

## **Management Discussion and Analysis of Financial Position and Operating Results**

This management discussion and analysis (MD&A) is intended to provide an overview of how the financial position of Héroux-Devtek Inc. (“Héroux-Devtek” or “the Company”) changed between March 31, 2005 and June 30, 2005. It also compares the operating results and cash flows for the first quarter ended June 30, 2005 to those for the same period the previous year. It should be read in conjunction with the audited consolidated financial statements dated March 31, 2005 and the related MD&A, both available on the Company’s website at [www.herouxdevtek.com](http://www.herouxdevtek.com), and with the interim consolidated financial statements to June 30, 2005. Héroux-Devtek’s financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”). The Company reports its results in Canadian dollars. All amounts in this MD&A are in Canadian dollars unless otherwise indicated.

### **Forward-Looking Statements**

In the interest of providing shareholders and potential investors with information regarding Héroux-Devtek, including management’s assessment of future plans and operations, certain statements in this MD&A are forward-looking statements subject to risks, uncertainties and other important factors that could cause the Company’s actual performance to differ materially from those expressed in or implied by such statements.

Such factors include, but are not limited to: the impact of general economic conditions in Canada and the United States; industry conditions including changes in laws and regulations; increased competition; the lack of availability of qualified personnel or management; fluctuations in commodity prices or availability; foreign exchange or interest rates; stock market volatility; and the impact of accounting policies issued by Canadian and US standard setters. Some of these factors are further discussed under Risks and Uncertainties in the Company’s MD&A for the year ended March 31, 2005.

Although the Company believes that the expectations conveyed by the forward-looking statements are based on information available to it on the date such statements were made, there can be no assurance that such expectations will prove to be correct. All subsequent forward-looking statements, whether written or orally attributable to the Company or persons acting on its behalf, are expressly qualified in their entirety by these cautionary statements.

### **OVERVIEW**

Héroux-Devtek designs, develops, manufactures and repairs systems and components for two main market segments: Aerospace and Industrial. The Aerospace segment comprises the following:

- landing gear products
- aerostructure products
- aircraft engine components

The Industrial segment includes:

- industrial gas turbine products
- other industrial products

On May 20, 2005, the Company concluded the sale of its Logistics and Defence Division, Diemaco, to Colt Defense LLC.

During the first quarter ended June 30, 2005, the economic and industry factors influencing Héroux-Devtek's business remained essentially unchanged from those discussed at our last fiscal year-end, March 31, 2005. Calendar year 2004 showed the first sign of a turnaround in the civil aerospace market. This recovery in the civil aerospace market is expected to have a favourable impact on Héroux-Devtek's sales for fiscal 2006. The military aerospace market remains generally strong, with continued interest in unmanned aircraft vehicles ("UAV") and unmanned combat aircraft vehicles ("UCAV"), as well as other potential opportunities that could have an impact on the Company's sales for fiscal 2006. On the industrial side, the downturn in the power generation market is believed to have ended in calendar year 2004, and modest growth is expected in calendar year 2005. Finally, the strength of the Canadian dollar and tight supply and price increases for raw materials continue to have a significant negative impact on Héroux-Devtek's results.

## **RESULTS OF OPERATIONS**

### **Consolidated Sales**

Consolidated sales for the quarter ended June 30, 2005 grew by 3.1% to \$53.9 million from \$52.3 million for the same period last year.

This sales increase in the first quarter ended June 30, 2005 was mainly due to improved commercial sales for large aircraft landing gear, somewhat offset by reduced aerostructure sales partially due to the lack of availability of raw materials and deliveries deferred to the next quarter. Sales were also negatively affected by the strength of the Canadian dollar relative to the US dollar (US dollar denominated sales), which reduced sales by \$4.1 million or 7.8%.

