INFOSYS TECHNOLOGIES LTD
Form 6-K
October 28, 2004

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United States Securities and Exchange Commission

Washington, D.C. 20549

FORM 6-K

Report of Foreign Issuer

Pursuant to Rule 13a-16 or 15d-16 of the Securities Exchange Act of 1934

For the quarter ended September 30, 2004

Commission File Number: 333-72195

INFOSYS TECHNOLOGIES LIMITED

*(Exact name of Registrant as specified in its charter)*

Not Applicable
*(Translation of Registrant s name into English)*

Bangalore, Karnataka, India
*(Jurisdiction of incorporation or organization)*

Electronics City, Hosur Road, Bangalore, Karnataka, India 560 100. +91-80-2852-0261
*(Address of principal executive offices)*

Indicate by check mark registrant files or will file annual reports under cover Form 20-F or Form 40-F.

Form 20-F þ  Form 40-F o

Indicate by check mark whether the registrant by furnishing the information contained in this Form is also thereby furnishing the information to the Commission pursuant to Rule 12g 3-2(b) under the Securities Exchange Act of 1934

Yes o  No þ

If Yes is marked, indicate below the file number assigned to registrant in connection with Rule 12g 3-2(b).

Not Applicable

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Currency of Presentation and Certain Defined Terms

In this Quarterly Report, references to U.S. or United States are to the United States of America, its territories and its possessions. References to India are to the Republic of India. References to $ or dollars or U.S. dollars are to the le currency of the United States and references to Rs. or rupees or Indian rupees are to the legal currency of India. Our financial statements are presented in Indian rupees and translated into U.S. dollars and are prepared in accordance with United States Generally Accepted Accounting Principles, or U.S. GAAP. References to Indian GAAP are to Indian Generally Accepted Accounting Principles. References to a particular fiscal year are to our fiscal year ended

March 31 of such year.

All references to we, us, our, Infosys or the Company shall mean Infosys Technologies Limited. Infosys is a trademark of Infosys Technologies Limited in the United States and India. All other trademarks or tradenames used in this Quarterly Report are the property of their respective owners.

Except as otherwise stated in this Quarterly Report, all translations from Indian Rupees to U.S. dollars are based on the noon buying rate in the City of New York on September 30, 2004, for cable transfers in Indian rupees as certified for customs purposes by the Federal Reserve Bank of New York which was Rs. 45.91 per $1.00. No representation is made that the Indian rupee amounts have been, could have been or could be converted into U.S. dollars at such a rate or any other rate. Any discrepancies in any table between totals and sums of the amounts listed are due to rounding. Information contained in our website, www.infosys.com, is not part of this Quarterly Report.

Forward-looking Statements May Prove Inaccurate

In addition to historical information, this Quarterly Report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The forward-looking statements contained herein are subject to certain risks and uncertainties that could cause actual results to differ materially from those reflected in the forward-looking statements. Factors that might cause such differences include but are not limited to, those discussed in the section entitled Management s Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this report. Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect management s analysis only as of the date hereof. In addition, readers should carefully review the other information in this Quarterly Report and in the Company s periodic reports and other documents filed with the Securities and Exchange Commission ( SEC ) from time to time.

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Part I Financial Information

Item 1. Financial Statements

INFOSYS TECHNOLOGIES LIMITED AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

*(Dollars in millions)*

| | AS OF | |
|---|---|---|
| | **March 31, 2004** (1) | **September 30, 2004 (Unaudited)** |
| **ASSETS** | | |
| ***Current Assets*** | | |
| Cash and cash equivalents | $ 445 | $ 335 |
| Investment in liquid mutual fund units | 218 | 210 |
| Trade accounts receivable, net of allowances | 150 | 202 |
| Deferred tax assets | | 2 |
| Prepaid expenses and other current assets | 36 | 30 |
| Unbilled revenue | 24 | 29 |
| *Total current assets* | 873 | 808 |
| Property, plant and equipment, net | 228 | 263 |
| Goodwill | 8 | 7 |
| Intangible assets, net | 2 | 1 |
| Deferred tax assets | 7 | 7 |
| Other assets | 14 | 22 |
| **Total Assets** | $1,132 | $ 1,108 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| ***Current Liabilities*** | | |
| Accounts payable | $ 1 | $ 2 |
| Client deposits | 15 | 9 |
| Other accrued liabilities | 99 | 101 |
| Income taxes payable | 22 | 28 |
| Unearned revenue | 15 | 22 |
| *Total current liabilities* | 152 | 162 |

| | | |
|---|---|---|
| *Non-current liabilities* | | |
| Preferred stock of subsidiary | 22 | 20 |
| Other non-current liabilities | 5 | 5 |
| ***Stockholders Equity*** | | |
| Common stock, $0.16 par value | | |
| 300,000,000 equity shares authorized as of September 30, 2004 | | |
| Issued and outstanding - 266,564,224 and 267,860,670 equity shares as of | | |
| March 31, 2004 and September 30, 2004 respectively (See Note 2.11) | 9 | 31 |
| Additional paid-in capital | 157 | 188 |
| Accumulated other comprehensive income | 39 | (15) |
| Retained earnings | 748 | 717 |
| Total stockholders equity | 953 | 921 |
| **Total Liabilities and Stockholders Equity** | $1,132 | $ 1,108 |

*(1) March 31, 2004 balances were obtained from audited financial statements*

*See accompanying notes to the unaudited consolidated financial statements*

UNAUDITED CONSOLIDATED STATEMENTS OF INCOME

*(Dollars in millions except share and per share data)*

| | **Three months ended September 30,** | | **Six months ended September 30,** | |
|---|---|---|---|---|
| | **2003** | **2004** | **2003** | **2004** |
| **Revenues** | $ 251 | $ 379 | $ 484 | $ 713 |
| Cost of revenues | 142 | 214 | 275 | 401 |
| **Gross profit** | 109 | 165 | 209 | 312 |
| Operating Expenses: | | | | |
| Selling and marketing expenses | 18 | 26 | 35 | 50 |
| General and administrative expenses | 20 | 30 | 38 | 56 |
| Amortization of stock compensation expense | | | 1 | |
| Amortization of intangible assets | 3 | | 4 | 1 |
| Total operating expenses | 41 | 56 | 78 | 107 |

| | | | | |
|---|---|---|---|---|
| **Operating income** | 68 | 109 | 131 | 205 |
| Other income | 10 | 6 | 16 | 6 |
| **Income before income taxes** | 78 | 115 | 147 | 211 |
| Provision for income taxes | 13 | 18 | 24 | 31 |
| **Net income** | $ 65 | $ 97 | $ 123 | $ 180 |
| **Earnings per equity share** | | | | |
| Basic | $ 0.25 | $ 0.36 | $ 0.47 | $ 0.68 |
| Diluted | $ 0.24 | $ 0.35 | $ 0.46 | $ 0.66 |
| **Weighted average equity shares used in computing earnings per equity share (See Note 2.11)** | | | | |
| Basic | 262,364,112 | 266,262,865 | 262,349,472 | 265,781,580 |
| Diluted | 265,650,900 | 272,121,905 | 264,979,408 | 271,186,823 |

*See accompanying notes to the unaudited consolidated financial statements*

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INFOSYS TECHNOLOGIES LIMITED AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME

*(Dollars in millions)*

| | Common stock | | Additional | | Accumulated other | Deferred | | Total |
|---|---|---|---|---|---|---|---|---|
| | Shares | Par value (See Note 2.11) | paid-in capital | Comprehensive income | Comprehensive income | stock compensation | Retained earnings | stockholders equity |
| **Balance as of March 31, 2003** | 264,972,312 | $ 9 | $ 127 | | $ (32) | $ (3) | $ 525 | $ 626 |
| Common stock issued | 103,576 | | 1 | | | | | 1 |
| Cash dividends | | | | | | | (23) | (23) |
| Amortization of compensation related to stock option grants | | | | | | 2 | | 2 |
| Comprehensive income | | | | | | | | |
| Net income | | | | $ 123 | | | 123 | 123 |
| Other comprehensive income | | | | | | | | |
| Translation adjustment | | | | 25 | 25 | | | 25 |
| Comprehensive income | | | | $ 148 | | | | |
| **Balance as of September 30, 2003** | 265,075,888 | $ 9 | $ 128 | | $ (7) | $ (1) | $ 625 | $ 754 |
| **Balance as of March 31, 2004** | 266,564,224 | $ 9 | $ 157 | | $ 39 | | $ 748 | $ 953 |
| Common stock issued | 1,296,446 | | 27 | | | | | 27 |
| Cash dividends | | | | | | | (189) | (189) |
| Income tax benefit arising on exercise of stock options | | | 4 | | | | | 4 |
| Stock split effected in the form of a stock dividend (See Note | | 22 | | | | | (22) | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| 2.11) | | | | | | | | |
| Comprehensive income | | | | | | | | |
| Net income | | | | $ 180 | | | 180 | 180 |
| Other comprehensive income | | | | | | | | |
| Translation adjustment | | | | (54) | (54) | | | (54) |
| Comprehensive income | | | | $ 126 | | | | |
| **Balance as of September 30, 2004** | 267,860,670 | $31 | $ 188 | | $ (15) | | $ 717 | $ 921 |

*See accompanying notes to the unaudited consolidated financial statements*

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INFOSYS TECHNOLOGIES LIMITED AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

*(Dollars in millions)*

| | Six months ended September 30, | |
|---|---|---|
| | **2003** | **2004** |
| **OPERATING ACTIVITIES:** | | |
| Net income | $ 123 | $ 180 |
| **Adjustments to reconcile net income to net cash provided by operating activities** | | |
| Depreciation | 20 | 25 |
| Amortization of intangible assets | 4 | 1 |
| Provision for investments | 1 | |
| Deferred taxes | 1 | (2) |
| Amortization of stock compensation expense | 2 | |
| **Changes in assets and liabilities** | | |
| Trade accounts receivable | (16) | (60) |
| Prepaid expenses and other current assets | (6) | 5 |
| Unbilled revenue | 2 | (7) |
| Income taxes | 10 | 9 |
| Accounts payable | | 1 |
| Client deposits | | (6) |
| Unearned revenue | 2 | 8 |
| Other accrued liabilities | 12 | 7 |
| **Net cash provided by operating activities** | 155 | 161 |
| **Investing Activities:** | | |
| Expenditure on property, plant and equipment | (29) | (72) |
| Loans to employees | 2 | 1 |
| Non-current deposits with corporations | | (8) |
| Investment in liquid mutual fund units | (98) | (24) |
| Redemption of liquid mutual fund units | | 20 |
| **Net cash used in investing activities** | (125) | (83) |
| **Financing Activities:** | | |
| Proceeds from issuance of common stock | 1 | 27 |
| Payment of dividends | (22) | (189) |

| | | |
|---|---|---|
| **Net cash used in financing activities** | (21) | (162) |
| Effect of exchange rate changes on cash | 13 | (26) |
| Net increase/(decrease) in cash and cash equivalents during the period | 22 | (110) |
| Cash and cash equivalents at the beginning of the period | 354 | 445 |
| **Cash and cash equivalents at the end of the period** | $ 376 | $ 335 |
| Supplementary information: | | |
| Cash paid towards taxes | $ 13 | $ 24 |

Stock split effected in the form of a stock dividend (See Note 2.11)

*See accompanying notes to the unaudited consolidated financial statements*

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INFOSYS TECHNOLOGIES LIMITED AND SUBSIDIARIES

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. Company overview and significant accounting policies

1.1 Company overview

Infosys Technologies Limited (Infosys) along with its majority owned and controlled subsidiary, Progeon Limited (Progeon), and wholly-owned subsidiaries Infosys Technologies (Australia) Pty. Limited (Infosys Australia), Infosys Technologies (Shanghai) Co. Limited (Infosys China) and Infosys Consulting Inc (Infosys Consulting) is a leading global information technology, or IT, services company. The company provides end-to-end business solutions that leverage technology thus enabling its clients to enhance business performance. The company provides solutions that span the entire software life cycle encompassing consulting, design, development, re-engineering, maintenance, systems integration and package evaluation and implementation. In addition, the company offers software products for the banking industry and business process management services.

1.2 Basis of preparation of financial statements

The consolidated financial statements include Infosys and its subsidiaries (the company) and are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). Infosys consolidates entities in which it owns or controls more than 50% of the voting shares. The results of acquired businesses are included in the consolidated financial statements from the date of acquisition. Inter-company balances and transactions are eliminated on consolidation.

Interim information presented in the consolidated financial statements has been prepared by the management without audit and, in the opinion of management, includes all adjustments of a normal recurring nature that are necessary for the fair presentation of the financial position, results of operations and cash flows for the periods shown, and is in accordance with GAAP. These financial statements should be read in conjunction with the consolidated financial statements and related notes included in the company s annual report on Form 20-F for the fiscal year ended March 31, 2004.

