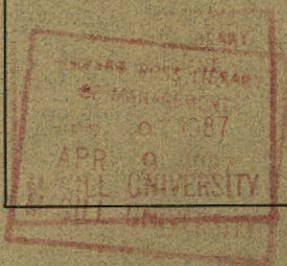


*The
Lumonics
Group*



*People,
Products
and Markets*



5-Year Financial Summary (thousands of Canadian dollars)

	1986	1985	1984	1983	1982
Operating Results:					
Sales	\$65,234	\$52,975	\$38,430	\$22,778	\$14,607
Net earnings (loss)					
- before extraordinary item	(1,995)	5,820	5,732	3,262	2,119
- after extraordinary item	(4,408)	2,680	5,732	3,262	2,119
Earnings (loss) per share* (dollars)					
- before extraordinary item	(.20)	.66	.70	.42	.35
- after extraordinary item	(.45)	.30	.70	.42	.35
Research and development	9,301	5,543	4,744	3,049	2,863
Financial data:					
Working capital	38,000	41,974	25,454	25,217	12,037
Current ratio	3.1:1	3.1:1	3.9:1	6.3:1	4.7:1
Fixed assets - net	19,081	20,374	9,839	4,489	4,088
Shareholders equity	71,465	75,359	44,989	35,527	22,160
Common share data* (thousands)					
Average number outstanding	9,891	8,811	8,140	7,826	6,072

*After giving retroactive effect to a 2 for 1 stock split on December 19, 1983.

Lumonics Inc. is a multi-national public corporation offering a variety of lasers and laser systems for marking, materials processing, scientific and medical applications. Founded in 1970, Lumonics is now one of the largest manufacturers of commercial laser based products in the world.

Lumonics is organized as a multi-national group of integrated companies. Each member company maintains an entrepreneurial style, while operating for mutual benefit with other companies in the group on marketing and technology interchange.

Lumonics stock is traded on the Toronto Stock Exchange under the symbol "LUM".

A Guide to Lumonics' Lasers

Type	Description	Applications
Carbon Dioxide (CO₂)	CO ₂ lasers utilize a mixture of gases (commonly Carbon-dioxide, Carbon, Monoxide, Helium and Nitrogen) of which Carbon-dioxide is the active laser molecule. The laser medium is excited by means of a continuous or pulsed electrical discharge to produce laser output in the infra-red spectrum at 10.6 microns. The continuous wave CO ₂ lasers are the most powerful of all types of lasers discussed here, producing kilowatts of average power.	Continuous wave CO ₂ lasers are used almost exclusively for cutting, drilling, welding and heat treating in industrial applications. The pulsed CO ₂ lasers are used for marking of electronic, semiconductor and consumer goods packages.
Solid State	Solid State lasers utilize a laser medium in which an active ion (Neodymium or Chromium) is present in a solid host material (Ruby, YAG or a special glass). The laser medium is in the form of a cylindrical rod which is excited by means of a flashlamp or arclamp. Laser emission is in the form of discrete lines in the visible and near infra-red spectral regions but are often shifted to shorter visible and ultra-violet wavelengths by non-linear optical techniques.	Principal applications are for materials processing (cutting, welding, drilling and marking), for scientific research in photochemistry, plasma physics and biology and for holography.
Excimer	Excimers utilize a mixture of a noble gas (Xenon, Krypton or Argon) with a halogen gas (Fluorine or Hydrogen Chloride), which is excited by an electrical discharge to produce stimulated emission at a series of discrete spectral lines in the ultra-violet region of the spectrum. The word "excimer" is a contraction of "excited-dimer" which is the state in which the gas molecule exists when laser emission occurs.	Principal applications are photochemistry, biology and spectroscopy. Emerging applications in materials processing, semiconductor manufacturing and medicine are of increasing importance.
Dye	Dye lasers utilize an organic dye, which has been dissolved in a liquid solvent, as the active material. The dye molecule is stimulated by absorbing light from either an excimer or YAG laser and emits laser light in the visible region of the spectrum. The emission wavelength of each dye may be scanned, or "tuned", across a range of some tens of nanometers by incorporating a wavelength selecting optical element into the dye laser resonator. Using a series of different dyes it is possible to access any part of the visible spectrum with intense, highly monochromatic light. Non-linear optical techniques extend this coverage to the ultra-violet region as well.	These lasers are used almost exclusively for scientific research, usually in the fields of spectroscopy, chemistry and biology.

To Our Shareholders

1986 turned out to be the most challenging year in the 16-year history of the Company. It was also a difficult year for the laser industry as a whole, with total commercial laser sales growing only 6% in 1986, the lowest rate of growth this decade.

For Lumonics it was a year of major investments in product development, new application development, market development and service and distribution. Re-organization and consolidation of operations, restructuring and strengthening of our management team and integration of a newly acquired U.S. subsidiary company were also accomplished.

Although we are reporting a net loss of \$4,408,000 on revenues of \$65,234,000, the first loss since 1971, it is important to note that it is primarily a result of the extraordinary and unusual costs of over \$5,000,000 associated with the restructuring of our operations. This is not indicative of a normal business pattern, nor does it have a serious impact on Lumonics' financial viability.

Certainly the bulk of the loss can be attributed to the very disappointing financial results of our most recently acquired subsidiary company, Photon Sources, Inc. which joined the Lumonics Group in December 1985.

Photon is a manufacturer of CO₂ lasers and laser systems for use in cutting, drilling, welding and heat treating of materials in the industrial marketplace. They bring a highly complementary and broad range of products to the Group, thereby extending Lumonics overall capabilities in industrial laser applications. Unfortunately, Photon experienced reduced order intake due to less favourable U.S. market conditions than originally envisaged and to stiffer competition, particularly in the Japanese market. This, coupled with unexpected operational difficulties, resulted in Photon incurring a substantial loss rather than meeting their forecasted profit.

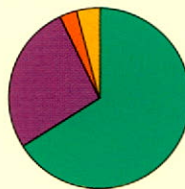
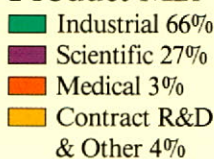
Photon's inability to achieve its financial forecasts, presented at the time of acquisition, became apparent at the mid-year point, at which time aggressive steps were taken to address their overall problems. These steps included the appointment of an experienced Chief Operating Officer from outside the Company, a 20% reduction in their total work force, consolidation of facilities, a write-down of product inventory and fixed assets, and a restructuring and strengthening of their management team.

As reported to you during the year, Photon's poor performance unfortunately occurred at a time when some of Lumonics' traditional product lines were also being hindered by a slow U.S. economy and depressed conditions in the semiconductor/electronics industry. Reduced order intake and downward pressure on prices had a negative effect on overall profitability as well.

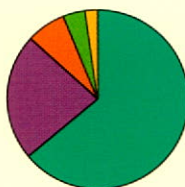
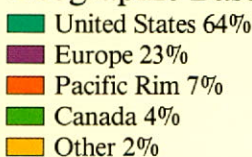
Sales

1985

Product Mix

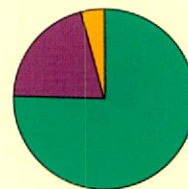
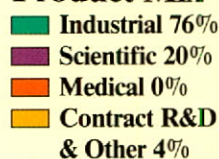


Geographic Base

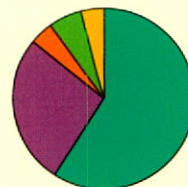
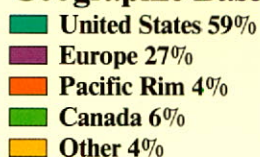


1986

Product Mix



Geographic Base



Despite these financial pressures, the Lumonics Group continued to support the long-term investment programs that are so vital to our future.

Strategic Investments

Although we could have improved our financial results by curtailing or deferring some of these market and product investments to a subsequent year, we believe the decision not to do so was absolutely correct for the long term positioning of the Company. Our investment in Research and Development during 1986 was \$9,300,000 or 14.2% of sales, a substantial 68% increase over 1985. Programs included the development of next generation laser products and systems, enhancement of existing products, and the investigation of new and wider applications for our scientific, medical and industrial lasers.

