce production costs.

It is important to note that the cost reduction plan implemented at the end of the third quarter of 2006 aims to reduce certain costs on a recurrent basis in order to competitively align these costs with the revenues generated by each sector.

### *Revenue*

For the third quarter ended September 29, 2006, consolidated revenue reached \$5.19 million, an increase of 5.4% compared to 2005. The civil engineering sector posted sales of \$3.86 million while sales in the industrial sector amounted to \$1.33 million.

The quarter's revenues from the civil engineering sector increased by 13.1% while the industrial sector registered a 12.1% decrease in revenues compared to the same quarter of 2005.

Third quarter 2006 revenues include \$0.84 million from our Smartec subsidiary acquired on May 19, 2006. Revenues from the civil engineering sector for the quarter ended September 29, 2006, excluding revenues from Smartec, decreased by \$0.39 million or 11.5%.

Revenues from the industrial sector decreased by \$0.18 million compared to the same period in 2005.

Lower revenues from the civil engineering sector, compared to the same period in 2005, excluding revenues from Smartec, result from the foreign exchange impact of US and Euro currencies as well as delays on certain projects and increased competition.

Even though the third quarter results are historically the weakest of the year, the 2006 third quarter results for civil engineering companies, excluding Smartec and En.Om.Fra. were lower than expected.

The order book of the Company and its subsidiaries stands at \$3.96 million as at September 29, 2006, compared to \$4.14 million for the corresponding period in 2005.

### *Sales and administration*

Compared to the third quarter of 2005, sales and administration expenses increased by \$0.18 million to stand at 32.3% of revenue, while they totaled \$1.49 million and represented 30.3% of revenues in 2005.

The increase in expenses comes from sales and administration costs for Smartec amounting to \$0.18 million.

### *Sales and administration (continued)*

Outside of Smartec, the increase caused by hirings effected at the end of 2005 in order to upgrade our local presence in Western United States and in our Hong Kong subsidiary were offset by savings realized by a reduction of other sales and marketing expenses since the beginning of 2006.

### *Research and Development*

For the quarter ended September 29, 2006, research and development (“R&D”) costs, net of grants and income tax credits, reached \$0.37 million and represented 7.2% of revenues while they represented 5.9% of revenues in 2005. This increase, attributable mainly to the civil engineering sector, includes R&D expenses incurred by Smartec and reflects our strategy of higher investments in new product development for the civil engineering sector. For the nine-month period terminated on September 29, 2006, these costs reached \$1.09 million and represented 7.3% of total revenues compared to 6.0% in 2005

### *Amortization of Capital Assets*

Amortization of capital assets stood at \$0.29 million compared to \$0.25 million in 2005, an increase of 15.2%. The increase in the amortization of capital assets during the quarter is attributable to capital assets acquired since the beginning of the year amounting to \$0.64 million.

During the quarter ended September 29, 2006, the Company’s capital expenditures totalled \$0.10 million.

The new capital expenditures of the quarter are comprised mainly of new research and development equipment including new installations to allow for research on distributed sensing technologies for the civil engineering sector.

### *Interest and Foreign Exchange*

The Company incurred interest expenses mainly on its long-term debt. Said interest expenses increased by \$0.04 million compared to the same period in 2005. New debts contracted at the end of the second quarter caused the higher interest expenses. These debts were incurred for the acquisition of Smartec and the financing of new capital expenditures.

The Company is exposed to foreign exchange adjustment risks. During the third quarter of 2006, fluctuations of the US dollar and the Euro had a marginal effect on earnings while these fluctuations during the third quarter of 2005 had resulted in a loss of \$0.26 million.

### *Interest and Foreign Exchange (continued)*

However, the average foreign exchange rates for the quarter compared to the same period in 2005 had a negative impact of \$0.16 million on our margins.

To reduce foreign exchange risks, the Company enters into forward exchange collars for the sale of US dollars with a floor varying from \$1.0845 to \$1.1344 and a cap varying from \$1.1533 to \$1.2060. As at September 29, 2006 those contracts represented an amount of US\$1.8 million compared to US\$1.6 million at December 30, 2005.

### *Income Taxes*

Income taxes, as a percentage of revenues, represent a recovery of 36.4% of loss before taxes, compared with 259% of earnings before taxes for the third quarter of 2005. The rate reflects a mix of the various income tax rates in the Canadian provinces and foreign jurisdictions in which the Company operates. This rate fluctuates depending on the proportion of net income by jurisdiction to consolidated net income.

The recovery of the third quarter of 2005 included prospective income tax benefits from losses carried forward of a subsidiary that was not previously recorded.

### *Net Income (loss)*

The Company incurred a loss of \$0.58 million, or \$0.11 per share, compared with earnings of \$0.13 million, or \$0.03 per share, for the same period in 2005.

This loss is mainly attributable to a 13.7% decrease in gross margins, an increase in sales and administration expenses as a percentage of revenue to 32.3%, and a \$0.30 million provision for a costs reduction plan. Compared to the same period of 2005, the earnings of \$0.13 million were attributable mainly to a 5.4% increase of revenues from the civil engineering sector, higher margins for both activity sectors of the company and an income tax recovery of \$0.09 million.