1.3 Use of estimates

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities, the disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates and assumptions are used for, but not limited to accounting for costs and efforts expected to be incurred to complete performance under software development arrangements, allowance for uncollectible accounts receivable, future obligations under employee benefit plans, provisions for post-sales customer support, the useful lives of property, plant, equipment and intangible assets and income tax valuation allowances. Actual results could differ from those estimates. Appropriate changes in estimates are made as management become aware of changes in circumstances surrounding the estimates. Changes in estimates are reflected in the financials statements in the period in which changes are made and, if material, their effects are disclosed in the notes to the consolidated financial statements.

1.4 Revenue recognition

The company derives revenues primarily from software development and related services, licensing of software products and from business process management services. Arrangements with customers for software development and related services are either on a fixed price, fixed timeframe or on a time and material basis.

Revenue on time-and-material contracts is recognized as the related services are performed and revenue from the end of the last billing to the balance sheet date is recognized as unbilled revenues. Revenue from fixed-price, fixed-time frame contracts is recognized as per the percentage-of-completion method. Guidance has been drawn from paragraph 95 of Statement of Position (SOP) 97-2, Software Revenue Recognition, to account for revenue from fixed price arrangements for software development and related services in conformity with SOP 81-1. The input (efforts expended) method has been used to measure progress towards completion as there is a direct relationship between input and productivity. Provisions for estimated losses, if any, on uncompleted contracts are recorded in the period in which such losses become probable based on the current contract estimates. Costs and earnings in excess of billings are classified as unbilled revenue while billings in excess of costs and earnings are classified as unearned revenue. Maintenance revenue is recognized ratably over the term of the underlying maintenance agreement.

The company provides its clients with a fixed-period warranty for corrections of errors and telephone support on all its fixed-price, fixed-time frame contracts. Costs associated with such support services are accrued at the time related revenues are recorded and included in cost of revenues. The company estimates such costs based on historical experience and estimates are reviewed on a periodic basis for any material changes in assumptions and likelihood of occurrence.

In accordance with SOP 97-2, license fee revenues are recognized when persuasive evidence of an arrangement exists, delivery has occurred, the license fee is fixed and determinable, and the collection of the fee is probable. Arrangements to deliver software products generally have three elements: license, implementation and Annual Technical Services (ATS). The company has applied the principles in SOP 97-2 to account for revenue from these multiple element arrangements. Vendor specific objective evidence of fair value (VSOE) has been established for ATS. VSOE is the price charged when the element is sold separately. When other services are provided in conjunction with the licensing arrangement, the revenue from such contracts are allocated to each component of the contract using the residual method, whereby revenue is deferred for the undelivered services and the residual amounts are recognized as revenue for delivered elements. In the absence of an established VSOE for implementation, the entire arrangement fee for license and implementation is recognized as the implementation is performed. Revenue from client training, support and other services arising due to the sale of software products is recognized as the services are performed. ATS revenue is recognized ratably over the period in which the services are rendered.

Revenues from business process management and other services are recognized on both, the time-and-material and fixed-price, fixed-time frame basis. Revenue on time-and-material contracts is recognized as the related services are rendered. Revenue from fixed-price, fixed-time frame contracts is recognized as per the proportional performance method using an output measure of performance.

When the company receives advances for services and products, such amounts are reported as client deposits until all conditions for revenue recognition are met.

1.5 Cash and cash equivalents

The company considers all highly liquid investments with a remaining maturity at the date of purchase / investment of three months or less and that are readily convertible to known amounts of cash to be cash equivalents. Cash and cash equivalents comprise cash, and cash on deposit with banks, and corporations.

1.6 Investments

Investments in non-readily marketable equity securities of other entities where the company is unable to exercise significant influence and for which there are no readily determinable fair values are recorded at cost. Declines in value judged to be other than temporary are included in earnings.

Investment securities designated as available for sale are carried at their fair value. Fair value is based on quoted market prices. Temporary unrealized gains and losses, net of the related tax effect are reported as a separate component of stockholders equity until realized. Realized gains and losses and declines in value judged to be other than temporary on available for sale securities are included in earnings.

The cost of securities sold is based on the specific identification method. Interest and dividend income are recognized when earned.

1.7 Property, plant and equipment

Property, plant and equipment are stated at cost, less accumulated depreciation. The company depreciates property, plant and equipment over their estimated useful lives using the straight-line method. The estimated useful lives of assets are as follows:

| | | | |
|---|---|---|---|
| Buildings | 15 years | Vehicles | 5 years |
| Plant and equipment | 5 years | Computer equipment | 2-5 years |
| Furniture and fixtures | 5 years | | |

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The cost of software purchased for internal use is accounted under SOP 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. Deposits paid towards the acquisition of these long lived assets outstanding at each balance sheet date and the cost of assets not put to use before such date are disclosed under Capital work-in-progress . Costs of improvements that substantially extend the useful life of particular assets are capitalized. Repairs and maintenance cost are charged to earnings when incurred. The cost and related accumulated depreciation are removed from the consolidated financial statements upon sale or disposition of the asset.

The company evaluates the recoverability of these assets whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying value of the assets exceeds the fair value of the assets. Assets to be disposed are reported at the lower of the carrying value or the fair value less the cost to sell.

1.8 Business combinations

Business combinations have been accounted using the purchase method under the provisions of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard (SFAS) No. 141, Business Combinations. Cash and amounts of consideration that are determinable at the date of acquisition are included in determining the cost of the acquired business.

1.9 Goodwill

Goodwill represents the cost of the acquired businesses in excess of the fair value of identifiable tangible and intangible net assets purchased. Goodwill is tested for impairment on an annual basis, relying on a number of factors including operating results, business plans and future cash flows. Recoverability of goodwill is evaluated using a two-step process. The first step involves a comparison of the fair value of a reporting unit with its carrying value. If the carrying amount of the reporting unit exceeds its fair value, the second step of the process involves a comparison of the fair value and carrying value of the goodwill of that reporting unit. If the carrying value of the goodwill of a reporting unit exceeds the fair value of that goodwill, an impairment loss is recognized in an amount equal to the excess. Goodwill of a reporting unit shall be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of the reporting unit below its carrying amount.

1.10 Intangible assets

Intangible assets are amortized over their respective individual estimated useful lives on a straight-line basis. The estimated useful life of an identifiable intangible asset is based on a number of factors including the effects of obsolescence, demand, competition, and other economic factors (such as the stability of the industry, and known technological advances), and the level of maintenance expenditures required to obtain the expected future cash flows from the asset.

Intangible assets are evaluated for recoverability whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying value of the assets exceeds the fair value of the assets.

1.11 Research and development

Research and development costs are expensed as incurred. Software product development costs are expensed as incurred until technological feasibility is achieved. Research and development costs and software development costs incurred under contractual arrangements with customers are accounted as cost of revenues.

1.12 Foreign currency

The functional currency of the company is the Indian rupee (Rs.). The functional currency for Infosys Australia, Infosys China and Infosys Consulting is the respective local currency. The consolidated financial statements are reported in U.S. dollars. The translation of Rs. to U.S. dollars is performed for balance sheet accounts using the exchange rate in effect at the balance sheet date and for revenue, expense and cash-flow items using a monthly average exchange rate for the respective periods. The gains or losses resulting from such translation are included in Other comprehensive income , a separate component of stockholders equity. The translation of the financial statements of foreign subsidiaries from the local currency to the functional currency of the company is also performed on the same basis.

Foreign-currency denominated assets and liabilities are translated into the functional currency at exchange rates in effect at the balance sheet date. The gains or losses resulting from such translation are included in earnings. Transaction gains or losses realized upon settlement of foreign currency transactions are included in determining net income for the period in which the transaction is settled. Revenue, expense and cash-flow items denominated in foreign currencies are translated into the functional currency using the exchange rate in effect on the date of the transaction.

1.13 Earnings per share

Basic earnings per share is computed by dividing net income for the period by the weighted average number of equity shares outstanding during the period. Diluted earnings per share is computed by dividing net income by the diluted weighted average number of equity shares outstanding during the period. The dilutive effect of convertible securities is reflected in diluted earnings per share by application of the if-converted method. Diluted earnings per share reflects the potential dilution from equity shares issuable through employee stock options and preferred stock of subsidiary.

If the number of common shares outstanding increases as a result of a stock dividend or stock split or decreases as a result of a reverse stock split, the computations of basic and diluted EPS are adjusted retroactively for all periods presented to reflect that change in capital structure. If such changes occur after the close of the reporting period but before issuance of the financial statements, the per-share computations for that period and any prior-period financial statements presented are based on the new number of shares.

1.14 Income taxes

Income taxes are accounted for using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities, and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect of changes in tax rates on deferred tax assets and liabilities is recognized as income in the period that includes the enactment date. The measurement of deferred tax assets is reduced, if necessary, by a valuation allowance for any tax benefits of which future realization is not more likely than not. Changes in valuation allowance from period to period are reflected in the income statement of the period of change. Deferred taxes are not provided on the undistributed earnings of subsidiaries outside India where it is expected that the earnings of the foreign subsidiary will be permanently reinvested. Tax benefits earned on exercise of employee stock options in excess of compensation charged to earnings are credited to additional paid in capital. The income tax provision for the interim period is based on the best estimate of the effective tax rate expected to be applicable for the full fiscal year.

1.15 Fair value of financial instruments

In determining the fair value of its financial instruments, the company uses a variety of methods and assumptions that are based on market conditions and risks existing at each balance sheet date. The methods used to determine fair value include discounted cash flow analysis and dealer quotes. All methods of assessing fair value result in general approximation of value, and such value may never actually be realized.

1.16 Concentration of risk

Financial instruments that potentially subject the company to concentrations of credit risk consist principally of cash equivalents, trade accounts receivable, investment securities and hedging instruments. By nature, all such financial instruments involve risk, including the credit risk of non-performance by counterparties. In management s opinion, as of September 30, 2004 there was no significant risk of loss in the event of non-performance of the counterparties to these financial instruments, other than the amounts already provided for in the financial statements, if any. Exposure to credit risk is managed through credit approvals, establishing credit limits and monitoring procedures. The company s cash resources are invested with corporations, financial institutions and banks with high investment grade credit ratings. Limitations are established by the company as to the maximum amount of cash that may be invested with any such single entity.

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1.17 Derivative financial instruments

On April 1, 2001, the company adopted SFAS 133, Accounting for Derivative Instruments and Hedging Activities as amended, when the rules became effective for companies with fiscal years ending March 31. The company enters into foreign exchange forward contracts where the counter party is generally a bank. The company purchases foreign exchange forward contracts to mitigate the risk of changes in foreign exchange rates on accounts receivable and forecasted cash flows denominated in certain foreign currencies. Although these contracts constitute hedges from an economic perspective, they do not qualify for hedge accounting under SFAS 133, as amended. Any derivative that is either not designated a hedge, or is so designated but is ineffective per SFAS 133, is marked to market and recognized in earnings immediately.

1.18 Retirement benefits to employees

1.18.1 Gratuity

In accordance with the Payment of Gratuity Act, 1972, Infosys provides for gratuity, a defined benefit retirement plan (the Gratuity Plan) covering eligible employees. The Gratuity Plan provides a lump sum payment to vested employees at retirement, death, incapacitation or termination of employment, of an amount based on the respective employee s salary and the tenure of employment.

Liabilities with regard to the Gratuity Plan are determined by actuarial valuation. The company fully contributes all ascertained liabilities to the Infosys Technologies Limited Employees Gratuity Fund Trust (the Trust). In case of Progeon, contributions are made to the Progeon Employees Gratuity Fund Trust. Trustees administer contributions made to the Trust and contributions are invested in specific designated instruments as permitted by law and investments are also made in mutual funds that invest in the specific designated instruments.

1.18.2 Superannuation

Certain employees of Infosys are also participants in a defined contribution plan. The company makes monthly contributions under the superannuation plan (the Plan) to the Infosys Technologies Limited Employees Superannuation Fund Trust based on a specified percentage of each covered employee s salary. The company has no further obligations to the Plan beyond its monthly contributions. Certain employees of Progeon are also eligible for superannuation benefit. Progeon makes monthly provisions under the superannuation plan based on a specified percentage of each covered employee s salary. Progeon has no further obligations to the superannuation plan beyond its monthly provisions which are periodically contributed to a trust fund, the corpus of which is invested with the Life Insurance Corporation of India.

1.18.3 Provident fund

Eligible employees of Infosys receive benefits from a provident fund, which is a defined contribution plan. Both the employee and the company make monthly contributions to the provident fund plan equal to a specified percentage of the covered employee s salary. The company contributes a part of the contributions to the Infosys Technologies Limited Employees Provident Fund Trust. The remaining portion is contributed to the government administered provident fund.

In respect of Progeon, eligible employees receive benefits from a provident fund, which is a defined contribution plan. Both the employee and Progeon make monthly contributions to this provident fund plan equal to a specified percentage of the covered employee s salary. Amounts collected under the provident fund plan are deposited in a government administered provident fund.