As a result of this investment in product innovation, we successfully launched a number of new lasers and systems during 1986. These are being enthusiastically received in the marketplace.

Materials Processing

Slightly more than 50% of our 1986 revenues were generated from the sale of industrial lasers and systems to manufacturers in the automotive, aerospace, electronic, appliance and other heavy manufacturing industries for welding, cutting, drilling and heat treating of materials.

The new JK 700 Series offers an unparalleled degree of control over all laser parameters to provide the highest precision in cutting, drilling and welding processes. The laser control interfaces are fully CNC and FMS compatible, taking maximum advantage of the sophisticated automation equipment available in factories of the future. The rugged construction of the JK 700 Series meets NEMA 12 standards for operation in even the harshest industrial environments and plug-in optical modules have eliminated the need for laser alignment.

The combination of the Multiflex fibre optics beam delivery with the 700 Series YAG laser can dramatically enhance the productivity and economic viability of many materials processing applications by allowing one laser to simultaneously serve up to eight work stations. The unique programmability of the 700 Series allows a different production task to be addressed at each work station with totally optimized process parameters.

With the addition of Photon's CW CO₂ products to the Group, Lumonics now offers manufacturers a broad choice of laser-based materials processing machines. During 1986, Photon's development efforts focussed on extending the power range of their new VFA[®] CW CO₂ series lasers from 600 watts to 2,000 watts, utilizing existing design concepts. Significant resources are being committed to value engineer these products and improve their overall reliability. In addition, the service organization has been strengthened to better serve our customers.

Lumonics is committed to sustaining its position as a significant supplier of industrial lasers and laser systems and to this end will continue to focus major efforts on developing new and appropriate products for emerging applications. One such example of this is in the area of excimer laser technology. Lumonics has invested heavily in the past in the development of excimer lasers for both scientific research and industrial applications. During 1986, we increased our investment significantly in the industrialization of excimer lasers, as we believe there is a promising future for this type of laser in the industrial marketplace.

Lumonics' demonstrated experience and reputation in supplying innovative and reliable industrial products, coupled with its significant market position in excimer lasers for scientific research applications, resulted in the winning of a \$1,500,000 order for a quantity of industrial excimer lasers. (We are constrained from disclosing the customer name and application.) As a consequence, we are very optimistic about this new area of opportunity for revenue growth and the market position Lumonics enjoys.

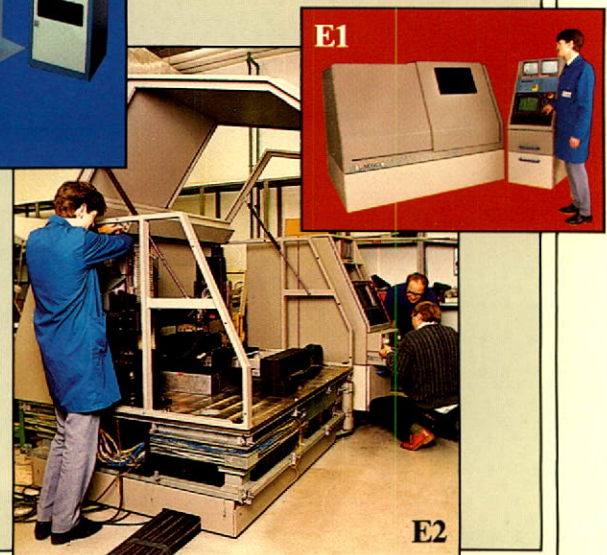
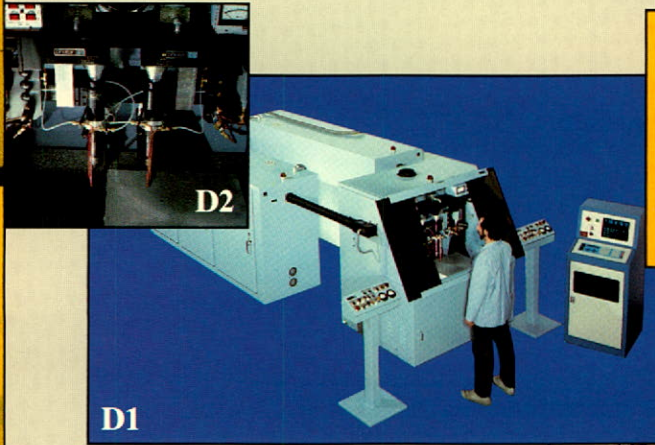
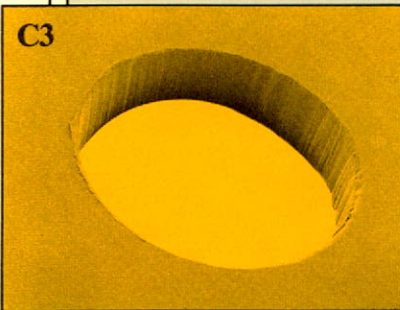
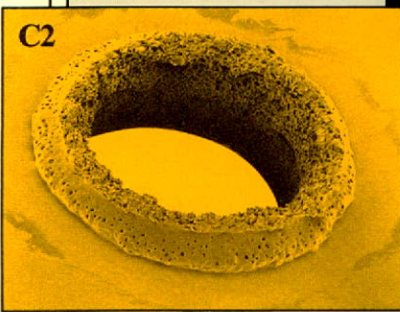
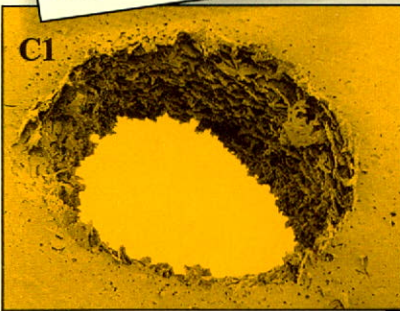
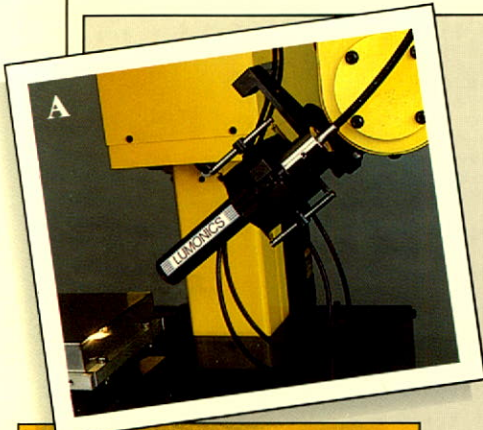
Although 1986 was not a good year for the industrial laser market in general, due to sales weakness in the U.S. machine tool and microelectronics industries, we believe Lumonics fared better than most, which is directly attributable to the strength of our technology, the capability to address and solve customer problems and a commitment to worldwide customer support.

Marking

Since pioneering the application of marking with CO₂ lasers ten years ago, Lumonics has expanded this part of its business to include a full line of both CO₂ and YAG laser-based systems, together accounting for over 25% of total revenues in 1986. In excess of 1,700 Lumonics' laser markers are currently installed throughout the world, marking everything from best before dates on consumer goods packages, to product identification codes on sophisticated electronics components. Despite some later market entrants with similar products, Lumonics enjoys a 60% world market share.

Investing in Materials Processing

Over half of this year's revenues were generated from sales of lasers and systems for materials processing. We are committing significant resources in this dynamic market area by developing new products for emerging applications, increasing our value engineering and further improving our already high product reliability. **A.** The sophisticated Multiflex fibre optics beam delivery system from a JK 700 Series laser uses robotics to weld a metal box. **B.** A JK 700 Series YAG laser and control unit. **C.** Microscope photos of holes drilled in a thin sheet of polymer film to compare the cutting capabilities of various lasers: [1] YAG laser, [2] CO₂ laser, [3] Excimer laser. The Excimer shows enormous potential for many materials processing applications. **D.** [1] Ceramic-substrate scribing system built for LasTec, Inc., uses dual Lumonics V505 CO₂ lasers to deliver separate beams [2] to a single workstation. This doubles the throughput rate while maximizing utilization of the available process area. **E.** [1] New JK 500 Series laser materials processing system. This particular unit is destined for the automated processing of combustion engine components for Rolls Royce. [2] A portion of the large JK systems production area with JK 500 systems in progress. **F.** This three-oven, glove-box laserwelding system built for Burroughs Corporation (Unisys) uses Lumonics' VFA 600 CO₂ laser to hermetically weld electronic components in a controlled atmosphere.