The Company's sales for the aerospace and industrial segments were as follows:

Segment	First quarter ended		% Change
	June 30, 2005 (\$'000)	June 30, 2004 Restated (\$'000)	
Aerospace			
- Military	10,886	12,261	(11.2)
- Civil			
- Military products sold to civil customers	14,713	13,707	7.3
- Commercial products	22,836	21,500	6.2
Total Civil	37,549	35,207	6.7
Total Aerospace segment	48,435	47,468	2.0
Total Industrial segment	5,482	4,850	13.0
<b>Total</b>	<b>53,917</b>	<b>52,318</b>	<b>3.1</b>

#### *Aerospace Segment*

Sales for the Aerospace segment explained above can be broken down by products as follows:

Sector	First quarter ended		% Change
	June 30, 2005 (\$'000)	June 30, 2004 Restated (\$'000)	
Landing Gear	28,648	24,962	14.8
Aerostructure	14,755	17,375	(15.1)
Aircraft Engine Components	5,032	5,131	(1.9)
<b>Total</b>	<b>48,435</b>	<b>47,468</b>	<b>2.0</b>

Sales for the Aerospace segment were up 2.0% in the first three months this year to \$48.4 million compared to \$47.5 million for the same period last year.

During the first quarter ended June 30, 2005, Landing Gear sales increased by \$3.7 million or 14.8% compared to the same period last year, mainly in commercial sales for large aircraft. In spite of this increase, the Landing Gear Division experienced a sales shortfall of about \$6 million in the first quarter of the current fiscal year due to late deliveries, mainly on recent military programs, and reduced productivity in repair and overhaul work. These deliveries are deferred to future quarters in the current fiscal year.

Aerostructure sales decreased by \$2.6 million, compared to the same period last year, due to late deliveries, which were deferred to the second quarter of this year. Some of these deferred deliveries were due to the lack of availability of raw materials on the market.

Aircraft Engine Component sales declined by \$0.1 million, compared to the same period last year, representing reduced sales on the commercial side with GE Aircraft Engines, essentially offset by a \$1.8 million increase in military program sales.

### *Industrial Segment*

Sales for the Industrial segment were as follows:

<b>Sector</b>	<b>First quarter ended</b>		<b>% Change</b>
	<b>June 30, 2005 (\$'000)</b>	<b>June 30, 2004 (Restated) (\$'000)</b>	
Industrial Gas Turbine	3,081	3,056	0.8
Other Industrial	2,401	1,794	33.8
<b>Total</b>	<b>5,482</b>	<b>4,850</b>	<b>13.0</b>

First quarter sales for the Industrial segment totalled \$5.5 million this year, up 13% from \$4.9 million for the same period last year. Industrial Gas Turbine sales remained stable, while new parts manufactured for Caterpillar resulted in a substantial increase in Other Industrial sales for the quarter, compared to the same period last year.

### *Sales by Destination*

The Company's sales by destination were as follows:

<b>Destination</b>	<b>First quarter ended</b>	
	<b>June 30, 2005</b>	<b>June 30, 2004 (Restated)</b>
Canada	28.1%	22.6%
US	70.0%	76.2%
International	1.9%	1.2%
	100.0%	100.0%

During the first quarter ended June 30, 2005, increase in sales by destination to Canada reflects the increase in commercial sales made to Canadian customers, compared to the same period last year.

## Gross Profit

Expressed as a percentage of sales, consolidated gross profit decreased by 1.9% in the first quarter this year to 3.8% from 5.7% in the same period last year. The continued strength of the Canadian dollar accounted for 1.9% of this decline.

In the Aerospace segment, in spite of the sales increase compared to the same period last year, gross profit was negatively impacted in the first quarter this year by the late deliveries and sales shortfall at the Landing Gear Division. This negative impact was offset in the Industrial segment by the improved performance of Industrial Gas Turbine and Other Industrial products. In the first quarter of last year, Industrial Gas Turbine experienced a sales shortfall of approximately \$2 million, due in part to manufacturing problems related to the introduction of new industrial business, as well as to material shortages.

## Selling and Administrative Expenses

This year's first quarter selling and administrative expenses were down from the same period last year, as shown below:

	First quarter ended	
	June 30, 2005	June 30, 2004 (Restated)
Selling and administrative expenses (\$'000)	\$4,153	\$4,544
% of sales	7.7%	8.7%

The main variation in selling and administrative expenses in the first quarter ended June 30, 2005 compared to the first quarter of last year resulted from a favourable impact of approximately \$100,000 attributable to the US/CAN exchange rate.