1.19 Stock-based compensation

The company applies the intrinsic value-based method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations including FASB Interpretation No. 44, Accounting for Certain Transactions involving Stock Compensation an interpretation of APB Opinion No. 25, issued in March 2000, to account for its fixed stock option plans. Under this method, compensation expense is recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. SFAS 123, Accounting for Stock-Based Compensation, established accounting and disclosure requirements using a fair value-based method of accounting for stock-based employee compensation plans. As allowed by SFAS 123, the Company has elected to continue to apply the intrinsic value-based method of accounting described above, and has adopted the disclosure requirements of SFAS 148, Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123. All stock options issued to date have been accounted as a fixed stock option plan.

The following table illustrates the effect on net income and earnings per share if the company had applied the fair value recognition provisions of SFAS Statement No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

*(Dollars in millions except share and per share data)*

| | **Six months ended September 30,** | |
|---|---|---|
| | **2003** | **2004** |
| Net income, as reported | $ 123 | $ 180 |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects | 2 | |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (29) | (16) |
| Pro forma net income | $ 96 | $ 164 |
| Earnings per share: (See Note 2.11) | | |
| Basic - as reported | $ 0.47 | $ 0.68 |
| Basic - pro forma | $ 0.36 | $ 0.62 |
| Diluted - as reported | $ 0.46 | $ 0.66 |
| Diluted - pro forma | $ 0.36 | $ 0.61 |

The fair value of each option is estimated on the date of grant using the Black-Scholes model with the following assumptions:

| | **Six months ended September 30,** | |
|---|---|---|
| | **2003** | **2004** |

| | | |
|---|---|---|
| Dividend yield % | 0.2% | |
| Expected life | 1-5 years | |
| Risk free interest rate | 5.2%-5.7% | |
| Volatility | 60-75% | — |

There have been no grants of stock options by Infosys during the six months ended September 30, 2004.

1.20 Dividends

Final dividends on common stock are recorded as a liability on the date of declaration by the stockholders and interim dividends are recorded as a liability on the date of declaration by the board of directors.

1.21 Reclassifications

Certain reclassifications have been made to conform prior period data to the current presentations.

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2. Notes to the consolidated financial statements

2.1 Cash and cash equivalents

The cost and fair values for cash and cash equivalents are as follows:

*(Dollars in millions)*

| | As of | |
|---|---|---|
| | **March 31, 2004** | **September 30, 2004** |
| Cost and fair values | | |
| Cash and bank deposits | $397 | $ 289 |
| Deposits with corporations | 48 | 46 |
| | $445 | $ 335 |

Cash and cash equivalents include restricted cash balances in the amount of $1 million as of September 30, 2004. The restrictions are primarily on account of unclaimed dividends.

2.2 Trade accounts receivable

Trade accounts receivable as of March 31, 2004 and September 30, 2004, net of allowance for doubtful accounts of $3 million and $4 million respectively, amounted to $150 million and $202 million. The age profile of trade accounts receivable, net of allowances is given below.

*In %*

| | As of | |
|---|---|---|
| | **March 31, 2004** | **September 30, 2004** |
| **Period (in days)** | | |
| 0 - 30 | 69.7 | 76.4 |
| 31 - 60 | 21.6 | 11.2 |
| 61 - 90 | 4.7 | 7.6 |
| More than 90 | 4.0 | 4.8 |
| | 100.0 | 100.0 |

2.3 Business combination

On January 2, 2004 the company acquired, for cash, 100% of the equity in Expert Information Services Pty. Limited, Australia for $14 million. The purchase consideration includes $3 million retained in escrow for representations and warranties made by the selling shareholders. The acquired company was renamed Infosys Technologies (Australia) Pty. Limited . There is further contingent consideration payable to the sellers subject to continued employment and meeting of defined operating and financial performance parameters. The contingent consideration is being accounted as compensation.

The purchase price, including transaction costs, has been allocated based on management s estimates and independent appraisals of fair values as follows:

*(Dollars in millions)*

| **Component** | **Purchase price allocated** |
|---|---|
| Plant and equipment | $ 1 |
| Net current assets | 5 |
| Non current liabilities | (1) |
| Customer contracts | 2 |
| Goodwill | 7 |
| Total purchase price | $ 14 |

The identified customer contracts intangible is being amortized over a period of two years beginning January 2004, being management s estimate of the useful life of the asset. The company believes that the acquisition resulted in recognition of goodwill primarily because of the acquired company s market position, skilled employees, management strength and potential to serve as a platform for enhancing business opportunities in Australia. The goodwill has been allocated to the Australia reporting unit.

2.4 Prepaid expenses and other current assets

Prepaid expenses and other current assets consist of the following:

*(Dollars in millions)*

| | **As of** | |
|---|---|---|
| | **March 31, 2004** | **September 30, 2004** |
| Rent deposits | $ 3 | $ 4 |

| | | |
|---|---|---|
| Security deposits with service providers | 2 | 3 |
| Loans to employees | 13 | 13 |
| Prepaid expenses | 13 | 10 |
| Other current assets | 5 | |
| | $ 36 | $ 30 |

Other current assets represent advance payments to vendors for the supply of goods and rendering of services and marked to market gains on foreign exchange forward contracts. Deposits with service providers relate principally to leased telephone lines and electricity supplies.

2.5 Property, plant and equipment net

Property, plant and equipment consist of the following:

*(Dollars in millions)*

| | As of | |
|---|---|---|
| | **March 31, 2004** | **September 30, 2004** |
| Land | $ 21 | $ 24 |
| Buildings | 106 | 121 |
| Furniture and fixtures | 59 | 64 |
| Computer equipment | 107 | 117 |
| Plant and equipment | 65 | 70 |
| Capital work-in-progress | 48 | 55 |
| | 406 | 451 |
| Accumulated depreciation | (178) | (188) |
| | $ 228 | $ 263 |

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Depreciation expense amounted to $19 million and $25 million for the six months ended September 30, 2003 and 2004 respectively. The amount of third party software (for internal use) expensed during the six months ended September 30, 2003 and 2004 was $ 8 million and $11 million respectively.

2.6 Intangible assets

During fiscal 2003, the company acquired the intellectual property rights to the Trade IQ product from IQ Financial Systems Inc., USA for its banking business unit. The consideration paid amounted to $4 million and was recorded as an intangible asset and amortized over two years being management s initial estimate of the useful life. In the same fiscal year, the company also entered into an agreement for transferring the intellectual property rights in a commercial software application product used in the design of high performance structural systems. The company is required to pay the committed consideration of $5 million within ten years of the contract date. The ownership of intellectual property in the product transfers to the company on remittance of the consideration. The committed consideration of $5 million was recorded as an intangible asset and was being amortized over management s estimate of the useful life, which was initially 5 years. During fiscal 2004, management revised its estimates of the remaining useful life of these intangible assets and the recorded values of these intangible assets have been completely amortized as of March 31, 2004. Amortization of the cost of these products aggregated to $4 million for the six months ended September 30, 2003.

The identified customer contracts intangible arising from the purchase price allocation of Expert Information Services Pty. Limited, Australia is being amortized over a period of two years beginning January 2004, being management s estimate of the useful life of the asset. The unamortized balance as of September 30, 2004 was $1 million.

2.7 Other assets

Other assets consist of the following:

*(Dollars in millions)*

| | As of | |
|---|---|---|
| | **March 31, 2004** | **September 30, 2004** |
| Non current portion of loans to employees | $ 14 | $ 12 |
| Non current deposits with corporations | | 8 |
| Others | | 2 |
| | $ 14 | $ 22 |

2.8 Related parties

The company provides loans to eligible employees in accordance with policy. No loans have been made to employees in connection with equity issues. The employee loans are repayable over fixed periods ranging from 1 to 100 months. The annual rates of interest at which the loans have been made to employees vary between 0% through 4%. Loans

aggregating $27 million and $25 million were outstanding as of March 31, 2004 and September 30, 2004.

The required repayments of employee loans outstanding as of September 30, 2004 are as detailed below.

*(Dollars in millions)*

| Year ending September 30, | Repayment |
|---|---|
| 2005 | $13 |
| 2006 | 3 |
| 2007 | 2 |
| 2008 | 3 |
| 2009 | 1 |
| Thereafter | 3 |
| | $25 |

The estimated fair values of related party receivables amounted to $24 million and $21 million as of March 31, 2004 and September 30, 2004 respectively. These amounts have been determined using available market information and appropriate valuation methodologies. Considerable judgment is required to develop these estimates of fair value. Consequently, these estimates are not necessarily indicative of the amounts that the company could realize in the market.

2.9 Other accrued liabilities

Other accrued liabilities comprise the following:

*(Dollars in millions)*

| | As of | |
|---|---|---|
| | March 31, 2004 | September 30, 2004 |
| Accrued compensation to staff | $71 | $ 51 |
| Accrued dividends | | 1 |
| Provision for post sales client support | 1 | 5 |
| Withholding taxes payable | 9 | 13 |
| Provision for expenses | 16 | 22 |
| Retainage | 1 | 3 |
| Marked to market loss accrued on foreign exchange forward contracts | | 4 |
| Others | 1 | 2 |
| | $99 | $ 101 |

2.10 Employee post-retirement benefits

2.10.1 Gratuity

The components of the benefit costs are:

*(Dollars in millions)*

| | Six months ended September 30 | |
|---|---|---|
| | **2003** | **2004** |
| Components of net benefit cost | | |
| Service cost | 2 | 3 |
| Interest cost | 1 | 1 |
| Expected return on assets | (1) | (1) |
| Net gratuity cost | 2 | 3 |

The company had previously disclosed in the financial statements for the year ended March 31, 2004 that the company expects to contribute approximately $5 million to the gratuity

trusts during fiscal 2005. As of September 30, 2004, $3 million of contributions have been made. Company presently anticipates contributing an additional $3 million to the gratuity trusts in fiscal 2005 for a total of $6 million.

2.10.2 Superannuation

The company contributed $1 million and $2 million to the superannuation plan in the six months ended September 30, 2003 and 2004, respectively.

2.10.3 Provident fund

The company contributed $3 million and $4 million to the provident fund in the six months ended September 30, 2003 and 2004, respectively.

2.11 Stockholders equity

Infosys has only one class of capital stock referred to as equity shares. On June 12, 2004, the members of the company approved a 3:1 bonus issue on the equity shares of the company. The bonus issue has the nature of a stock split effected in the form of a stock dividend with 3 additional shares being issued for every share held. Bonus shares have been allotted to shareholders on July 3, 2004. The computations of basic and diluted EPS has been adjusted retroactively for all periods presented to reflect the change in capital structure. All references in these financial statements to number of shares, per share amounts and market prices of equity shares are retroactively restated to reflect stock splits made. The rights of equity shareholders are set out below.

2.11.1 Voting

Each holder of equity shares is entitled to one vote per share. The equity shares represented by American Depositary Shares (ADS) carry similar rights to voting and dividends as the other equity shares. Each ADS represent one underlying equity share.

2.11.2 Dividends

Should the company declare and pay dividends, such dividends will be paid in Indian Rupees. Indian law mandates that any dividend be declared out of distributable profits only after the transfer of a specified percentage of net income computed in accordance with current regulations to a general reserve. Moreover, the remittance of dividends outside India is governed by Indian law on foreign exchange and is subject to applicable taxes.

2.11.3 Liquidation

In the event of liquidation of the company, the holders of common stock shall be entitled to receive any of the remaining assets of the company, after distribution of all preferential amounts. The amounts will be in proportion to the number of equity shares held by the stockholders.

2.11.4 Stock options

There are no voting, dividend or liquidation rights to the holders of options issued under the company s stock option plans.

2.12 Preferred stock of subsidiary

Infosys holds a majority of the equity share capital of Progeon. The equity shares have been issued to Infosys as per the terms of the stock subscription agreement signed in April 2002, between Infosys, Citicorp International Finance Corporation (CIFC) and Progeon. 12,250,000 equity shares have been issued to Infosys in each of April 2002 and March 2004 for an aggregate consideration approximating $5 million. Pursuant to the agreement, CIFC has been issued 4,375,000 (0.0005%) cumulative convertible preference shares in each of June 30, 2002 and March 31, 2004 for an aggregate consideration approximating $20 million.

Unless earlier converted pursuant to an agreement in this behalf between the company and CIFC, these cumulative convertible preference shares shall automatically be converted into equity shares upon the earlier of, (i) one year prior to Progeon s initial public offering (IPO) date, (ii) June 30, 2005, or (iii) at the holder s option, immediately upon the occurrence of any Liquidity Event.; The term Liquidity Event includes any of a decision of the Board of Directors of the company to make an IPO, merger, reconstruction, capital reorganization or other event which, in the sole opinion of the holder of the convertible preference shares, amounts to an alteration in the capital structure of the company. Each preference share is convertible into one equity share, par value $0.20 each. Indian law requires redemption of preference shares within a period of 20 years.