The fifth generation of Lumonics' CO₂ LaserMark® lasers, the 940, was introduced in May of 1986 at Semicon West, the U.S. semiconductor industry's major showcase. With the highest power and throughput of all available industrial marking lasers of its type, the 940 also features enhanced self diagnostics, microprocessor controls, and external communications to factory automation equipment. Service operations in the field can even be directed by Lumonics' factory based personnel using a remote diagnostic capability to communicate directly with the laser's control electronics. Market response has been very positive and shipments of this new model commenced in the fourth quarter.

The new BD-50 and BD-60 beam delivery systems, developed and introduced during 1986, have greatly increased our ability to address high speed, variable information marking applications. Using a proprietary technology that is dramatically superior to our previous techniques, the marking mask is accessed via software at up to 100 characters per second. This enables us to individually serialize parts, to mark test results on electronic components and to bar code parts at speeds that are six times faster than previously possible. Patent applications have been submitted on the technology involved.

Our System Six model, introduced late in 1985, is a low-cost, no frills system. It has been able to compete aggressively with ink marking systems in the consumer goods industry.

Lumonics is recognized as the undisputed leader in silicon wafer marking technology, with installations of YAG-based laser systems in nearly every major semiconductor manufacturing plant in the world. Recognizing the cyclical nature of the semiconductor industry, Lumonics has expanded its efforts in identifying other YAG marking opportunities. As a result, a family of general purpose marking systems has been developed and introduced in the market. Products within this group include the LightWriter™, a general purpose YAG-based laser marking system to make marks on a variety of materials including hardened metals; TagMark™, a turnkey system for marking metal tags that are attached to various items for identification; DiskMark™, a YAG system for marking computer discs; and WireMark, a YAG system for marking wires.

With our unmatched experience in laser marking technology, total commitment to customer satisfaction and significant ongoing investment in new products and applications, Lumonics believes it will maintain its market leadership position in this segment.

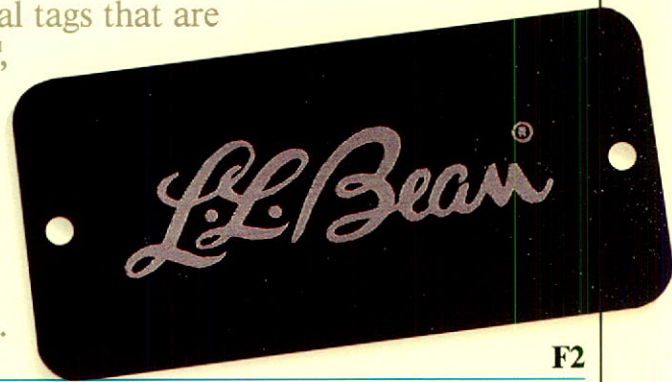
Scientific

Lumonics' scientific business represents about 20% of total revenues. We are an established supplier of CO₂, Excimer, Dye, YAG, Glass and Ruby lasers to scientists engaged in basic and applied research at universities, government and industrial laboratories throughout the world. These lasers are used in physics, chemistry, biology, biochemistry and engineering services as well as in special applications such as holography.

Research done with these products in our own and customers' laboratories helps provide the foundation for entrance into scientific, industrial and medical markets. One significant development in 1986 was the HyperTRAK 1000 module. It is used to expand the tunability of the HD-300™ dye laser deep into the ultraviolet spectral region which is of key interest to many photochemists and spectroscopists. The availability of this module has increased our market size, our market share and the value per unit in the market for tunable laser sources.

Medical

Although disappointed by the turn of events in the marketplace for our ophthalmic surgical system (discussed in our 1985 Annual Report), Lumonics remains committed to pursuing the application of our technology to the field of medicine with particular emphasis on cardio-

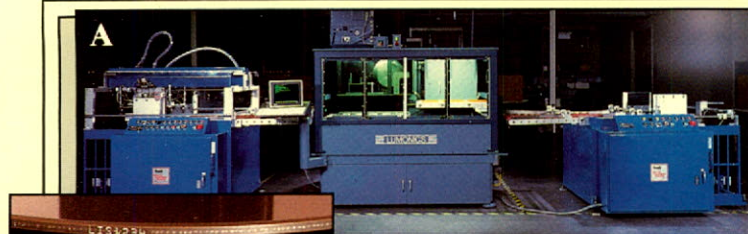


F2

Investing in Marking

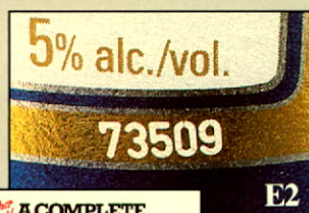
As the pioneers and continuing leaders in laser marking technology, Lumonics is totally committed to customer satisfaction and substantial ongoing investment in new products and applications.

A. The fully automated Model 7100 LaserMark system handles, codemarks and stacks printed circuit boards while they are still in multiboard panels. **B.** Rigid computer disks are edge-marked by a DiskMark YAG-based marking system. **C.** Barcoded carbon-steel wire marked with a YAG-based system shows good mark contrast with minimum surface penetration. **D.** A LaserMark 940 ad points out the advanced technology of this fifth generation CO₂-based marking system which features the highest power and throughput of all industrial lasers in its class. **E.** LaserMark System Six [1] was launched this year and budget-priced to compete head-on with ink marking in consumer goods applications such as [2] the batch coding of labels for a major brewery. **F.** [1] TagMark is a turnkey, YAG-based system for marking metal identification tags [2] the L.L. Bean tag shown opposite is marked by a similar YAG-based system. **G.** The Lumonics PCB Top Side Marker system uses the BD-55 beam delivery module interfaced to a LaserMark 940 CO₂ laser via computer to provide alphanumeric and bar code marking of printed circuit boards. **H.** BD-50 beam delivery systems are a proprietary technology which perform high speed, variable information marking applications up to six times faster than our existing systems. **I.** [1] Lumonics LightWriter YAG-based markers are now used by Intel Corp to mark and remark [2] all of their ceramic (and some plastic) integrated circuit packages at a rate of up to 32 characters per second.



The new LaserMark 940 laser marking system.
It's simply the best.

LUMONICS
We put the laser into marking



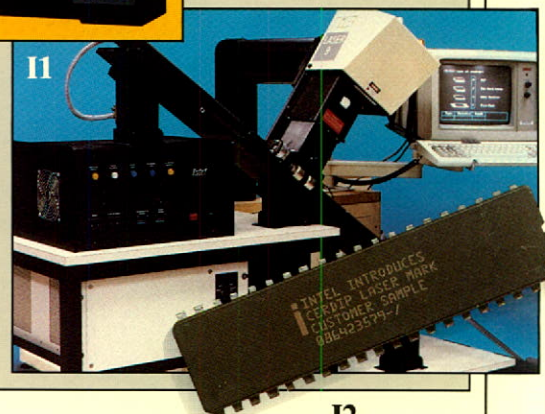
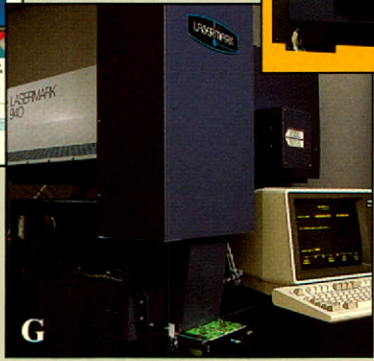
Another great LaserMark System Six

A COMPLETE LASERMARK SYSTEM FOR ONLY \$18,900

LUMONICS
We put the laser into marking

D

E1



vascular surgery, vision correction and endoscopy. During 1986, we continued to invest in related areas of joint research activity with leading hospitals and research institutions and are currently exploring possible strategic alliances with major medical firms.

Lumonics Software Ltd.