## Financial Expenses

Net financial expenses for the first quarter ended June 30, 2005 were up compared to the corresponding quarter last year, as shown below:

	First quarter ended	
	June 30, 2005 (\$'000)	June 30, 2004 (Restated) (\$'000)
Interest expense	1,167	1,059
Interest revenue	(53)	(128)
Gain on financial derivative instrument - net	-	(487)
Financial expenses - net	1,114	444

On May 20, 2004, the Company designated its interest rate swap agreement as a hedging instrument to be recorded under the hedge accounting rules. This resulted in a gain of \$487,000, representing the change in the fair value of the interest rate swap agreement between April 1, 2004 and May 20, 2004, net of the amortization of the related deferred loss recorded on April 1, 2004.

The interest expense increased in the first quarter of the current fiscal year, compared to the same period last year, in spite of the \$15 million capital repayment on the Company's Secured Syndicated Revolving Credit Facilities; this repayment was made late in the first quarter of this fiscal year. In addition, the increase in the interest expense mainly reflects the general increase in US interest rates, which had an impact on the interest expense related to our US credit facilities.

### **Discontinued Operations**

On May 20, 2005, the Company concluded the sale of its Logistics & Defence Division, Diemaco, to Colt Defense LLC. The total sale price was \$19.3 million. All assets and liabilities related to Diemaco were reclassified as discontinued assets and liabilities in the balance sheets. Diemaco's revenues, expenses and net income are shown under discontinued operations in the statements of income (loss), and the impact of Diemaco's operations on the Company's cash and cash equivalents is presented under discontinued operations in the statements of cash flows (see below and Note 3 to the interim consolidated financial statements).

A significant portion of the net proceeds from the sale of Diemaco was essentially used to repay \$15.3 million on the Company's Secured Syndicated Revolving Credit Facilities.

### **Net Income (Loss)**

For the first quarter ended June 30, 2005, the Company posted a net income of \$6.4 million compared to a net loss of \$1.3 million for the same period last year, as shown below:

	<b>First quarter ended</b>	
	<b>June 30, 2005</b>	<b>June 30, 2004 (Restated)</b>
Net loss from continuing operations (\$'000)	(2,432)	(1,440)
Net income from discontinued operations (\$'000)	8,844	124
Net income (loss) (\$'000)	6,412	(1,316)
Loss per share from continuing operations (\$)	(0.09)	(0.05)
Earnings per share, from discontinued operations (\$)	0.33	0.00
Earnings (loss) per share (\$)	0.24	(0.05)

In the first quarter ended June 30, 2005, net income from discontinued operations includes the \$8.6 million gain on the sale of the Company's Logistics and Defence Division, Diemaco, net of income taxes of \$2.3 million and the net income from operations for the period from April 1, 2005 until May 20, 2005, the closing date of the sale transaction.

The increase in the net loss from continuing operations in the first quarter ended June 30, 2005, compared to the same period last year, resulted mainly from the continued strength of the Canadian dollar relative to the US dollar in the first quarter this year and, the non recurring gain on financial derivative instrument recorded in the first quarter last year. Earnings (loss) per share figures are based on weighted averages of 26,959,538 common shares outstanding for the first quarter of this year and 26,864,361 for the same period last year. The increase is due to the issuance of common shares pursuant to the stock purchase and ownership incentive plan and the exercise of stock options (see Note 6 to the interim consolidated financial statements).

On August 3, 2005, the date of this MD&A, the Company had 26,966,012 common shares outstanding.

## LIQUIDITY AND CAPITAL RESOURCES

### *Operating Activities*

Internally, the Company generated cash flow from continuing operations and used cash flow in operating activities as follows:

	First quarter ended	
	June 30, 2005 (\$'000)	June 30, 2004 (Restated) (\$'000)
Cash flow from continuing operations	2,379	2,002
Net change in non-cash items related to operations	(7,501)	(7,963)
Cash flow used in operating activities	(5,122)	(5,961)

For the first quarter ended June 30, 2005, cash flow from continuing operations increased by \$0.4 million to \$2.4 million compared to the same period last year due mainly to a \$0.3 million future income tax expense included in the Company's net loss from continuing operations.