2.13 Other income

Other income consists of the following:

*(Dollars in millions)*

| | **Six months ended September 30,** | |
|---|---|---|
| | **2003** | **2004** |
| Interest income | $ 9 | $ 7 |
| Income from mutual fund investments | 1 | 4 |
| Foreign exchange gain/ (loss), net | 7 | (5) |
| Provision for investments | (1) | |
| | $ 16 | $ 6 |

The provision for investments during the six months ended September 30, 2003 include write-downs to investments in CiDRA Corporation ($1.0 million) and Stratify Inc ($0.4 million). These write-downs were required due to the non-temporary impact of adverse market conditions on these entities business models and contemporary transactions on the securities of the entities which have been indicative of their current fair value

2.14 Research and development

Cost of revenues in the accompanying statements of income include research and development expenses of $3 million and $5 million for the six months ended September 30, 2003 and 2004 respectively. General and administrative expenses in the accompanying statements of income include research and development expenses of $1 million for the six months ended September 30, 2003 and 2004.

2.15 Employees Stock Offer Plans (ESOP)

In September 1994, the company established the 1994 plan, which provided for the issue of 24,000,000 warrants, as adjusted, to eligible employees. The warrants were issued to an employee welfare trust (the Trust). In 1997, in anticipation of a share dividend to be declared by the company, the Trust exercised all warrants held by it and converted them into equity shares. As and when the Trust issued options/stock to eligible employees, the difference between the market price and the exercise price was accounted as deferred stock compensation expense and amortized over the vesting period. Such amortized deferred compensation expense was $2 million for the six months ended September 30, 2003. The deferred stock compensation expense has been completely amortized as of March 31, 2004. The 1994 plan lapsed in fiscal 2000, and consequently no further shares will be issued to employees under this plan.

1998 Employees Stock Offer Plan (the 1998 Plan). The company s 1998 Plan provides for the grant of non-statutory stock options and incentive stock options to employees of the company. The establishment of the 1998 Plan was approved by the board of directors in December 1997 and by the stockholders in January 1998. The Government of India has approved the 1998 Plan, subject to a limit of 5,880,000 equity shares representing 5,880,000 ADS to be issued under the 1998 Plan. Unless terminated sooner, the 1998 Plan will terminate automatically in January 2008. All options under the 1998 Plan will be exercisable for equity shares represented by ADSs. The 1998 Plan is administered by a Compensation Committee comprising four members, all of who are independent directors on the Board of Directors.

1999 Stock Offer Plan (the 1999 Plan). In fiscal 2000, the company instituted the 1999 Plan. The stockholders and the Board of Directors approved the 1999 Plan in June 1999. The 1999 Plan provides for the issue of 26,400,000 equity shares to employees. The 1999 Plan is administered by a Compensation Committee comprising four members, all of who are independent directors on the Board of Directors. Under the 1999 Plan, options will be issued to employees at an exercise price, which shall not be less than the Fair Market

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Value (FMV). Under the 1999 Plan, options may also be issued to employees at exercise prices that are less than FMV only if specifically approved by the members of the company in a general meeting. All options under the 1999 plan are exercisable for equity shares.

The options under the 1998 Plan and 1999 Plan vest over a period of one through four years and expire 5 years from the date of completion of vesting.

The activity in the warrants/equity shares of the 1994, 1998 and 1999 ESOP in the six months ended September 30, 2003 and 2004 are set out below and are adjusted to reflect the change in the capital structure of the company (See Note 2.11)

| | Six months ended September 30, 2003 | | 2004 | |
|---|---|---|---|---|
| | **Shares arising out of options** | **Weighted average exercise price** | **Shares arising out of options** | **Weighted average exercise price** |
| 1994 Option plan: | | | | |
| Outstanding at the beginning of the period | 1,272,800 | | 1,266,400 | |
| Granted | | | | |
| Forfeited | (2,400) | $ 0.3 | | |
| Exercised | | | (1,266,400) | $ 0.3 |
| Outstanding at the end of the period | 1,270,400 | | | |
| 1998 Option plan: | | | | |
| Outstanding at the beginning of the period | 5,006,812 | | 3,871,008 | |
| Granted | 190,800 | $ 24 | | |
| Forfeited | (318,872) | $ 36 | (85,190) | $ 45 |
| Exercised | (70,320) | $ 9 | (83,768) | $ 30 |
| Outstanding at the end of the period | 4,808,420 | | 3,702,050 | |
| Exercisable at the end of the period | 1,450,300 | | 1,858,270 | |
| Weighted-average fair value of options granted during the period | | $ 6 | | |
| 1999 Option plan: | | | | |
| Outstanding at the beginning of the period | 20,244,684 | | 18,362,120 | |
| Granted | 744,800 | $ 16 | | |
| Forfeited | (702,868) | $ 24 | (570,545) | $ 25 |
| Exercised | (33,256) | $ 14 | (1,212,678) | $ 20 |

| | | |
|---|---|---|
| Outstanding at the end of the period | 20,253,360 | 16,578,897 |
| Exercisable at the end of the period | 6,783,996 | 9,811,259 |
| Weighted-average fair value of options granted during the period | | $ 7 |

The following table summarizes information about stock options outstanding as of September 30, 2004

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| **Range of exercise prices per share ($)** | **No. of shares arising out of options** | **Weighted average remaining contractual life in years** | **Weighted average exercise price** | **No. of shares arising out of options** | **Weighted average exercise price** |
| 1998 Plan | | | | | |
| 9-25 | 918,044 | 5.1 | $ 20 | 387,440 | $ 18 |
| 26-50 | 2,281,846 | 5.0 | $ 39 | 1,046,430 | $ 43 |
| 51-75 | 234,400 | 4.1 | $ 60 | 156,640 | $ 60 |
| 76-100 | 210,760 | 3.6 | $ 81 | 210,760 | $ 81 |
| 101-165 | 57,000 | 3.4 | $ 130 | 57,000 | $ 130 |
| Total | 3,702,050 | | | 1,858,270 | |
| 1999 Plan | | | | | |
| 13-25 | 10,386,155 | 5.0 | $ 19 | 5,098,477 | $ 19 |
| 26-50 | 6,171,142 | 4.1 | $ 34 | 4,691,182 | $ 34 |
| 51-70 | 21,600 | 3.5 | $ 55 | 21,600 | $ 55 |
| Total | 16,578,897 | | | 9,811,259 | |

Progeon s 2002 Plan provides for the grant of stock options to its employees and was approved by its board of directors and stockholders in June 2002. All options under the 2002 Plan are exercisable for equity shares. The 2002 Plan is administered by a Compensation Committee comprising two members, all of whom are directors of the company. The 2002 Plan provides for the issue of 5,250,000 equity shares to employees, at an exercise price, which shall not be less than the FMV. Options may also be issued to employees at exercise prices that are less than FMV only if specifically approved by the members of the company in general meeting. The options issued under the 2002 Plan vest in periods ranging between one through six years, although accelerated vesting based on performance

conditions is provided in certain instances. All options granted have been accounted for as a fixed plan.

| | Six months ended September 30, 2003 | | Six months ended September 30, 2004 | |
|---|---|---|---|---|
| | Shares arising out of options | Weighted average exercise price | Shares arising out of options | Weighted average exercise price |
| Progeon's 2002 Plan: | | | | |
| Outstanding at the beginning of the period | 1,801,175 | | 3,124,625 | |
| Granted | 663,750 | $ 1.26 | 271,400 | $ 2.29 |
| Forfeited | | | (208,907) | $ 1.54 |
| Exercised | | | (6,325) | $ 0.69 |
| Outstanding at the end of the period | 2,464,925 | $ 0.84 | 3,180,793 | $ 1.08 |
| Exercisable at the end of the period | | | 482,895 | $ 0.76 |
| Weighted-average fair value of options granted during the period | | $ 0.36 | | $ 0.89 |

Options outstanding as of September 30, 2004 have exercise prices in the range of $0.69-$2.29 with a weighted average remaining contractual life of 2.6 years

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2.16 Income taxes

The provision for income taxes in the income statement comprises:

*(Dollars in millions)*

| | Six months ended September 30, 2003 | 2004 |
|---|---|---|
| Current taxes | | |
| Domestic taxes | $ 7 | $ 8 |
| Foreign taxes | 16 | 25 |
| | 23 | 33 |
| Deferred taxes | | |
| Domestic taxes | 1 | (1) |
| Foreign taxes | | (1) |
| | 1 | (2) |
| Aggregate taxes | $24 | $31 |

All components of the aggregate taxes of $24 million and $31 million for the six months ended September 30, 2003 and 2004 are allocated to the continuing operations of the company. Tax benefits of $4 million earned on exercise of employee stock options have been credited to additional paid in capital during the six months ended September 30, 2004. The tax effects of significant temporary differences that resulted in deferred tax assets and liabilities, and a description of the financial statement items that created these differences are as follows:

*(Dollars in millions)*

| | As of March 31, 2004 | September 30, 2004 |
|---|---|---|
| Deferred tax assets | | |
| Property, plant and equipment | $ 6 | $ 7 |
| Allowances on trade accounts receivable | 1 | 1 |
| Investments | 3 | 3 |
| Accrual for compensated absences | 1 | 1 |
| Others | | 1 |

| | | |
|---|---|---|
| | 11 | 13 |
| Less: Valuation allowance | (2) | (3) |
| | 9 | 10 |
| Deferred tax liabilities | | |
| Gains on foreign exchange forward contracts | (1) | |
| Intangible assets | (1) | (1) |
| | (2) | |
| Net deferred tax assets | $ 7 | $ 9 |

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which the temporary differences become deductible. Management considers the scheduled reversals of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based on the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes that it is more likely than not the company will realize the benefits of those deductible differences, net of the existing valuation allowance at September 30, 2004. The valuation allowance relates to provision for doubtful debts and investments. The amount of the deferred tax assets considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carry forward period are reduced. The valuation allowance was $2 million as of March 31, 2004. The valuation allowance increased by $1 million during the six months ended September 30, 2004.

The provision for foreign taxes is due to income taxes payable overseas, principally in the United States of America. The company benefits from certain significant tax incentives provided to software firms under Indian tax laws. These incentives presently include an exemption from payment of Indian corporate income taxes for a period of ten consecutive years of operation of software development facilities designated as Software Technology Parks (the STP Tax Holiday). The Government of India has amended the tax incentives available to companies set up in designated STPs. The period of the STP Tax Holiday available to such companies is restricted to ten consecutive years, beginning from the financial year when the unit started producing computer software or April 1, 1999, whichever is earlier.

2.17 Earnings per share

The following is a reconciliation of the equity shares used in the computation of basic and diluted earnings per equity share:

| | **Six months ended September 30,** | |
|---|---|---|
| | **2003** | **2004** |
| | 262,349,472 | 265,781,580 |

| | | |
|---|---|---|
| Basic earnings per equity share  weighted average number of common shares outstanding excluding unallocated shares of ESOP | | |
| Effect of dilutive common equivalent shares  stock options outstanding | 2,629,936 | 5,405,243 |
| Diluted earnings per equity share  weighted average number of common shares and common equivalent shares outstanding | 264,979,408 | 271,186,823 |

Options to purchase 1,072,399 shares under the 1998 Plan and 3,936,042 shares under the 1999 Plan were not considered for calculating diluted earnings per share for the six months ended September 30, 2004 as their effect was anti-dilutive.

The computations of basic and diluted EPS has also been adjusted retroactively for all periods presented to reflect the change in capital structure. See Note 2.11

2.18 Derivative financial instruments

The company enters into foreign exchange forward contracts where the counter-party is generally a bank. The company considers the risks of non-performance by the counter party as non-material. Infosys held foreign exchange forward contracts of $149 million and $188 million as of March 31, 2004 and September 30, 2004, respectively. The foreign exchange forward contracts mature between one to 12 months.

2.19 Segment reporting

SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, establishes standards for the way that public business enterprises report information about operating segments and related disclosures about products and services, geographic areas, and major customers. The company s operations predominantly relate to providing IT solutions, delivered to customers located globally, across various industry segments. The Chief Operating Decision Maker evaluates the company s performance and allocates resources based on an analysis of various performance indicators by industry classes and geographic segmentation of customers. Accordingly, revenues represented along industry classes comprise the principal basis of segmental information set out in these financial statements. Secondary segmental reporting is performed on the basis of the geographical location of customers. The accounting principles consistently used in the preparation of the financial statements are consistently applied to record revenue and expenditure in individual segments, and are as set out in the summary of significant accounting policies.

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Industry segments for the company are primarily financial services comprising enterprises providing banking, finance and insurance services, manufacturing enterprises, enterprises in the telecommunications (telecom) and retail industries, and others such as utilities, transportation and logistics companies. Geographic segmentation is based on business sourced from that geographic region and delivered from both on-site and off-shore. North America comprises the United States of America, Canada and Mexico; Europe includes continental Europe (both the east and the west), Ireland and the United Kingdom; and the Rest of the World comprising all other places except those mentioned above and India.