LSL was founded in 1985 to market our internally developed computerized manufacturing and financial control system. We extended the capability of this system during 1986 by integrating distribution software into the system. The package, originally written for the Hewlett-Packard 3000™ computers, was also released on Digital Equipment's VAX™ hardware.

Investment in Organization and Markets

During 1986 we undertook an aggressive restructuring and strengthening of our operations Company-wide. Although the reorganization proved to be more disruptive than originally envisaged, particularly to our sales effort in the second half of the year, the long-term strategic benefits far outweigh the short-term negative impact. We believe our customers will be better served, our opportunities in the marketplace expanded and the return to shareholders enhanced.

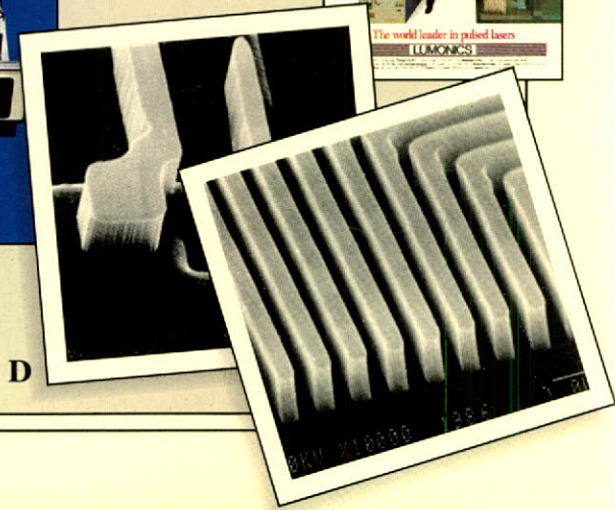
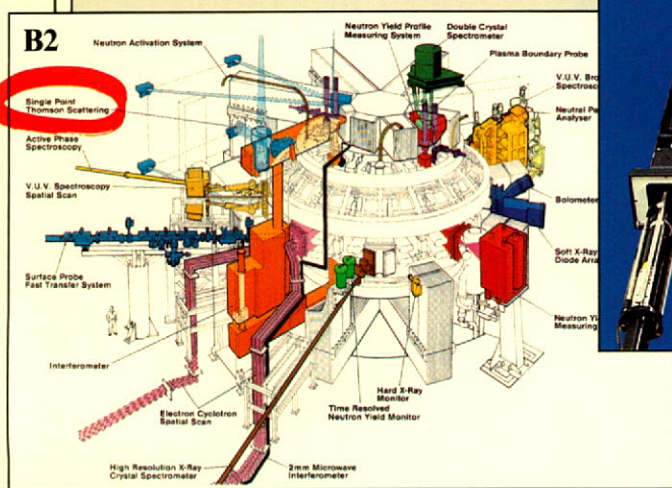
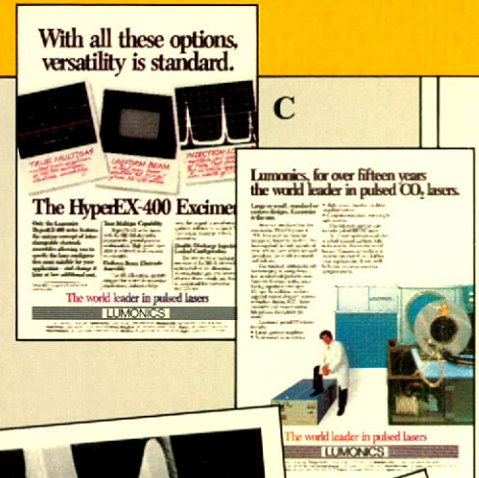
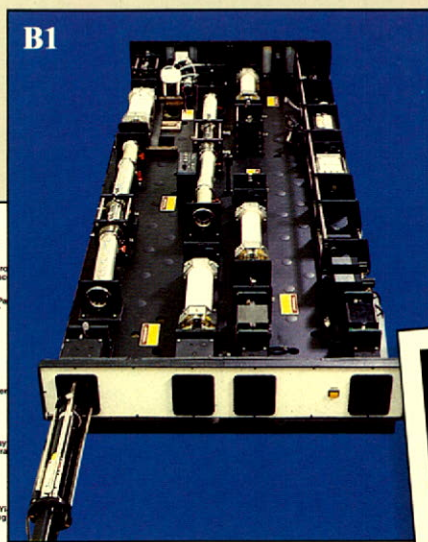
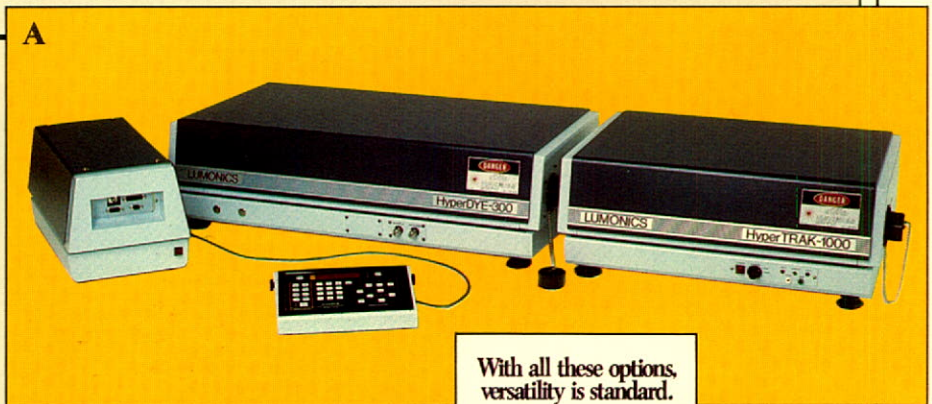
The highlights of these operating changes include:

- In the first quarter, we amalgamated our two North American marking product sales teams into a single unit reporting to Laser Identification Systems, Inc., our subsidiary company in Camarillo, California. We also announced that a similar move with the JK Lasers and Photon Sources materials processing sales organizations was planned.
- During the second and third quarters, we transferred all laser marking activities from Tempe, Arizona to our subsidiary company, Laser Identification Systems, Inc., Camarillo, California and those related to materials processing to Photon Sources, Inc., Livonia, Michigan. This action combined our forces into two much larger product centres, with greater marketing, engineering and operational resources. The result is a more economic and effective approach to our markets.
- In the third quarter, we decided to close Photon Sources' Ann Arbor, Michigan facility, reducing the number of their operating locations to three. We continue to review the possibility of consolidation of other Photon locations.
- In the fourth quarter, we decided as a Group, to change the name of all member companies to Lumonics as the common identity. In the United States, Laser Identification Systems, Inc. (LIS) of Camarillo, California was re-named Lumonics Marking Corp. and

Investing in Science

Research with Lumonics' broad range of products, undertaken in our own and customers' laboratories, helps provide the foundation for entrance into scientific, industrial and medical markets. **A.** The new HyperTRAK laser module expands the tunability of the HyperDYE laser deep into the ultra-violet. **B.** [1] Large pulse energy mode-locked Ruby laser supplied to the Joint European Torus (JET) in the UK as part of [2] a diagnostics system in the world's largest experiment to harness fusion for power generation. **C.** Advertising creates awareness of Lumonics' scientific product range and features. **D.** The deep ultra-violet output of a Lumonics HyperEX laser was used in a commercial photolithographic process to produce the sub-micron features shown in these integrated circuit photographs.*

*Photos courtesy of AT&T Bell Laboratories

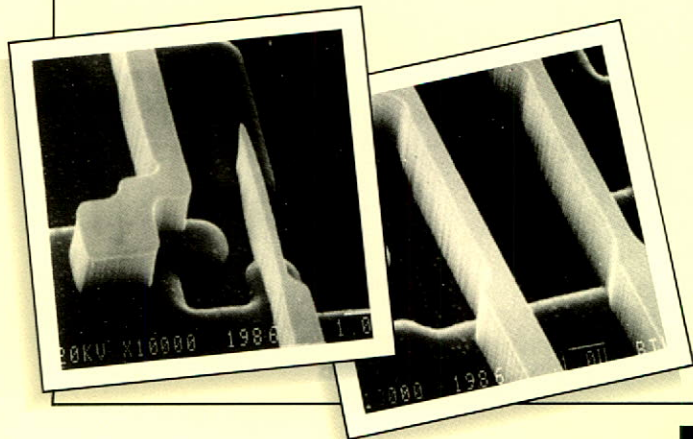


Photon Sources, Inc. of Livonia, Michigan became Lumonics Material Processing Corp. In Europe, JK Lasers Limited, Rugby, England, was re-named Lumonics Ltd., JK Lasers France SARL of Paris became Lumonics SARL; and JK Lasers Deutschland GmbH and Photon Sources GmbH, both of Munich, are being combined into one unit as Lumonics Deutschland GmbH. Other member names already utilizing the Lumonics identity remained unchanged.