In the first quarter of this year, the net change in non-cash items included a \$2.7 million reduction in accounts payable and accrued liabilities and other liabilities, a \$2.2 million increase in income tax receivable and a \$6.1 million increase in inventories. The increase in inventories is directly related to the overall increase in business activity and to the sales shortfall experienced in the first quarter this year, explained earlier. These items were partially offset by a \$3.5 million reduction in accounts receivable during the quarter ended June 30, 2005.

## *Investing Activities*

The Company's first quarter investing activities were as follows:

	<b>First quarter ended</b>	
	<b>June 30, 2005 (\$'000)</b>	<b>June 30, 2004 (Restated) (\$'000)</b>
Net change in temporary investments	-	(4,972)
Purchase of capital assets	(1,178)	(4,325)
Proceeds on disposition of capital assets	6	793
Business acquisition	-	(63,554)
Proceeds on sale of Logistics and Defence Division, Diemaco	19,172	-
Cash flow provided by (used for) investing activities	18,000	(72,058)

On May 20, 2005, the Company concluded the sale of its Logistics and Defence Division, Diemaco.

The total sale price amounted to \$19.3 million, of which \$19.2 million was received as of the closing date on May 20, 2005. The balance of \$0.1 million is included in the Company's other receivables as of June 30, 2005, and will be received in the second quarter of the current fiscal year (see Note 3 to the interim consolidated financial statements).

In the first quarter of last year, on April 1, 2004, the Company acquired Progressive for a total purchase price of \$74.2 million (US \$56.4 million) which purchase price was adjusted downward to \$71.3 million at March 31, 2005. During the first quarter of last year, the Company paid \$63.6 million (US \$48.3 million), representing payment of the basic purchase price, the acquisition of a new piece of specialized equipment and a portion of the transaction costs (see Note 2 to the interim consolidated financial statements).

Purchase of capital assets totalled \$1.2 million in the first quarter of this year compared to \$4.3 million for the same period last year, and included \$0.8 million for the Landing Gear Division. However, about \$6 million in capital expenditures for Landing Gear were deferred and will be affected during the remaining quarters of the current fiscal year.



## *Financing Activities*

The Company's first quarter financing activities were as follows:

	First quarter ended	
	June 30, 2005 (\$'000)	June 30, 2004 (Restated) (\$'000)
Increase in long-term debt	-	36,598
Repayment of long-term debt	(16,656)	(8,746)
Issuance of common shares	32	16,267
Other	-	(80)
Cash flow provided by (used for) financing activities	(16,624)	44,039

During the first quarter ended June 30, 2005, subsequent to the sale of the Logistics and Defence Division, Diemaco, the Company repaid \$15.3 million on its Secured Syndicated Revolving Term Credit Facilities.

In the first quarter last year, the Company drew \$36.4 million (US \$27.7 million) on its US Syndicated Revolving Term Credit Facility, issued 3.5 million common shares through private placements for a net cash consideration of \$16.2 million, and used \$18.7 million of its available cash to finance the acquisition of Progressive (see Note 2 to the interim consolidated financial statements).

### *Restrictive Debt Covenants*

At June 30, 2005, the Company was in compliance with all its restrictive debt covenants. At March 31, 2005, based on the expected results of operations and cash flow levels for the first three quarters of the current fiscal year, the Company renegotiated less restrictive debt covenants on its Secured Syndicated Credit Facilities ("Credit Facilities) for these quarters.

These Credit Facilities were extended on February 20, 2004, on a secured basis for a period of two years up to March 21, 2006.

In fiscal 2005, the Company extended the renewal date (annual extension) of these Credit Facilities to August 30, 2005. On that basis, the balance due on the operating Credit Facilities of \$10,2 million at June 30, 2005 (\$16,0 million at March 31, 2005) was reclassified in the Company's current portion of Long-term debt.