Revenue in relation to segments is categorized based on items that are individually identifiable to that segment, while expenditure is categorized in relation to the associated turnover of the segment. Allocated expenses of the geographic segments include expenses incurred for rendering services from the company s offshore software development centers and on-site expenses. Certain expenses such as depreciation, which form a significant component of total expenses, are not specifically allocable to specific segments as the underlying assets are used interchangeably. Management believes that it is not practical to provide segment disclosures relating to those costs and expenses, and accordingly these expenses are separately disclosed as unallocated and adjusted only against the total income of the company.

Fixed assets used in the company s business are not identified to any of the reportable segments, as these are used interchangeably between segments. Management believes that it is currently not practicable to provide segment disclosures relating to total assets and liabilities since a meaningful segregation of the available data is onerous.

Geographical information on revenue and industry revenue information is collated based on individual customers invoiced or in relation to which the revenue is otherwise recognized.

2.19.1 Industry segments

*(Dollars in millions)*

| **Six months ended September 30, 2003** | **Financial services** | **Manufacturing** | **Telecom** | **Retail** | **Others** | **Total** |
|---|---|---|---|---|---|---|
| Revenues | $ 185 | $ 74 | $ 73 | $ 56 | $ 96 | $ 484 |
| Identifiable operating expenses | 78 | 32 | 29 | 21 | 39 | 199 |
| Allocated expenses | 50 | 19 | 20 | 14 | 25 | 128 |
| Segmental operating income | $ 57 | $ 23 | $ 24 | $ 21 | $ 32 | $ 157 |
| Unallocable expenses | | | | | | 26 |
| Operating income | | | | | | 131 |
| Other income, net | | | | | | 16 |
| Income before income taxes | | | | | | 147 |
| Provision for income taxes | | | | | | 24 |
| Net income | | | | | | $ 123 |

| **Six months ended September 30, 2004** | **Financial services** | **Manufacturing** | **Telecom** | **Retail** | **Others** | **Total** |
|---|---|---|---|---|---|---|

| | | | | | | |
|---|---|---|---|---|---|---|
| Revenues | $ 246 | $ 106 | $ 130 | $ 74 | $ 157 | $ 713 |
| Identifiable operating expenses | 106 | 46 | 56 | 29 | 65 | 302 |
| Allocated expenses | 67 | 24 | 31 | 17 | 42 | 181 |
| Segmental operating income | $ 73 | $ 36 | $ 43 | $ 28 | $ 50 | 230 |
| Unallocable expenses | | | | | | 25 |
| Operating income | | | | | | 205 |
| Other income, net | | | | | | 6 |
| Income before income taxes | | | | | | 211 |
| Provision for income taxes | | | | | | 31 |
| Net income | | | | | | $ 180 |

2.19.2 Geographic segments

*(Dollars in millions)*

| Six months ended September 30, 2003 | North America | Europe | India | Rest of the World | Total |
|---|---|---|---|---|---|
| Revenues | $ 360 | $ 86 | $ 9 | $ 29 | $ 484 |
| Identifiable operating expenses | 151 | 34 | 3 | 11 | 199 |
| Allocated expenses | 95 | 22 | 2 | 9 | 128 |
| Segmental operating income | $ 114 | $ 30 | $ 4 | $ 9 | 157 |
| Unallocable expenses | | | | | 26 |
| Operating income | | | | | 131 |
| Other income, net | | | | | 16 |
| Income before income taxes | | | | | 147 |
| Provision for income taxes | | | | | 24 |
| Net income | | | | | $ 123 |

| Six months ended September 30, 2004 | North America | Europe | India | Rest of the World | Total |
|---|---|---|---|---|---|
| Revenues | $ 464 | $ 156 | $ 12 | $ 81 | $ 713 |
| Identifiable operating expenses | 199 | 63 | 3 | 37 | 302 |
| Allocated expenses | 113 | 36 | 3 | 30 | 182 |
| Segmental operating income | $ 152 | $ 57 | $ 6 | $ 14 | 229 |
| Unallocable expenses | | | | | 24 |
| Operating income | | | | | 205 |
| Other income, net | | | | | 6 |
| Income before income taxes | | | | | 211 |

| | |
|---|---|
| Provision for income taxes | 31 |
| Net income | $180 |

2.19.3 Significant clients

No client individually accounted for more than 10% of the revenues in the six months ended September 30, 2003 and 2004.

2.20 Litigation

The company is subject to legal proceedings and claims, which have arisen, in the ordinary course of its business. Legal actions, when ultimately concluded and determined, will not, in the opinion of management, have a material effect on the results of operations or the financial position of the company.

In the year ended March 31, 2004, Ms. Jennifer Griffith, a former employee, filed a lawsuit against the company and its former director, Mr. Phaneesh Murthy. The lawsuit was served on the company during the quarter ended December 31, 2003. The trial of the lawsuit is scheduled shortly. Based on its present knowledge of facts, management estimates that the lawsuit will not have a material impact on the results of operations or financial position of the company.

2.21 Commitments and contingencies

The company has outstanding performance guarantees for various statutory purposes totaling $2 million and $3 million as of March 31, 2004 and September 30, 2004, respectively. These guarantees are generally provided to governmental agencies.

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Item 2. Managements Discussion and Analysis of Financial Condition and Results of Operations

Investors are cautioned that this discussion contains forward-looking statements that involve risks and uncertainties. When used in this discussion, the words anticipate, believe, estimate, expect, intend, project, seek, shoul other similar expressions as they relate to us or our business are intended to identify such forward-looking statements. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise. Actual results, performances or achievements could differ materially from those expressed or implied in such forward-looking statements. Factors that could cause or contribute to such differences include those described under the heading Risk Factors in this Quarterly Report. Readers are cautioned not to place undue reliance on these forward-looking statements, as they speak only as of the date of this Quarterly Report. The following discussion and analysis should be read in conjunction with our financial statements included herein and the notes thereto.

Overview

We are a leading global IT services company founded in 1981, and headquartered in Bangalore, India. Progeon Limited ( Progeon ) is a majority-owned and controlled subsidiary while Infosys Technologies (Australia) Pty. Limited (Infosys Australia), Infosys Technologies (Shanghai) Co. Limited (Infosys China) and Infosys Consulting Inc. (Infosys Consulting) are our wholly-owned and controlled subsidiaries. We provide end-to-end business solutions that leverage technology, thus enabling our clients to enhance business performance. Our solutions span the entire software life cycle, encompassing consulting, design, development, re-engineering, maintenance, systems integration, package evaluation, and implementation. In addition, we offer software products for the banking industry and we also offer business process management services through Progeon, which typically include offsite customer relationship management, finance and accounting, administration and sales order processing functions.

We completed our initial public offering of equity shares in India in 1993 and our initial public offering of ADSs in the United States in 1999. In August 2003, on behalf of our stockholders, we completed a sponsored secondary offering of ADSs in the United States. We did not receive any of the proceeds from this sponsored secondary offering.

Our revenues grew from $121 million in fiscal 1999 to $1,063 million in fiscal 2004, representing a compound annual growth rate of 54.4%. Our net income grew from $18 million, after a one-time stock compensation expense to $270 million during the same period, representing a compound annual growth rate of 72.9%. Our revenue growth is attributable to a number of factors, including an increase in the size and number of projects for existing and new clients. For fiscal 2004, 93.4% of our revenue came from repeat business, which we define as revenue from a client who also contributed to our revenue during the prior fiscal year. Between March 31, 1999 and March 31, 2004 our total employees grew from approximately 3,800 to approximately 23,800 representing a compound annual growth rate of 44.3%. In addition, Progeon had approximately 1,900 employees as of March 31, 2004. Our revenues were $713 million for the six months ended September 30, 2004 and repeat business was 97.4% of our revenues for the period. We had approximately 32,900 employees as of September 30, 2004 including 2,700 employees in Progeon.

We use a distributed project management methodology that we refer to as our Global Delivery Model. We divide projects into components that we execute simultaneously at client sites and at our geographically dispersed development centers in India and around the world. Our Global Delivery Model allows us to efficiently execute projects across time zones and development centers, thereby optimizing our cost structure. We also offer a secure and redundant infrastructure for all client data. We earned 71.2% of our total revenues from North America, 19.2% from Europe, 1.4% from India and 8.2% from the rest of the world for fiscal 2004.

Our revenues are generated principally from IT services provided on either a time-and-materials or a fixed-price, fixed-time frame basis. Revenues from services provided on a time-and-materials basis are recognized as the related

services are performed. Revenues from services provided on a fixed-price, fixed-time frame basis are recognized pursuant to the percentage of completion method. Most of our client contracts, including those that are on a fixed-price, fixed-timeframe, basis can be terminated with or without cause, without penalties and with short notice periods between zero and 90 days. Since we collect revenues on contracts as portions of the contracts are completed, terminated contracts are only subject to collection for portions of the contract completed through the time of termination. Our contracts do not contain specific termination-related penalty provisions. In order to manage and anticipate the risk of early or abrupt contract terminations, we monitor the progress on all contracts and change orders according to their characteristics and the circumstances in which they occur. This includes a focused review of our ability and our client s ability to perform on the contract, a review of extraordinary conditions that may lead to a contract termination, as well as historical client performance considerations. Since we also bear the risk of cost overruns and inflation with respect to fixed-price, fixed-time frame projects, our operating results could be adversely affected by inaccurate estimates of contract completion costs and dates, including wage inflation rates and currency exchange rates that may affect cost projections. Losses on contracts, if any, are provided for in full in the period when determined. Although we revise our project completion estimates from time to time, such revisions have not, to date, had a material adverse effect on our operating results or financial condition. We also generate revenue from software application products, including banking software. Such software products represented 2.8% of our total revenues for fiscal 2004.

Even though we are witnessing a stable pricing environment at present, we have experienced pricing pressure from our clients, especially during the recent economic downturn, which has adversely affected our revenues, margins and gross profits. For example, clients often expect that as we do more business with them, they will receive volume discounts. Additionally, clients may ask for fixed-price arrangements or reduced rates. We attempt to use fixed-price agreements for work where the specifications are complete, so individual rates are not negotiated. We are also adding new services at higher price points and where more value is added for our clients.

Our cost of revenues primarily consists of salary and other compensation expenses, depreciation, overseas travel expenses, cost of software purchased for internal use, cost of technical subcontractors, data communications expenses and computer maintenance. We depreciate our personal computers and servers over two years and mainframe computers over three years. Third party software is written off over the estimated useful life. Cost of revenues also includes amortization of deferred stock compensation expense arising from option grants relating to the 1994 stock option plan which have been accounted for under the intrinsic value method. The deferred stock compensation expenses have been completely amortized as of March 31, 2004.

We typically assume full project management responsibility for each project that we undertake. Approximately 68.1% of the total billed person months during fiscal 2004 were performed at our global development centers in India, and the balance of the work was performed at client sites and global development centers located outside India. The proportion of work performed at our facilities and at client sites varies from quarter to quarter. We charge higher rates and incur higher compensation and other expenses for work performed at client sites and global development centers located outside India. Services performed at a client site or global development centers located outside India typically generate higher revenues per-capita at a lower gross margin than the same services performed at our facilities in India. As a result, our total revenues, cost of revenues and gross profit in absolute terms and as a percentage of revenues fluctuate from quarter to quarter based on the proportion of work performed outside India. Additionally, any increase in work performed at client sites or global development centers located outside India can decrease our gross profits. We hire subcontractors on a limited basis from time to time for our own IT development needs, and we generally do not perform subcontracted work for other IT service providers. For fiscal 2004 approximately 2.3% of our cost of revenues was attributable to cost of technical subcontractors. We do not anticipate that our subcontracting needs will increase significantly as we expand our business.

Revenues and gross profits are also affected by employee utilization rates. We define employee utilization as the proportion of total billed person months to total available person months excluding support personnel. We manage utilization by monitoring project requirements and timetables. The number of consultants assigned to a project will

vary according to size, complexity, duration, and demands of the project. An unanticipated termination of a significant project could also cause us to experience lower IT professional utilization resulting in a higher than expected number of unassigned IT professionals. In addition, we do not fully utilize our IT professionals when they are enrolled in training programs, particularly our 14-week training course for new employees.

Selling and marketing expenses represent 5.0%, 7.4% and 7.2% of total revenues for fiscal 2002, 2003 and 2004. Our selling and marketing expenses primarily consist of expenses relating to salaries of sales and marketing personnel, travel, brand building, rental for sales and marketing offices and telecommunications. We have recently decided to increase our selling and marketing expenses as a percentage of revenues to increase brand awareness among target clients and promote client loyalty and repeat business among existing clients. During fiscal 2003, we redeployed certain employees from our delivery function to sales and marketing. General and administrative expenses represent 8.1%, 7.7% and 7.7% of total revenues for fiscal 2002, 2003 and 2004. Our general and administrative expenses comprise of expenses relating to salaries of senior management and other support personnel, travel expenses, legal and other professional fees, telecommunications, utilities and other miscellaneous administrative costs.