The new common Lumonics identity emphasizes the positive interaction among the companies within the Group and reflects the enhanced support of all products on a worldwide basis.

- In the third quarter, the consolidation of our sales activities on a geographical basis was completed with the formation of a European Sales Division based out of Lumonics Ltd, in Rugby, England. This Division is now responsible for the sale and promotion of all Lumonics products throughout Europe.
- A network of new distributors in the Pacific Rim was established during the year to market the majority of Lumonics Group products. We also recruited our own personnel in the Pacific Rim to provide direct support to distributors and customers. Initial results from this increased investment are most encouraging, with a good level of new orders received in the fourth quarter.

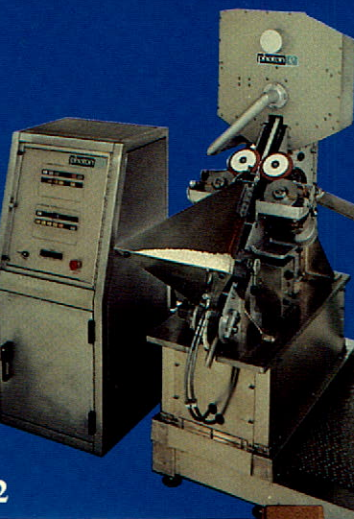
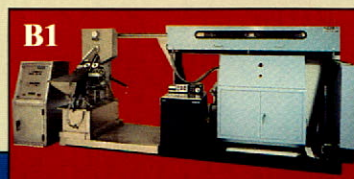
I also stated in last year's Annual Report that we planned to strengthen our top management team in 1986. This was accomplished with positive results.



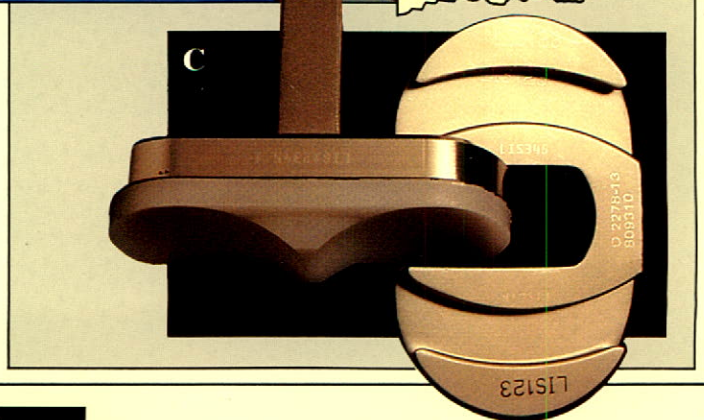
Investing in Medical Applications

Lumonics' commitment to the field of medicine continues in joint activities with leading hospitals, research institutions and major pharmaceutical and medical firms. We place particular emphasis on application of our technology in areas such as cardiovascular surgery, vision correction and endoscopy. **A.** Lumonics has provided unique custom-designed Excimer laser technology for experiments in cardiovascular surgery. **B.** An exciting new development in pharmaceutical products utilizes [1] a Lumonics V150 CO₂ laser system with [2] computer-controlled beam delivery and handling components to drill holes in tablets for timed release of medication. **C.** Medical implants marked with a Light-Writer YAG laser-based marking system as an applications experiment.

A



B2



Heart surgery on verge of laser revolution

Excerpts from two articles
by Cathy Campbell
Ottawa Citizen staff writer

It's a space-age affair of the heart. Once confined to blasting aliens in the imagination of science-fiction writers, lasers are about to take on a real killer — coronary artery disease.

This year, doctors say, is the year of the laser, expected to revolutionize human heart surgery.

The University of Ottawa heart institute, one of the world's leading centres of medical research, is pioneering the use of lasers in 1987.

“This is the leading edge, there is no question about that.”

The heart institute is adding an Excimer laser to its arsenal.

The Excimer laser, to be used in open heart surgery, will open up arteries and clean them out, vaporizing the clots.

It won't make coronary-artery bypass surgery unnecessary, but it could replace the painstaking method of clearing out clogged arteries.

The Excimer, valued at \$75,000 and designed by Lumonics Inc. of Kanata, in collaboration with doctors at the heart institute and scientists at the National Research Council, has been used only on pigs, whose cardiovascular system is similar to that of humans.

The Excimer laser, the only one of its kind, is being loaned to the heart institute for trials. If it's successful, Lumonics hopes to market it around the world.

Lasers have proven effective surgical tools in many other areas of medicine, especially eye surgery.

In August, Doug James was appointed Executive Vice-President and Chief Operating Officer, with Corporate responsibility for the day-to-day operation of all member companies. Doug has held a number of senior technical and management positions in Lumonics during the past 10 years including Vice-President and General Manager of Kanata Operations and Managing Director of Lumonics Ltd., Rugby, England.

Our Corporate Finance area was divided in two, with Dick Hall appointed to the position of Vice-President and Secretary Treasurer. Dick is a CGA and has been with Lumonics for the past 5 years in both line and Corporate staff positions. His responsibilities will cover all Corporate treasury activities, as well as involvement in legal and investor relations. Responsibility for internal financial planning, budgeting, performance measurement and asset management was assigned to Colin Avery, who joined the Corporate Office in August as Vice-President, Finance and Administration. Colin holds a CMA and MBA degree and has a broad-based international background and experience in the high technology and consumer industries.

Other realignment of responsibilities for current corporate personnel included the appointment of Dr. Jim Wright, co-founder of JK Lasers, to the position of Vice-Chairman. While continuing to operate out of Rugby, England, Jim has responsibility in the European sector for the fields of government, customer and investor relations. Jim continues to have both a local and corporate overview responsibility for our developing technologies on a worldwide basis.

At Corporate Office, Gordon Mauchel retired on September 1 as Chairman and I assumed his responsibilities along with my CEO duties at that time.

Subsequent to the year end, we were pleased to announce the appointment of Hugh MacDiarmid to the position of corporate President. He will be instrumental in determining the effectiveness of Research and Development programs and marketing strategies. Hugh has been a principal with McKinsey & Co., an international management consulting firm, and has been working with Lumonics for the past 8 months on several areas of long-term planning and strategy development. Hugh will continue to play a leading role in these areas and will also share responsibility with the rest of the Corporate team for overall results. Hugh graduated from Stanford University with an MBA degree and, in addition to his business consulting experience, has held marketing management positions in industry. Hugh's special skills and experience as a business strategist will be of tremendous value to Lumonics.

Based on our business opportunities in the Pacific Rim countries and our recent increased investment in this area, David Valley, who joined Lumonics in 1985 as Director of Corporate Marketing, was appointed Vice-President of Pacific Operations. David has extensive business experience including managing a joint venture in Japan.

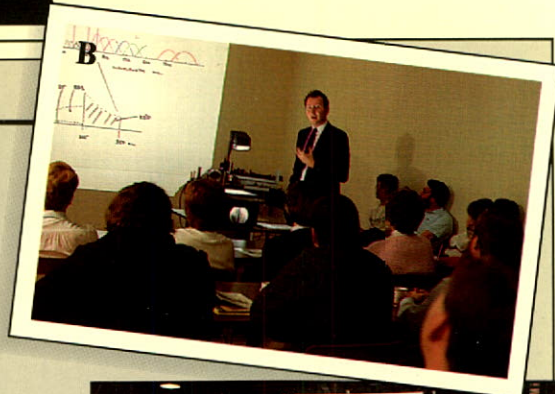
In August we appointed Jack McAllister as Executive Vice-President and Chief Operating Officer of Lumonics Material Processing Corp. Jack, who holds technical degrees in metallurgical science and chemistry and mathematics, brings a combination of broad industrial and direct laser materials processing industry management experience to the team.