### *Cash Flows from Operations*

Negative cash flow from operations was at \$0.59 million compared to positive cash flow of \$0.53 million in 2005. The decrease results mainly from a loss of \$0.58 million as opposed to earnings of \$0.13 million in 2005, an increase of \$0.31 million in future income tax and a reduction in non cash working capital of \$0.14 million. The working capital decreased by \$1.65 million compared to December 30, 2005 from \$9,734,270 to \$8,082,160.

### *Liquidity and Share Capital and Stock Options*

At September 29, 2006, the Company had \$1.88 million in cash and cash equivalents and temporary investments, net of bank advances, compared to \$4.18 million as at December 30, 2005. The cash and cash-equivalents are made up of cash on hand, bank balances, and short-term investments with maturity dates equal to or less than three months. During the previous quarter, the Company contracted a new debt in the amount of \$1.75 million in order to finance its acquisition of Smartec, it also entered into capital lease commitments for an amount of \$0.26 million. Furthermore, new debts in an amount of \$463,450 were contracted during the current quarter pursuant to an agreement allowing for the financing of new capital expenditures.

At the end of the third quarter of 2006, there were 5,563,071 common shares issued and outstanding. There were no new shares issued during this quarter.

During the third quarter of 2006, no stock options were granted by the Company. The cost of stock-based compensation, using the fair value method of accounting, was recognized in net loss with the corresponding credit to contributed surplus for an amount of \$0.03 million, the same amount as in 2005.

### *Risks and uncertainties*

For discussion of the risks that could affect our business, please refer to our 2005 annual MD&A.

Since December 30, 2005 there have been no significant changes to the risks and uncertainties which could affect the Company

Certain of the risk factors which could cause results or events to differ materially from current expectations include the following: the length of the sales cycle and the fact that certain contracts are subject to delay, the capacity of the Company to efficiently maintain new product development at a high level, increased competition in certain markets, currency fluctuations and economical, geopolitical and international events in general.

## **Forward-looking statements**

Certain statements made in this MD&A may constitute forward-looking statements and are subject to significant risks and uncertainties which are difficult to predict and assumptions which may prove to be inaccurate. The results or events predicted in these statements may differ materially from actual results or events.

The forward-looking statements contained in this document represent the Company's expectation as of October 27, 2006 and, accordingly, are subject to change after that date. However, the Company disclaims any intention or obligations to update or revise any forward-looking statements whether as a result of new information, future events or otherwise

On behalf of Management,

*(Signed)*

Michel Plante  
Chief Financial Officer  
October 27, 2006



## Quarterly Review

### Financial Information (in millions of dollars, except for per share amounts)

	2006				2005			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
<b>SALES</b>	4.44	5.25	<b>5.19</b>		5.22	5.44	4.93	5.28
<b>COST OF SALES</b>	2.78	3.07	<b>3.39</b>		3.17	3.20	2.55	3.34
<b>GROSS MARGIN</b>	1.66	2.18	<b>1.80</b>		2.05	2.24	2.38	1.94
<b>EXPENSES</b>								
Sales and administration	1.51	1.81	<b>1.68</b>		1.38	1.72	1.49	1.66
Scientific Research Cost	0.61	0.67	<b>0.67</b>		0.54	0.58	0.53	0.48
Grants and scientific tax credits	(0.26)	(0.31)	<b>(0.30)</b>		(0.24)	(0.24)	(0.24)	(0.80)
Interest on Long-term debt	0.04	0.04	<b>0.07</b>		0.04	0.04	0.04	0.04
Amortization	0.26	0.32	<b>0.29</b>		0.31	0.28	0.25	0.41
Foreign Exchange Gain (Loss)	(0.03)	(0.16)			(0.08)	0.05	(0.27)	0.05
Cost reduction plan	-	-	<b>0.30</b>		-	-	-	-
	2.19	2.69	<b>2.71</b>		2.11	2.33	2.34	1.74
<b>EARNINGS (LOSS)</b>								
<b>Before Income Taxes</b>	(0.53)	(0.51)	<b>(0.91)</b>		(0.06)	(0.09)	0.04	0.20
<b>INCOME TAXES</b>	(0.23)	(0.13)	<b>(0.33)</b>		(0.01)	(0.10)	(0.09)	0.08
<b>NET EARNINGS (LOSS)</b>	(0.30)	(0.38)	<b>(0.58)</b>		(0.05)	0.01	0.13	0.12
<b>PER COMMON SHARE</b>								
Basic	(0.06)	(0.07)	<b>(0.11)</b>		(0.01)	0.00	0.03	0.03
Diluted	(0.06)	(0.07)	<b>(0.11)</b>		(0.01)	0.00	0.03	0.03
<b>EBITDA</b>	(0.22)	(0.13)	<b>(0.54)</b>		0.29	0.24	0.33	0.68
<b>TOTAL ASSETS</b>	23.70	26.53	<b>26.31</b>		22.07	21.15	21.49	24.40