Amortization of stock compensation expense consists of costs relating to option grants under the 1994 stock option plan which have not been included in cost of revenues. These costs have been accounted under the intrinsic value method. The deferred stock compensation expenses have been completely amortized as of March 31, 2004.

Our amortization of intangible assets consists of non-cash expenses arising from the acquisition of certain intellectual property rights and identified intangibles arising from purchase price allocations for business combinations. We amortize intangible assets over their estimated useful lives.

Other income/(expense), net includes interest income, income from mutual fund investments, foreign currency exchange gains/losses including marked to market gain/losses on foreign exchange forward contracts, and provisions for losses on investments.

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Our functional currency is the Indian rupee. The functional currency for Infosys Australia, Infosys China and Infosys Consulting is the respective local currency. The financial statements included in this Report are reported in U.S. dollars. The translation of rupees to dollars is performed for the balance sheet accounts using the exchange rate in effect at the balance sheet date, and for revenue and expense accounts using a monthly average exchange rate for the respective periods. The gains or losses resulting from such translation are reported as other comprehensive income.

Generally, Indian law requires residents of India to repatriate any foreign currency earnings to India to control the exchange of foreign currency. More specifically, Section 8 of the Foreign Exchange Management Act, or FEMA, requires an Indian company to take all reasonable steps to realize and repatriate into India all foreign exchange earned by the company outside India, within such time periods and in the manner as specified by the Reserve Bank of India, or RBI. The RBI has promulgated guidelines that require the company to repatriate any realized foreign exchange back to India, and either:

- sell it to an authorized dealer for rupees within seven days from the date of receipt of the foreign exchange;
- retain it in a foreign currency account such as an Exchange Earners Foreign Currency; or EEFC, account with an authorized dealer; or
- use it for discharge of debt or liabilities denominated in foreign exchange.

We typically collect our earnings and pay expenses denominated in foreign currencies using a dedicated foreign currency account located in the local country of operation. In order to do this, we are required to, and have obtained, special approval from the RBI to maintain a foreign currency account in overseas countries like the United States. However, the RBI approval is subject to limitations, including a requirement that we repatriate all foreign currency in the account back to India within a reasonable time, except an amount equal to our local monthly operational cost of our overseas branch and personnel. We currently pay such expenses and repatriate the remainder of the foreign currency to India on a regular basis. We have the option to retain those in an EEFC account (foreign currency denominated) or an Indian-rupee-denominated account. We convert substantially all of our foreign currency to rupees to fund operations and expansion activities in India.

Our failure to comply with these regulations could result in RBI enforcement actions against us.

Income taxes

Our net income earned from providing services outside India is subject to tax in the country where we perform the work. Most of our tax paid in countries other than India can be applied as a credit against our Indian tax liability to the extent that the same income is subject to tax in India.

Currently, we benefit from the tax holidays the Government of India gives to the export of IT services from specially designated software technology parks in India. As a result of these incentives, our operations have been subject to relatively low tax liabilities. These tax incentives include a 10-year tax holiday from Indian corporate income taxes for the operation of most of our Indian facilities. As a result of these tax exemptions, a substantial portion of our pre-tax income has not been subject to significant tax in recent years. These tax incentives resulted in a decrease in our income tax expense of $51 million, $78 million and $56 million for fiscal 2003, 2004 and six months ended September 30, 2004 compared to the effective tax rates that we estimate would have applied if these incentives had not been available.

The Finance Act, 2000 phases out the ten-year tax holiday over a ten-year period from fiscal 2000 through fiscal 2009. Accordingly, facilities set up in India on or before March 31, 2000 have a ten-year tax holiday, new facilities set up on or before March 31, 2001 have a nine-year tax holiday and so forth until March 31, 2009. After March 31, 2009, the

tax holiday will no longer be available to new facilities. Our current tax holidays expire in stages by 2009

When our tax holiday expire or terminate, our tax expense will materially increase, reducing our profitability. As a result of such tax incentives, our effective tax rate for fiscal 2004 was 15.8% and our Indian statutory tax rate for the same period was 35.9%. The Indian statutory tax rate increased to 36.6% for the six months ended September 30, 2004.

Results for the three months ended September 30, 2004 compared to the three months ended September 30, 2003

*Revenues.* Our revenues were $379 million in the three months ended September 30, 2004, representing an increase of $128 million, or 51.0 % over revenues of $251 million for the three months ended September 30, 2003. Revenues continued to increase in most segments of our services. The increase in revenues was attributable, in part, to an increase in business from existing clients and from certain new clients, particularly in industries such as manufacturing, telecom, and other industries such as utilities, logistics and services. Our clients in the financial services industry comprised 35.1% and 38.9% of revenues for the three months ended September 30, 2004 and 2003. Clients in the manufacturing sector comprised 14.7% and 15.0% of revenues for the same periods. Our clients in the retail industry comprised 9.6% and 11.7% of revenues for the three months ended September 30, 2004 and 2003, while our clients in the telecom industry comprised 18.5% and 15.4% of revenues for the same periods. Clients in other industries such as utilities, logistics and services contributed 22.1% and 19.0% of revenues for the three months ended September 30, 2004 and 2003. Sales of our software products represented 2.9% of our total revenues for the three months ended September 30, 2004 as compared to 2.8% for the three months ended September 30, 2003. Revenues from services represented 97.1% of total revenues for the three months ended September 30, 2004, as compared to 97.2% for the three months ended September 30, 2003. Revenues from fixed-price, fixed-time frame contracts and from time-and-materials contracts represented 29.7% and 70.3% of total services revenues for the three months ended September 30, 2004, as compared to 35.2% and 64.8% for the three months ended September 30, 2003. Revenues from North America, Europe, India and the rest of the world represented 65.2%, 21.4%, 1.7% and 11.7% of total revenues for the three months ended September 30, 2004 as compared to 73.9%, 18.0%, 1.6% and 6.5% for the three months ended September 30, 2003.

During the three months ended September 30, 2004, the total billed person months for our services other than business process management grew by 50.8% compared to the three months ended September 30, 2003. The onsite and offshore volume growth were 45.4% and 53.4% during the three months ended September 30, 2004 compared to the three months ended September 30, 2003. During the three months ended September 30, 2004 there was a pricing decline of 1.0% in U.S. dollar terms consisting of 0.3% decline in onsite rates and a 0.7% increase in offshore rates compared to the three months ended September 30, 2003.

*Cost of revenues.* Our cost of revenues was $214 million for the three months ended September 30, 2004, representing an increase of $72 million, or 50.7%, over our cost of revenues of $142 million for the three months ended September 30, 2003. Cost of revenues represented 56.5% and 56.6% of total revenues for the three months ended September 30, 2004 and 2003. The increase in our cost of revenues is mainly attributable to an increase of approximately $55 million in personnel costs due to new hires and compensation review effected in April 2004, $5 million in overseas travel expenses, $4 million in charges of technical sub-contractors, $3 million in depreciation expenses, $3 million in accruals for post sales client support, $1 million in communication expenses, and $1 million in software purchased for own use, Cost of revenue for the three months ended September 30, 2003 also included amortization of deferred stock compensation expense of $1 million. The deferred stock compensation has been completely amortized as of March 31, 2004.

*Gross profit.* As a result of the foregoing, our gross profit was $165 million for the three months ended September 30, 2004, representing an increase of $56 million, or 51.4%, over our gross profit of $109 million for the three months ended September 30, 2003. As a percentage of revenues, gross profit increased to 43.5% for the three months ended September 30, 2004 from 43.4% for the three months ended September 30 2003. The increase is attributable to a

51.0% increase in revenues for the three months ended September 30, 2004 offset by a 50.7% increase in cost of revenues in the same period compared to the three months ended September 30, 2003.

*Selling and marketing expenses.* We incurred selling and marketing expenses of $26 million in the three months ended September 30, 2004 representing an increase of $8 million, or 44.4%, over the $18 million expended in the three months ended September 30, 2003. As a percentage of total revenues, selling and marketing expenses were 6.9% and 7.2% for the three months ended September 30, 2004 and 2003. The number of our sales and marketing personnel increased to 334 as of September 30, 2004, from 264 as of September 30, 2003. The increase in selling and marketing expenses is mainly attributable to increase of approximately $4 million in personnel costs of selling and marketing employees on account of new hires and compensation review effective April 2004, $2 million in sales commissions, $1 million in overseas travel expenses, and $1 million in professional charges.

*General and administrative expenses.* Our general and administrative expenses were $30 million for the three months ended September 30, 2004, representing an increase of $10 million, or 50%, over general and administrative expenses of $20 million for the three months ended September 30, 2003. General and administrative expenses were 7.9% and 8.0% of total revenues for the three months ended September 30, 2004 and 2003. The increase in general and administrative expenses was primarily attributable to increase of approximately $2 million for personnel costs on account of new hires and compensation review effective April 2004, increase of $2 million in professional charges and increase of $1 million each in travel, telecommunication charges, office maintenance, power and fuel charges and rental expenses. The provision for bad and doubtful debts has decreased by $1 million. The factors which affect the fluctuations in our provisions for bad debts and write offs of uncollectible accounts include the financial health and economic environment of our clients. We specifically identify the credit loss and then make the provision. No one client has contributed significantly to a loss, and we have had no significant changes in our collection policies or payment terms.

*Amortization of stock compensation expenses.* Amortization of stock compensation expenses was less than $1 million for the three months ended September 30, 2003. The deferred stock compensation has been completely amortized as of March 31, 2004.

*Amortization of intangible assets.* Amortization of intangible assets was $3 million for the three months ended September 30, 2003. This relates to amortization of certain intellectual property rights we acquired through purchases and licenses of software during fiscal 2003. These intangible assets were completely amortized as of March 31, 2004. The amortization for the three months ended September 30, 2004 represents amortization of the identified customer contract intangibles arising on the allocation of purchase price of Expert Information Services Pty. Limited, Australia. The same was less than $1 million for the three months ended September 30, 2004.

*Operating income.* Our operating income was $109 million for the three months ended September 30, 2004 representing an increase of $41 million, or 60.3%, over our operating income of $68 million for the three months ended September 30, 2003. As a percentage of revenues, operating income increased to 28.8% for the three months ended September 30, 2004 from 27.1% for the three months ended September 30, 2003.

*Other income.* Other income, consisting mainly of interest and dividend income, foreign exchange gains and provision for investments, was $6 million for the three months ended September 30, 2004 compared to $10 million for the three months ended September 30, 2003. Interest and dividend income was approximately $5 million during the three months ended September 30, 2004 and 2003.

We had foreign currency exchange gains of $5 million in the three months ended September 30, 2003 compared to $1 million in the three months ended September 30, 2004. The exchange rate between the rupee and the U.S. dollar decreased by 1.3% from Rs. 46.40 per U.S. dollar on June 30, 2003 to Rs. 45.78 on September 30, 2003. The exchange rate between the rupee and the U.S. dollar decreased by 0.2% from Rs. 45.99 per U.S. dollar on June 30, 2004 to Rs. 45.91 on September 30, 2004. The average exchange rate between the rupee and the U.S. dollar was Rs. 45.94 and Rs. 46.22 per U.S. dollar for the three months ended September 30, 2003 and 2004 respectively. For the three months ended September 30, 2004 and 2003, U.S. dollar denominated revenues represented and 80.2% and 86.5% of total revenues. The company purchases foreign exchange forward contracts to mitigate the risk of changes in foreign exchange rates on accounts receivable and forecasted cash flows denominated in certain foreign currencies. As of September 30, 2004 and 2003 we had $188 million and $150 million of forward cover and we have recorded gains of $1 million and $6 million on account of foreign exchange forward contracts for the three months ended September 30, 2004 and 2003. Our accounting policy requires us to mark to market and recognize the effect in earnings immediately of any derivative that is either not designated a hedge, or is so designated but is ineffective as per SFAS 133.

*Provision for income taxes.* Our provision for income taxes was $18 million for the three months ended September 30, 2004, representing an increase of $5 million, or 38.5% over our provision for income taxes of $13 million for the three months ended September 30, 2003. Our effective tax rate decreased to 15.7% for three months ended September 30, 2004 from 16.7% for the three months ended September 30, 2003.

*Net income.* Our net income was $97 million for the three months ended September 30, 2004, representing an increase of $32 million, or 49.2%, over our net income of $65 million for the three months ended September 30, 2003. As a percentage of total revenues, net income decreased to 25.6% for three months ended September 30, 2004 from 25.9% for three months ended September 30, 2003.