In November Alastair Samson was recruited to the position of Managing Director Europe, responsible for all Lumonics Operations in Europe. Alastair holds an MBA degree and brings to the team substantial management experience gained in a variety of roles within Europe and Canada in both the commercial and military businesses.

Dr. Rollie McInnis joined Kanata Operations as Executive Director of Research and Engineering and was promoted to Vice-President and General Manager at year end. Rollie holds a Ph.D. degree in Engineering and has extensive experience at both the technical and general management levels.

Investing in the Future

In addition to our R&D commitments we employ an active policy of investment in our future: pursuing new markets and applications for our products; maintaining and improving our strong presence in existing markets; and cultivating our most important asset, our people. **A.** The new Lumonics Pacific Operations sales office in Tokyo, Japan. **B.** Employee awareness is encouraged through activities such as this new product seminar, and **C.** this employee's open house. **D.** Scientific and industrial trade shows provide direct contact with potential clients and increase our sensitivity to market trends.



1986 was certainly a year of change and transition for the Lumonics organization, both in people, structure and managerial working relationships. We enter 1987 confident that the capabilities are in place for long-term growth and profitability.

Outlook

The tremendous progress and accomplishment of the Lumonics Group during 1986 was somewhat obscured by the extraordinary and special costs associated with absorbing Photon Sources, restructuring our U.S. business and making heavy investments in marketing and sales as well as Research and Development. However, we have entered 1987 in a very strong operational condition. Our team of top notch people are capable of developing and directing the Company along its path of growth and future prosperity. The significant investments made in 1986 will bring positive results in 1987 and beyond. We are cautiously optimistic that demand will increase in all our market areas and that 1987 will show reasonable growth and profitability, albeit not until the second half of the year.

We are currently experiencing some improvement in the rate of order intake, which is partially attributable to the early signs of a turnaround in the semiconductor industry. However, until we have more reliable indications that this trend can continue, we will ensure that expenditures stay within prudent boundaries.

A time of change generally produces a lot of uncertainty and anxiety, therefore, a special thank you is extended to our customers, all Lumonics Group employees, our suppliers, our shareholders and our Directors for their understanding and support.

R.J. Atkinson
Chairman and Chief Executive Officer

March 2, 1987

Financial Review

1986 operating results are a consolidation of the full year's financial results of subsidiaries, Lumonics Corporation, Lumonics Ltd., Lumonics Marking Corp., Lumonics Material Processing Corp., Lumonics Pacific Co., Ltd. and Lumonics Software Ltd.

Sales

Sales in 1986 reached a new high for Lumonics at \$65,234,000 compared to \$52,975,000 in 1985, an increase of 23%. While sales of materials processing equipment increased, mainly because of the acquisition of Photon Sources, Inc. (December 1985), traditional sales were down as a result of the continued weakness in the electronic/semiconductor markets and United States capital equipment spending.

Sales by product (thousands of Canadian dollars)

	1986	%	1985	%
Industrial	\$49,494	76	\$34,873	66
Scientific	12,905	20	14,397	27
Medical	—	—	1,617	3
Contract R&D and Other	2,835	4	2,088	4
Total Corporate	\$65,234	100	\$52,975	100

It should be noted that sales derived from shipments of standard lasers and systems for use in medical applications are included in the industrial sales figure.

Gross Profit

Cost of goods sold at \$58,056,000 was 89% of sales compared to \$40,451,000 or 76% in 1985. This unfavourable variance is attributed to the poor operating results of our latest acquisition, Photon Sources, and the lower revenue from the higher margin sectors of our business. As a result, gross profit at \$7,178,000 compared unfavourably to last year at \$12,524,000, 11% of sales versus 24% in 1985.

Research and Development

The gross cost of research and development in 1986 amounted to \$9,301,000, a 68% increase over 1985 expenditures of \$5,543,000. Although 44% of the increase was due to the addition of Photon Sources, the company considered it prudent for the long term to maintain its high level commitment to the future as evidenced by the new and advanced products introduced during the year. R&D was 14% of sales in 1986 compared to 10% last year.

Government assistance and investment tax credits of \$1,730,000 were 19% of gross R&D compared to \$1,233,000 and 22% in 1985. The resultant net amount funded by the company for the year totalled \$7,569,000, 11.6% of sales, compared to \$4,284,000, 8.1% of sales in 1985.

Other Income and Expenses

Investment income, comprising interest income on money market investments and dividend income on floating rate preferred shares, was \$1,217,000 compared to \$1,328,000 last year. The decrease of 8% was mainly due to lower interest rates on the investments and a shift in the portfolio in the first half of the year to floating rate preferred shares (yielding tax free dividends) from money market instruments (yielding taxable interest).

Interest expense was \$1,359,000 during the year which included a large portion on Photon's debt assumed at acquisition and some less significant increases in borrowing at other locations. This represents an increase in expense of \$1,103,000 over last year's expense of \$256,000.

Unusual items of \$2,359,000 incurred in the year represented non-recurring investments in the corporate reorganization, start-up costs of direct marketing and distribution in Europe and the Pacific Rim and the write-down of the carrying value of inventories as a result of the rationalization and consolidation of U.S. businesses.



Recovery (Income Taxes)

Due to the unusual expenditures and the resultant loss for the year, a tax recovery of \$897,000 resulted which was net of taxes payable in other locations. No tax recovery was available on the operating loss, reorganization costs and asset write-downs associated with Photon.

(Loss) Income Before Extraordinary Item

The pre-extraordinary item loss for the year, at this level, was \$1,995,000 compared to a profit in 1985 of \$5,820,000.

Extraordinary Item

As a result of the decisions to transfer operations from Tempe, Arizona to Camarillo, California and Livonia, Michigan and to consolidate the Michigan facilities, extraordinary costs were incurred and provided for during the year in the amount of \$2,413,000, net of income taxes of \$435,000.

Net (Loss) Income

The net loss for the year, therefore, amounted to \$4,408,000 compared to a profit in 1985 of \$2,680,000. On 9,891,000 shares outstanding, this amounted to \$.20 before and \$.45 after the extraordinary item versus \$.30 earnings per share on 8,811,000 shares outstanding last year.

Share Data

LUM is the symbol under which the company's shares trade on The Toronto Stock Exchange. There were 1,832 registered shareholders holding 9,919,653 shares at December 31, 1986. Geographically, the shares were held 90% in Canada, 4% in the United States and 6% in the United Kingdom. Last year end there were 1,963 shareholders with 9,799,086 shares distributed 88% in Canada, 6% in the United States and 6% in the United Kingdom.

Price range of the common shares

	1986	1985
High	\$18.13	\$23.00
Low	\$ 8.25	\$16.13
Close	\$ 9.00	\$17.75
Volume of shares traded	2,933,295	2,746,696

Financial Position

Entering 1987 the financial position of the company remains very strong. Working capital totals \$38,000,000 with a ratio of current assets to current liabilities of 3.1:1. This compares to \$41,974,000 and a current ratio of 3.1:1 last year end.

The new Statement of Changes in Cash Position replaces the traditional Statement of Changes in Financial Position in compliance with recommendations of the Canadian Institute of Chartered Accountants. This statement itemizes all of the changes in the company's cash position during the year from operating, financing and investing activities.

The cash and short-term investments are comprised of cash in bank and short-term investments in bank term deposits, commercial paper and floating rate preferred shares.

The increase in the excess cost of subsidiaries over net assets acquired represents the final installment in the acquisition earn-out of Lumonics Marking Corp.

The book value per share of the company's stock at December 31, 1986 is \$7.20, a 6% decrease from \$7.69 last year end. The value of net tangible assets amounts to \$4.75 compared to \$5.48 one year ago.

Personnel

The number of personnel decreased 74 and 12% during the year to 540 compared to 614 at December 31, 1985. This decrease was mainly the result of the reorganization and consolidation of our United States operations. Based on the average number of employees for the year, sales per employee amounted to \$114,000 in 1986 compared to \$122,000 in 1985.