The annual extension of the Credit Facilities will be negotiated through August 30, 2005 or up to a later date to be agreed upon by the parties involved during the current fiscal year (but before March 21, 2006).

The Company expects to continue to comply with its restrictive debt covenants in the current fiscal year. However, should the Company fail to comply with these covenants, it will attempt to renegotiate them, although the Company cannot predict what would be the outcome of these renegotiations.

### Consolidated Balance Sheets

The following table itemizes and explains the significant changes in the consolidated balance sheets between March 31, 2005 and June 30, 2005:

<u>Item</u>	<u>Change (\$ million)</u>	<u>Explanation</u>
Cash and temporary investments	(4.4)	See statements of cash flows
Accounts receivable	(3.5)	Due to reduced sales in the first quarter compared to the last quarter of fiscal 2005
Income tax receivable	2.2	Due to an income tax recovery related to the Company's operating losses
Inventories	6.1	Due to late deliveries and a sales shortfall at the Landing Gear and Aerostructure Divisions
Capital assets	(2.3)	Due to: <ul style="list-style-type: none"> <li>• Purchase of capital assets (\$1.2 million)</li> <li>• A higher US exchange rate used to convert the net assets of self-sustaining US subsidiaries (\$0.5 million)</li> </ul> Net of: <ul style="list-style-type: none"> <li>• Amortization (\$4.0 million)</li> </ul>
Backlog, net (\$7.5 Backlog, net included in Finite-life intangible assets)	(0.2)	Represents mainly the amortization on the underlying value of the net backlog acquired as part of the acquisition of Progressive
Goodwill	0.2	Due to a higher US exchange rate used to convert the goodwill of self-sustaining US subsidiaries
Accounts payable and accrued liabilities	(1.5)	Reduction partially due to payment of certain transaction costs related to the sale of the Logistics and Defence Division, Diemaco
Income taxes payable	1.4	Due mainly to the tax impact related to the sale of Logistics and Defence Division, Diemaco (\$2.3 million)
Long-term debt (including current portion)	(16.0)	Due to: <ul style="list-style-type: none"> <li>• Repayment of long-term debt (\$16.7 million)</li> </ul>

<u>Item</u>	<u>Change (\$ million)</u>	<u>Explanation</u>
		Net of: <ul style="list-style-type: none"> <li>A higher US exchange rate used to convert the net assets of self-sustaining US subsidiaries (\$0.7 million)</li> </ul>
Cumulative translation adjustment	0.7	Represents the counterpart of the impact of foreign exchange rate fluctuations on the net assets of self-sustaining US subsidiaries
Retained earnings	6.4	See consolidated statements of retained earnings

At June 30, 2005 and March 31, 2005, the Company's working capital ratio, cash and cash equivalents and long-term debt-to-equity ratio were as follows:

	<b>June 30, 2005</b>	<b>March 31, 2005</b>
Working capital ratio	1.65:1	1.48:1
Cash and cash equivalents	\$5.1 million	\$9.6 million
Long-term debt-to-equity ratio	0.40:1	0.51:1

## **CHANGES IN ACCOUNTING POLICIES**

The changes in accounting policies adopted in the last fiscal year ended March 31, 2005 along with the future changes in accounting policies are discussed in the Company's MD&A included in its annual report for fiscal 2005.

## **RISKS AND UNCERTAINTIES**

Héroux-Devtek operates in industry segments that have a variety of risk factors and uncertainties that could have a material adverse effect on the Company's business, financial condition and results of operations. Such risks and uncertainties include, but are not limited to, those mentioned below, which are more fully described in the Company's MD&A for the year ended March 31, 2005.

- Reliance on large customers
- Operational risks
- General economic conditions
- Military spending
- Foreign currency fluctuations
- Liquidity and access to capital resources
- Restrictive debt covenants

- Changing interest rates
- External business environment
- Warranty casualty claim losses
- Environmental matters
- Collective bargaining agreements

### **Additional Information and Continuous Disclosure**

This MD&A was prepared as of August 3, 2005. Updated information on the Company, including the annual information form, can be found on the SEDAR web site at [www.sedar.com](http://www.sedar.com).