Results for the six months ended September 30, 2004 compared to the six months ended September 30, 2003

*Revenues.* Our revenues were $713 million in the six months ended September 30, 2004, representing an increase of $229 million, or 47.3% over revenues of $484 million for the six months ended September 30, 2003. Revenues continued to increase in most segments of our services. The increase in revenues was attributable, in part, to an increase in business from existing clients and from certain new clients, particularly in industries such as manufacturing, telecom and other industries such as utilities, logistics and services. Our clients in the financial

services industry comprised 34.5% and 38.2% of revenues for the six months ended September 30, 2004 and 2003. Clients in the manufacturing sector comprised 14.9% and 15.3% of revenues for the same periods. Our clients in the retail industry comprised 10.4% and 11.6% of revenues for the six months ended September 30, 2004 and 2003, while our clients in the telecom industry comprised 18.2% and 15.1% of revenues for the same periods. Clients in other industries such as utilities, logistics and services contributed 22.0% and 19.8% of revenues for the six months ended September 30, 2004 and 2003. Sales of our software products represented 2.7% of our total revenues for the six months ended September 30, 2004 as compared to 3.2% for the six months ended September 30, 2003. Revenues from services represented 97.3% of total revenues for the six months ended September 30, 2004, as compared to 96.8% for the six months ended September 30, 2003. Revenues from fixed-price, fixed-time frame contracts and from time-and-materials contracts represented 29.7% and 70.3% of total services revenues for the six months ended September 30, 2004, as compared to 35.4% and 64.6% for the six months ended September 30, 2003. Revenues from North America, Europe, India and the rest of the world represented 65.1%, 21.9%, 1.7% and 11.3% of total revenues for the six months ended September 30, 2004 as compared to 74.4%, 17.8%, 1.9% and 5.9% for the six months ended September 30, 2003.

During the six months ended September 30, 2004, the total billed person months for our services other than business process management grew by 47.8% compared to the six months ended September 30, 2003. The onsite and offshore volume growth were 42.3% and 50.6% during the six months ended September 30, 2004 compared to the six months ended September 30, 2003. During the six months ended September 30, 2004 there was a pricing decline of 0.8% in U.S. dollar terms consisting of 0.4% decline in onsite rates and a 1.4% increase in offshore rates compared to the six months ended September 30, 2003.

*Cost of revenues.* Our cost of revenues was $401 million for the six months ended September 30, 2004, representing an increase of $126 million, or 45.8%, over our cost of revenues of $275 million for the six months ended September 30, 2003. Cost of revenues represented 56.2% and 56.8% of total revenues for the six months ended September 30, 2004 and 2003. The increase in our cost of revenues is mainly attributable to an increase of approximately $103 million in personnel costs due to new hires and compensation review effected in April 2004, $10 million in overseas travel expenses, $5 million in depreciation expenses, $4 million in accruals for post sales client support, $3 million in software purchased for own use and $2 million in communication expenses. Cost of revenue for the six months ended September 30, 2003 also included amortization of deferred stock compensation expense of $1 million. The deferred stock compensation has been completely amortized as of March 31, 2004.

*Gross profit.* As a result of the foregoing, our gross profit was $312 million for the six months ended September 30, 2004, representing an increase of $103 million, or 49.3%, over our gross profit of $209 million for the six months ended September 30, 2003. As a percentage of revenues, gross profit increased to 43.8% for the six months ended September 30, 2004 from 43.2% for the six months ended September 30 2003. The increase is attributable to a 47.3% increase in revenues for the six months ended September 30, 2004 offset by a 45.8% increase in cost of revenues in the same period compared to the six months ended September 30, 2003.

*Selling and marketing expenses.* We incurred selling and marketing expenses of $50 million in the six months ended September 30, 2004 representing an increase of $15 million, or 42.9%, over the $35 million expended in the six months ended September 30, 2003. As a percentage of total revenues, selling and marketing expenses were 7.0% and 7.2% for the six months ended September 30, 2004 and 2003. The number of our sales and marketing personnel increased to 334 as of September 30, 2004, from 264 as of September 30, 2003. The increase in selling and marketing expenses is mainly attributable to increase of approximately $7 million in personnel costs of selling and marketing employees on account of new hires and compensation review effective April 2004, $2 million in overseas travel expenses, $1 million in professional charges, $2 million in sales commissions and $1 million each in professional charges, travel expenses and brand building.

*General and administrative expenses.* Our general and administrative expenses were $56 million for the six months ended September 30, 2004, representing an increase of $18 million, or 47.4%, over general and administrative

expenses of $38 million for the six months ended September 30, 2003. General and administrative expenses were 7.9% of total revenues for the six months ended September 30, 2004 and 2003. The increase in general and administrative expenses was primarily attributable to increase of approximately $5 million for personnel costs on account of new hires and compensation review effective April 2004, increase of $3 million in professional charges, increase of $2 million each in travel expenses, telecommunication charges and office maintenance and increase of $1 million each in taxes other than income taxes, power and fuel charges, advertisements and insurance expenses. The provision for bad and doubtful debts has decreased by $1 million. The factors which affect the fluctuations in our provisions for bad debts and write offs of uncollectible accounts include the financial health and economic environment of our clients. We specifically identify the credit loss and then make the provision. No one client has contributed significantly to a loss, and we have had no significant changes in our collection policies or payment terms.

*Amortization of stock compensation expenses.* Amortization of stock compensation expenses was $1 million for the six months ended September 30, 2003. The deferred stock compensation has been completely amortized as of March 31, 2004.

*Amortization of intangible assets.* Amortization of intangible assets was $4 million for the six months ended September 30, 2003. This relates to amortization of certain intellectual property rights we acquired through purchases and licenses of software during fiscal 2003. These intangible assets were completely amortized as of March 31, 2004. The amortization for the six months ended September 30, 2004 represents amortization of the identified customer contract intangibles arising on the allocation of purchase price of Expert Information Services Pty. Limited, Australia. The same was $1 million for the six months ended September 30, 2004.

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*Operating income.* Our operating income was $205 million for the six months ended September 30, 2004 representing an increase of $74 million, or 56.5%, over our operating income of $131 million for the six months ended September 30, 2003. As a percentage of revenues, operating income increased to 28.8% for the six months ended September 30, 2004 from 27.1% for the six months ended September 30, 2003.

*Other income.* Other income, consisting mainly of interest and dividend income, foreign exchange gains and provision for investments, was $6 million for the six months ended September 30, 2004 compared to $16 million for the six months ended September 30, 2003. Interest and dividend income was approximately $11 million and $10 million during the six months ended September 30, 2004 and 2003.

We had foreign currency exchange gains of $7 million in the six months ended September 30, 2003 compared to $5 million loss in the six months ended September 30, 2004. The exchange rate between the rupee and the U.S. dollar decreased by 3.7% from Rs 47.53 per U.S. dollar on March 31, 2003 to Rs 45.78 on September 30, 2003. The exchange rate between the rupee and the U.S. dollar increased by 5.8% from Rs 43.40 per U.S. dollar on March 31, 2004 to Rs 45.91 on September 30, 2004. The average exchange rate between the rupee and the U.S. dollar was Rs 46.44 and Rs 45.77 per U.S. dollar for the six months ended September 30, 2003 and 2004 respectively. For the six months ended September 30, 2004 and 2003, U.S. dollar denominated revenues represented 79.0% and 86.9% of total revenues. The company purchases foreign exchange forward contracts to mitigate the risk of changes in foreign exchange rates on accounts receivable and forecasted cash flows denominated in certain foreign currencies. As of September 30, 2004 and 2003 we had $188 million and $150 million of forward cover and we have recorded a loss of $14 million on account of foreign exchange forward contracts for the six months ended September 30, 2004 while we had recorded gains of $10 million for the six months ended September 30, 2003. Our accounting policy requires us to mark to market and recognize the effect in earnings immediately of any derivative that is either not designated a hedge, or is so designated but is ineffective as per SFAS 133.

The provision for investments during the six months ended September 30, 2003 include write-downs to investments in CiDRA Corporation ($1.0 million) and Stratify Inc ($0.4 million). These write-downs were required due to the non-temporary impact of adverse market conditions on these entities business models and contemporary transactions on the securities of the entities which have been indicative of their current fair value.

*Provision for income taxes.* Our provision for income taxes was $31 million for the six months ended September 30, 2004, representing an increase of $7 million, or 29.2% over our provision for income taxes of $24 million for the six months ended September 30, 2003. Our effective tax rate decreased to 14.7% for six months ended September 30, 2004 from 16.3% for the six months ended September 30, 2003.

*Net income.* Our net income was $180 million for the six months ended September 30, 2004, representing an increase of $57 million, or 46.3%, over our net income of $123 million for the six months ended September 30, 2003. As a percentage of total revenues, net income decreased to 25.2% for six months ended September 30, 2004 from 25.4% for six months ended September 30, 2003.

Liquidity and capital resources

Our growth has been financed largely by cash generated from operations and, to a lesser extent, from the proceeds from the sale of equity. In 1993, we raised approximately $4.4 million in gross aggregate proceeds from our initial public offering of equity shares in India. In 1994, we raised an additional $7.7 million through private placements of our equity shares with foreign institutional investors, mutual funds, Indian domestic financial institutions and corporations. On March 11, 1999 we raised $70.4 million in gross aggregate proceeds from our initial U.S. public offering of ADSs.

As of September 30, 2004 we had $335 million in cash and cash equivalents, $210 million invested in liquid mutual fund units, $646 million in working capital and no outstanding bank borrowings. We believe that a sustained reduction in IT spending, a longer sales cycle, and a continued economic downturn in any of the various industry segments in which we operate, could result in a decline in our revenue and negatively impact our liquidity and cash resources.

Net cash provided by operating activities was $161 million and $155 million for the six months ended September 30, 2004 and 2003. Net cash provided by operations consisted primarily of net income adjusted for depreciation and increases in unearned revenue, provision for income taxes and other accrued liabilities, and decrease in prepaid expenses and other current assets offset in part by an increase in accounts receivable and decrease in unbilled revenue and client deposits.

Trade accounts receivable increased by $60 million during the six months ended September 30, 2004. Accounts receivable as a percentage of last 12 months revenues represented 15.6% and 14.4% as of September 30, 2004 and 2003. Prepaid expenses and other current assets decreased by $5 million during the six months ended September 30, 2004, as compared to a $6 million increase during the six months ended September 30, 2003. The decrease during the six months ended September 30, 2004 is primarily due to reversal of marked to market gains on forward foreign exchange contracts as of March 31, 2004. Other accrued liabilities increased by $7 million during the six months ended September 30, 2004, primarily due to $4 million accrual of marked to market loss on forward foreign exchange contracts. Other accrued liabilities increased by $12 million during the six months ended September 30, 2003.

There has been an increase in unbilled revenues of $7 million during the six months ended September 30, 2004. Unbilled revenues represent revenues that are recognized but not yet invoiced. Client deposits decreased by $6 million during the six months ended September 30, 2004. Unearned revenues increased by $8 million during the six months ended September 30, 2004 compared to an increase of $2 million during the six months ended September 30, 2003. Unearned revenue resulted primarily from advance client billings on fixed-price, fixed-time frame contracts for which related efforts have not been expended. Revenues from fixed-price, fixed-time frame contracts and from time-and-materials contracts represented 29.7% and 70.3% of total services revenues for the six months ended September 30, 2004, as compared to 35.4% and 64.6% for the six months ended September 30, 2003.

Net cash used in investing activities was $83 million and $125 million for the six months ended September 30, 2004 and 2003. Net cash used in investing activities, relating to our acquisition of additional property, plant and equipment for the six months ended September 30, 2004 and 2003, was $72 million and $29 million. During the six months ended September 30, 2004 we invested $24 million in liquid mutual funds, $8 million in non-current deposits with corporations, and redeemed mutual fund investments of $20 million. During the six months ended September 30, 2003, we invested $98 million in liquid mutual fund units.

We provide various loans primarily to employees in India who are not executive officers or directors, including car loans, home loans, personal computer loans, telephone loans, medical loans, marriage loans, personal loans, salary advances, education loans and loans for rental deposits. All of these loans, except for the housing and car loans, are available to all of our employees, who are not executive officers or directors, in India. Housing and car loans are available only to mid-level managers and senior managers. The loan program is designed to assist our employees and increase employee satisfaction. These loans are generally collateralized against the assets of the loan and the terms of the loans range from 1 to 100 months. In the aggregate, these loans represented approximately $27 million and $25 million as of March 31, 2004 and September 30 2004. During fiscal 2004, we discontinued fresh disbursements under several of these loan schemes including housing and car loans.

Net cash used in financing activities for the six months ended September 30, 2004 was $162 million. This primarily comprises $27 million of cash raised by issuance of common stock on exercise of stock options by employees, offset by dividend payments of $189 million. Dividend payments are on account of a final dividend of Rs. 3.75 per equity share for fiscal 2004 and a special one-time dividend of Rs. 25 per equity share paid in June 2004. Net cash used in financing activities for six months ended September 30, 2003 primarily comprised $22 million of dividend payments.

As of September 30, 2004, we had contractual commitments for capital expenditure of $57 million. These commitments include approximately $50 million in domestic purchases and $7 million in imports and overseas commitments for hardware, supplies and services to support our operations generally, which we expect to be significantly completed by March 2005.

We have provided information to the public regarding forward-looking guidance on our business operations. This information is consistent with market expectations.