Auditors' Report

To the Shareholders of Lumonics Inc.:

We have examined the consolidated balance sheet of Lumonics Inc. as at December 31, 1986 and the consolidated statements of operations and retained earnings and of changes in cash position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at December 31, 1986 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Deloitte Haskins & Sells
Chartered Accountants
Ottawa, Ontario
February 20, 1987



Consolidated Financial Statements**Consolidated Balance Sheet**

December 31	1986	1985
	(thousands of Canadian dollars)	
Assets		
Current assets		
Cash and short-term investments	\$ 12,956	\$ 14,847
Accounts receivable	19,560	23,214
Inventories (Note 2)	20,608	20,595
Income taxes recoverable	1,605	2,358
Prepaid expense	1,045	708
	55,774	61,722
Property, plant and equipment (Note 3)	19,081	20,374
Deferred development costs (Note 4)	704	702
Excess cost of subsidiaries over net assets acquired (Note 5)	23,568	23,222
	\$ 99,127	\$ 106,020
Liabilities		
Current liabilities		
Bank indebtedness	\$ 6,450	\$ 5,027
Accounts payable and accrued charges	10,924	14,149
Current portion of long-term debt	400	572
	17,774	19,748
Long-term debt (Note 6)	8,688	8,918
Deferred income taxes (Note 9)	1,200	1,995
	27,662	30,661
Shareholders' Equity		
Share capital (Note 7)	57,469	56,391
Retained earnings	13,575	17,983
Accumulated foreign currency translation adjustment	421	985
	71,465	75,359
	\$ 99,127	\$ 106,020

Approved by the Board: A.V. Castledine, Director

R.J. Atkinson, Director

Consolidated Statement of Operations and Retained Earnings

Year ended December 31	1986	1985
	(thousands of Canadian dollars)	
Sales	\$65,234	\$ 52,975
Cost of goods sold	58,056	40,451
Gross profit	7,178	12,524
Research and development costs — net (Note 8)	7,569	4,284
(Loss) income from operations	(391)	8,240
Other income (expenses)		
Investment income	1,217	1,328
Interest expense	(1,359)	(256)
Unusual items (Note 10)	(2,359)	—
(Loss) income before income taxes and extraordinary item	(2,892)	9,312
Recovery (income taxes) (Note 9)	897	(3,492)
(Loss) income before extraordinary item	(1,995)	5,820
Extraordinary item (Note 11)	(2,413)	(3,140)
Net (loss) income	(4,408)	2,680
Retained earnings, beginning of year	17,983	15,303
Retained earnings, end of year	\$13,575	\$ 17,983
Earnings per common share		
(Loss) earnings before extraordinary item	\$ (.20)	\$.66
Extraordinary item	(.25)	(.36)
Net (loss) earnings	\$ (.45)	\$.30
Average number of common shares outstanding (thousands)	9,891	8,811

Consolidated Statement of Changes in Cash Position

Year ended December 31	1986	1985
	(thousands of Canadian dollars)	
Increase (decrease) in cash and short-term investments resulting from		
Operating activities		
(Loss) income before extraordinary item	\$ (1,995)	\$ 5,820
Items not affecting cash		
Depreciation and amortization	2,854	1,537
Amortization of excess cost of subsidiary over net assets acquired	602	328
Deferred income taxes	(795)	154
	666	7,839
Changes in non-cash working capital balances		
Accounts receivable	3,055	(4,406)
Inventories	(13)	(3,558)
Accounts payable and accrued charges	(3,107)	3,728
Income taxes	753	(3,733)
Foreign currency translation adjustment	(83)	(399)
Other	(337)	(67)
	934	(596)
Financing activities		
Issue of common shares	1,078	25,637
Reduction of long-term debt	(402)	(4,423)
	676	21,214
Investing activities		
Net non-cash assets of acquired business	—	(13,191)
Additions to fixed assets	(1,255)	(5,144)
Deferred development costs	(308)	(344)
Additional consideration on purchase of Lumonics Marking Corp.	(948)	(956)
Extraordinary item (Note 11)	(2,413)	(3,140)
	(4,924)	(22,775)
Decrease in cash and short-term investments	(3,314)	(2,157)
Cash and short-term investments (net of bank indebtedness), beginning of year	9,820	11,977
Cash and short-term investments (net of bank indebtedness), end of year	\$ 6,506	\$ 9,820

Notes to the Consolidated Financial Statements

December 31, 1986

(tabular amounts in thousands of Canadian dollars)

1. Significant accounting policies

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles, and reflect the following policies:

Basis of consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries Lumonics Ltd. (formerly JK Lasers Limited), Lumonics Marking Corp. (formerly Laser Identification Systems, Inc.), Lumonics Corporation, Lumonics Material Processing Corp. (formerly Photon Sources, Inc.), and Lumonics Pacific K.K. Also included is a 70%-owned subsidiary, Lumonics Software Ltd.

Short-term investments

Short-term investments are carried at the lower of cost and net realizable value.

Inventories

Inventories are valued on the following basis:

Finished goods — at the lower of cost and net realizable value.
Work-in-process and raw materials — at the lower of cost and replacement cost.

Property, plant and equipment

Property, plant and equipment are stated at cost. Buildings, machinery and equipment are predominantly depreciated using the diminishing-balance method.

Excess cost of subsidiaries over net assets acquired

The excess cost of subsidiaries over net assets acquired is amortized on a straight-line basis over a period of forty years from date of acquisition.

Government assistance

Grant amounts resulting from government assistance programs are recorded in the accounts on the following basis:

Capital grants related to capital expenditures are reflected as a reduction of the costs of such assets.

Operating grants related to current period expenditures on research and development are recorded as a reduction of expenses at the time the eligible expenses are incurred.

Translation of foreign currencies

Foreign currency accounts in Lumonics Inc. and the accounts of Lumonics Corporation and Lumonics Pacific K.K., integrated foreign subsidiaries, are translated to Canadian dollars on the following basis:

Monetary assets and monetary liabilities — at the rate of exchange prevailing at the year end. Non-monetary assets (and related depreciation and amortization) and non-monetary liabilities — at the rates of exchange prevailing when the assets were acquired or the liabilities assumed. Revenue and expenses (other than depreciation and amortization) — at a rate approximating the rates of exchange prevailing on the dates of the transactions. Gains and losses on translation of foreign currencies are included in income.

The accounts of Lumonics Ltd., Lumonics Marking Corp. and Lumonics Material Processing Corp., all self-sustaining foreign subsidiaries, are translated to Canadian dollars on the following basis:

Assets and liabilities — at the rate of exchange prevailing at the year end. Revenue and expenses (including depreciation and amortization) — at a rate approximating the rates of exchange prevailing on the dates of the transactions. Adjustments arising from the translation of foreign currency are deferred and included in Accumulated Foreign Currency Translation Adjustment, a separate component of shareholders' equity.

2. Inventories

	1986	1985
Raw materials	\$ 9,681	\$11,249
Work-in-process	8,495	8,302
Finished goods	2,432	1,044
	\$20,608	\$20,595

3. Property, plant and equipment

	Depreciation Rates	1986	1985
Land		\$ 2,716	\$ 2,736
Buildings	1 - 5%	12,491	12,044
Machinery and equipment	20 - 30%	11,996	13,328
		27,203	28,108
Less accumulated depreciation		8,122	7,734
		\$ 19,081	\$20,374

Depreciation of plant and equipment expensed during the year amounted to \$2,548,000 (1985 - \$1,194,000).

4. Deferred development costs

	1986	1985
Balance, beginning of year	\$ 702	\$ 676
Amounts deferred in year	308	344
Amortization	(306)	(318)
	\$ 704	\$ 702

Additions are amortized on a straight-line basis over a three-year period.

5. Excess cost of subsidiaries over net assets acquired

	1986	1985
Cost	\$25,048	\$24,100
Less accumulated amortization	1,480	878
	\$23,568	\$23,222

Notes to the Consolidated Financial Statements

6. Long-term debt

	1986	1985
National Bank of Detroit term loan, interest at 6.75% through December 31, 1987 and at a rate based upon either LIBOR or the U.S. prime rate thereafter, due December 31, 1988. The loan may be repaid after one year at the option of the Company, secured by the net assets of Lumonics Material Processing Corp. with a book value of \$3,513,000 and short-term investments of \$4,000,000.	\$ 6,902	\$ 6,712
Industrial Development Authority promissory notes due in installments of \$14,000 and \$5,000 each month through to March 31, 1992 and March 31, 1989 respectively, secured by land, building and equipment with a book value of \$1,600,000. Interest is payable at 75% - 80% of the prime rate of the First Interstate Bank of Arizona, N.A.	1,027	1,188
Mortgage notes, repayable in blended monthly installments of \$9,660 through to 1991 and 1997 with interest rates of 8.75% and 9.75%, secured by land, building and equipment with a book value of \$2,060,000.	826	874
Other	333	716
	9,088	9,490
Less current portion	400	572
	\$ 8,688	\$ 8,918

All of the above loans are negotiated in United States dollars.

Interest on long-term debt during the year amounted to \$919,000 (1985 — \$105,000). The principal amounts due in each of the next five years are:

1987	\$ 400
1988	7,264
1989	301
1990	286
1991	504

7. Share capital

	1986	1985
Authorized		
An unlimited number of common shares		
Outstanding and fully paid		
Common - 9,919,653 (1985 - 9,799,086)	\$57,469	\$56,391

During the year common shares were issued as follows:

	1986	1985
Exercise of employee stock options		
- 75,835 shares for cash (1985 - 141,976 shares)	\$ 424	\$ 1,094
Issued to former principals of Lumonics Marking Corp.		
- 44,732 shares (1985 - 44,732 shares)	654	654
Private placement		
- (1985 — 1,400,000 shares for cash)	—	23,889
	\$ 1,078	\$25,637

Stock options

At December 31, 1986, options to employees to purchase 718,308 common shares were outstanding and are exercisable at prices ranging from \$3.25 to \$13.34 for a total consideration of \$7,610,723.

Of the stock options outstanding, 391,168 shares may be purchased in 1987, 105,410 in 1988, 95,710 in 1989, 66,610 in 1990 and 59,410 in 1991.

8. Research and development costs

	1986	1985
Research and development costs	\$ 9,301	\$ 5,543
Amortization of deferred development costs	306	318
	9,607	5,861
Development costs deferred	(308)	(344)
	9,299	5,517
Investment tax credits	(813)	(716)
Other governments' assistance	(917)	(517)
	\$ 7,569	\$ 4,284

9. Income taxes

The effective tax rate differs from the statutory combined rates of 50% due to the manufacturing and processing tax reduction, inventory credits and a deduction from taxable income for share issue expenses.

Deferred income taxes relate primarily to claiming capital cost allowances for income tax purposes in excess of depreciation and amortization charged in the financial statements, and to claiming deferred development costs for income tax purposes in the year they are incurred.

At December 31, 1986 a U.S. subsidiary has tax losses carried forward of approximately U.S. \$8,300,000 available to reduce future years' taxable income and investment tax credits of approximately U.S. \$170,000 available to reduce future years' taxes payable. These amounts expire in the years 1998 through 2000. No tax benefit has been recognized in these consolidated financial statements in relation to the above items.

Notes to the Consolidated Financial Statements

10. Unusual items

During the year the company recorded the following unusual items of a non-recurring nature:

a) Costs associated with the corporate reorganization	\$ 752
b) Start-up costs associated with direct marketing and distribution operations in Europe and the Pacific Rim	700
c) Write down of carrying value of inventories in a U.S. subsidiary	907
	\$ 2,359

11. Extraordinary item

	1986	1985
Provision for loss resulting from the discontinuance and the relocation of operations in the United States, less income taxes of \$435,000	\$2,413,000	\$ —
Write down of investment in ophthalmic lasers, less income taxes of \$2,460,000	\$ —	\$3,140,000

12. Litigation

The Company is currently the defendant in two actions alleging patent infringement, one in Canada and one in the United States. In both cases, the plaintiffs are various persons including Gordon Gould, Refac International Limited, and Patlex Corporation. Both Refac and Patlex have an interest in certain patents originally issued to Mr. Gould.

In 1983, the United States Patent Office ordered the patent under litigation in the United States be re-examined and at the present time all claims in that patent are under rejection. The plaintiffs are however following various appeal routes and no early resolutions are expected.

The Canadian action is proceeding slowly through the discovery phase and is not expected to go to trial until late 1987 or 1988.

It remains the Company's opinion that neither patent under litigation is valid. In the event of an adverse judgement in either or both actions, it is reasonable to believe that license arrangements could be negotiated and that such arrangements would have no material long-term adverse effect on the Company.

13. Statement of changes in cash position

The method of presentation adopted for the Statement of Changes in Cash Position has been changed in the current year in accordance with the revised requirements of the Canadian Institute of Chartered Accountants. Cash position is defined as cash and cash equivalents, such as short-term investments, net of any current bank indebtedness. Previously, financial position was defined as working capital. Certain of the prior year's comparative figures have been reclassified to conform to these definitions and method of presentation.

14. Segmented information

The Company's activities represent one industry segment, manufacture and sale of laser systems, and are conducted in three main geographic segments, Canada, United States and Europe.

Export sales of the Canadian operation are as follows:

	1986	1985
United States	\$ 8,906	\$ 12,170
Europe	1,791	2,858
Other	2,886	3,150
	\$ 13,583	\$ 18,178

	Canada	United States	Europe	Eliminations	Consolidated
Sales from geographic segments	\$11,015	\$38,528	\$15,691	\$ —	\$65,234
Transfers between geographic segments	5,635	342	4,653	(10,630)	—
Total revenue	\$16,650	\$38,870	\$20,344	\$(10,630)	\$65,234
Segment operating income	\$ 2,184	\$ 2,156	\$ 3,691	\$ (853)	\$ 7,178
Research and development					(7,569)
Investment income					1,217
Interest expense					(1,359)
Unusual items					(2,359)
Income tax recovery					897
(Loss) before extraordinary item					(1,995)
Extraordinary item					(2,413)
Net (loss)					\$ (4,408)
Total assets	\$65,594	\$37,834	\$15,229	\$(19,530)	\$99,127

Corporate Information

Directors and Corporate Officers

Robert J. Atkinson†*

Chairman and Chief Executive Officer Lumonics Inc.

Colin R. Avery*

Vice-President, Finance and Administration Lumonics Inc.

Allan R. Buchanan†

President Buchanan Consulting

Douglas C. Cameron†

President Noranda Enterprise Limited

Allan V. Castledine†

Chairman Davidson Partners Limited

Charles J. Gardner, Q.C.†

Partner Goldberg, Shinder, Gardner Kronick & Tavel

Richard E. Hall*

Vice President and Secretary Treasurer Lumonics Inc.

Douglas J. James†*

Executive Vice President and Chief Operating Officer Lumonics Inc.

R. Timothy Kenny†

President Noranda Forest Inc.

Gordon A. Mauchel†

Business Consultant

Philip R. Schmidt†*

Vice President Lumonics Inc. and President Lumonics Marking Corp.

James K. Wright†*

Vice Chairman Lumonics Inc. and Chairman Lumonics Ltd.

†Director

*Officer

Auditors

Deloitte Haskins & Sells
Ottawa, Ontario

Transfer Agents

The Canada Trust Company
Toronto, Ontario

Stock Exchange Listing

The Toronto Stock Exchange
Symbol — LUM

Solicitors

Goldberg, Shinder, Gardner
Kronick & Tavel
Ottawa, Ontario

Tory, Tory, DesLauriers &
Binnington
Toronto, Ontario

Bankers

Canadian Imperial Bank of
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Ottawa, Ontario

Corporate Office

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Other

Contact the foregoing geographical centres for information on local Lumonics offices, distributors and representatives.

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*The Annual Meeting
of the Shareholders
of Lumonics Inc.
will be held
at 4:00 p.m.
on Thursday,
May 7, 1987,
in the Rideau Room
of the Four Seasons Hotel,
Ottawa, Ontario, Canada*

ANNUAL REPORT