Reconciliation between Indian and U.S. GAAP

All financial information in this quarterly report is presented in U.S. GAAP, although we also report for Indian statutory purposes under Indian GAAP. There are material differences between financial statements prepared in Indian and U.S. GAAP. The material differences that affect us are primarily attributable to U.S. GAAP requirements for the:

- accounting for stock-based compensation;
- amortization of intangible assets; and
- deferred taxes;

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Reconciliation of net income

*(Dollars in millions)*

| | Six months ended September 30, | |
|---|---|---|
| | **2003** | **2004** |
| Net profit as per Indian GAAP | $ 124 | $ 183 |
| Amortization of stock compensation expense | (2) | |
| Forward contracts marked to market | 1 | (4) |
| Amortization of intangible assets | | (1) |
| Deferred taxes | | 2 |
| Net income as per U.S. GAAP | $ 123 | $ 180 |

Quantitative and qualitative disclosures about market risk

General

Market risk is the risk that changes in the price of a financial instrument will impact future earnings or cash flow. The value of a financial instrument may change as a result of changes in the interest rates, foreign currency exchange rates, commodity prices, equity prices and other market changes that affect market risk sensitive instruments. Market risk is attributable to all market sensitive financial instruments including foreign currency receivables and payables.

Our exposure to market risk is a function of our borrowing activities and revenue generating activities in foreign currency. The objective of market risk management is to avoid excessive exposure of our earnings and equity to loss. Most of our exposure to market risk arises out of our foreign currency accounts receivable.

Risk management procedures

We manage market risk through treasury operations. Treasury operations objectives and policies are approved by senior management and our audit committee. The activities of treasury operations include management of cash resources, implementing hedging strategies for foreign currency exposures, borrowing strategies, if any, and ensuring compliance with market risk limits and policies.

Components of market risk

*Exchange rate risk.* Our exposure to market risk arises principally from exchange rate risk. Even though our functional currency is the Indian rupee, we transact a major portion of our business in foreign currencies, particularly the U.S. dollar. The exchange rate between the rupee and the dollar has changed substantially in recent years and may fluctuate substantially in the future. Consequently, the results of our operations are adversely affected as the rupee appreciates against dollar. For the six months ended September 30, 2004, and 2003 our U.S. dollar denominated revenues represented 79.0% and 86.9% of our total revenues. Our exchange rate risk primarily arises from our foreign currency revenues, receivables and payables. We have sought to reduce the effect of exchange rate fluctuations on our operating results by purchasing foreign exchange forward contracts to cover a portion of outstanding accounts receivable. As of March 31, 2004 and September 30, 2004, we had outstanding forward contracts in the amount of $149 million and $188 million. These contracts typically mature within one to twelve months, must be settled on the

day of maturity and may be cancelled subject to the payment of any gains or losses in the difference between the contract exchange rate and the market exchange rate on the date of cancellation. We use these instruments only as a hedging mechanism and not for speculative purposes. We may not purchase adequate contracts to insulate ourselves from foreign exchange currency risks. The policies of the Reserve Bank of India may change from time to time which may limit our ability to hedge our foreign currency exposures adequately. In addition, any such contracts may not perform adequately as a hedging mechanism. We may, in the future, adopt more active hedging policies, and have done so in the past.

*Fair value.* The fair value of our market rate risk sensitive instruments approximates their carrying value.

Critical accounting policies

We consider the policies discussed below to be critical to an understanding of our financial statements as their application places the most significant demands on management s judgment, with financial reporting results relying on estimation about the effect of matters that are inherently uncertain. Specific risks for these critical accounting policies are described in the following paragraphs. For all of these policies, future events rarely develop exactly as forecast, and the best estimates routinely require adjustment.

Estimates

We prepare financial statements in conformity with U.S. GAAP, which requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities on the date of the financial statements and the reported amounts of revenues and expenses during the financial reporting period. We primarily make estimates related to contract costs expected to be incurred to complete development of software, allowances for doubtful accounts receivable, our future obligations under employee retirement and benefit plans, useful lives of property, plant and equipment, future income tax liabilities and contingencies and litigation.

We continually evaluate these estimates and assumptions based on the most recently available information, our own historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Since the use of estimates is an integral component of the financial reporting process, actual results could differ from those estimates.

Revenue recognition

We derive our revenues primarily from software development and related services, licensing of software products and from business process management services. We make and use significant management judgments and estimates in connection with the revenue that we recognize in any accounting period. Material differences may result in the amount and timing of our revenue for any period, if we made different judgments or utilized different estimates.

Arrangements with customers for software development and related services are either on a fixed-price, fixed-time frame or on a time-and-material basis. Revenue on time-and- material contracts is recognized as the related services are rendered. Revenue from the end of the last billing to the balance sheet date is recognized as unbilled revenues. Maintenance revenues are recognized ratably over the term of the underlying maintenance arrangement. When the company receives advances for services and products, such amounts are reported as client deposits until all conditions for revenue recognition are met.

Revenue from our fixed-price arrangements for software development and related services that involves significant production, modification or customization of the software, is accounted in conformity with ARB No. 45, using the guidance in Statement of Position (SOP) 81-1, and the Accounting Standards Executive Committee s conclusion in paragraph 95 of SOP 97-2. Fixed-price arrangements, which are similar to contracts to design, develop, manufacture,

or modify complex aerospace or electronic equipment to a buyer s specification or to provide services related to the performance of such contracts and contracts for services performed by architects, engineers, or architectural or engineering design firms, as laid out in Paragraph 13 of SOP 81-1, are also accounted for in conformity with SOP 81-1.

In the above mentioned fixed price arrangements, revenue has been recognized using the percentage-of-completion method. Costs and earnings in excess of billings are classified as unbilled revenue while billings in excess of costs and earnings are classified as unearned revenue. In measuring progress towards completion, we have selected a method that we believe is reliable and best approximates the progress to completion. The input (efforts expended) method has been used to measure progress towards completion as there is a direct relationship between labor hour input and productivity and the method indicates the most reliable measure of progress. However, we evaluate each contract and apply judgment to ensure the existence of a relationship between labor hours input and productivity.

At the end of every reporting period, we evaluate each project for estimated revenue and estimated efforts. Any revisions or updates to existing estimates are made wherever required by obtaining approvals from officers having the requisite authority. Management regularly reviews and evaluates the status of each contract in progress to estimate the profit or loss. As part of the review, detailed actual efforts and a realistic estimate of efforts to complete all phases of the project is compared with the details of the original estimate and the total contract price. To date, we have not had any fixed-price, fixed-time frame contracts that resulted in a material loss. However, our policy is to establish a provision for losses on a

contract as soon as losses become evident. We evaluate change orders according to their characteristics and the circumstances in which they occur. If such change orders are considered by the parties to be a normal element within the original scope of the contract, no change in the contract price is made. Otherwise, the adjustment to the contract price may be routinely negotiated. Contract revenue and costs are adjusted to reflect change orders approved by the client and us, regarding both scope and price. Changes are reflected in revenue recognition only after the change order has been approved by both parties. The same principle is also followed for escalation clauses. Costs that are incurred for a specific anticipated contract that will result in no future benefits unless the contract is obtained are not included in contract costs or deferred costs before the signing of the contract. Such costs are deferred only if the costs can be directly associated with a specific anticipated contract and if their recoverability from that contract is determined to be probable.

We provide our clients with a fixed-period warranty for corrections of errors and telephone support on all fixed-price, fixed-time frame contracts. Costs associated with such support services are accrued at the time related revenues are recorded and included in cost of revenues. We estimate such costs based on historical experience, and review estimates on a periodic basis for any material changes in assumptions and likelihood of occurrence.

In accordance with SOP 97-2, Software Revenue Recognition, license fee revenues are recognized when persuasive evidence of an arrangement exists, delivery has occurred, the license fee is fixed and determinable, and the collection of the fee is probable. Arrangements to deliver our software product generally have three elements: license, implementation and Annual Technical Services, or ATS. We have applied the principles in SOP 97-2 to account for revenue from these multiple element arrangements. Vendor Specific Objective Evidence of fair value or VSOE has been established for ATS. VSOE is the price charged when the element is sold separately. When other services are provided in conjunction with the licensing arrangement, the revenue from such contracts are allocated to each component of the contract using the residual method, whereby revenue is deferred for the undelivered services and the residual amounts are recognized as revenue for delivered elements. In the absence of an established VSOE for implementation, the entire arrangement fee for license and implementation is recognized as the implementation is performed. Revenue from client training, support and other services arising due to the sale of software products is recognized as the services are performed. ATS revenue is recognized ratably over the period in which the services are rendered.

Revenues from business process management and other services are recognized on both the time-and-material and fixed-price, fixed-time frame bases. Revenue on time-and-material contracts is recognized as the related services are rendered. Revenue from fixed-price, fixed-time frame contracts is recognized as per the proportional performance method using an output measure of performance.

We recognize revenue only on collectibility being probable and hence credit losses do not have an impact on our revenue recognition policy. Fluctuations in our provisions for bad debts and write offs of uncollectible accounts depend on the financial health and economic environment governing our clients. Our provisions are based on specific identification of the credit loss. No one client has contributed significantly to credit losses. We have had no significant changes in our collection policies or payment terms.

Income taxes

As part of our financial reporting process, we are required to estimate our liability for income taxes in each of the tax jurisdictions in which we operate. This process requires us to estimate our actual current tax exposure together with an assessment of temporary differences resulting from differing treatment of items, such as depreciation on property, plant and equipment, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our balance sheet.

We face challenges from domestic and foreign tax authorities regarding the amount of current taxes due. These challenges include questions regarding the timing and amount of deductions and the allocation of income among various tax jurisdictions. Based on our evaluation of our tax position and the information presently available to us, we believe we have adequately accrued for probable exposures as of September 30, 2004. To the extent we are able to prevail in matters for which accruals have been established or are required to pay amounts in excess of our reserves, our effective tax rate in a given financial statement period may be materially impacted.

Our deferred tax liabilities mainly arise from taxable basis differences in foreign exchange forward contracts, intangible assets and investments in liquid mutual funds. Our deferred tax assets comprise assets arising from basis differences in depreciation on property, plant and equipment, investments for which the ultimate realization of the tax asset may be dependent on the availability of future capital gains, and provisions for doubtful accounts receivable. We assess the likelihood that our deferred tax assets will be recovered from future taxable income. This assessment takes into consideration tax planning strategies, including levels of historical taxable income and assumptions regarding the availability and character of future taxable income over the periods in which the deferred tax assets are deductible. We believe it is more likely than not that we will realize the benefits of those deductible differences, net of the existing valuation allowance at September 30, 2004. The ultimate amount of deferred tax assets realized may be materially different from those recorded, as influenced by potential changes in income tax laws in the tax jurisdictions where we operate.

To the extent we believe that realization of a deferred tax asset is not likely, we establish a valuation allowance or increase this allowance in an accounting period and include an expense within the tax provision in our statements of income. As of March 31, 2004 and September 30, 2004, we recorded valuation allowances of $2 million and $3 million due to uncertainties related to our ability to utilize some of our deferred tax assets comprising provisions for doubtful accounts receivable and investments. In the event that actual results differ from these estimates of valuation allowance or if we adjust these estimates in future periods, we may need to establish an additional valuation allowance, which could materially impact our financial position and results of operations.

Business Combinations, Goodwill and Intangible Assets

We account for business combinations in accordance with SFAS No. 141, Business Combinations. Cash and amounts of consideration that are determinable at the date of acquisition are included in determining the cost of the acquired business. The accounting for contingent consideration based on earnings or other performance measures is a matter of judgment that depends on the relevant facts and circumstances. If the substance of the contingent consideration is to provide compensation for services, use of property, or profit sharing, we account for the additional consideration as an expense of the appropriate period. Otherwise, the additional consideration paid is recorded as an additional cost of the acquired business.

Goodwill represents the cost of the acquired businesses in excess of the fair value of identifiable tangible and intangible net assets purchased. We generally seek the assistance of independent valuation experts in determining the fair value of the identifiable tangible and intangible net assets of the acquired business. We assign all the assets and liabilities of the acquired business, including goodwill, to reporting units in accordance with SFAS No. 142, Goodwill and Other Intangible Assets.

We test goodwill for impairment on an annual basis. In this process, we rely on a number of factors including operating results, business plans and future cash flows. Recoverability of goodwill is evaluated using a two-step process. The first step involves a comparison of the fair value of a reporting unit with its carrying value. If the carrying amount of the reporting unit exceeds its fair value, the second step of the process involves a comparison of the fair value and carrying value of the goodwill of that reporting unit. If the carrying value of the goodwill of a reporting unit exceeds the fair value of that goodwill, an impairment loss is recognized in an amount equal to the excess. Goodwill of a reporting unit shall be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of the reporting unit below its carrying

amount.

We amortize intangible assets over their respective individual estimated useful lives on a straight-line basis. Our estimates of the useful lives of identified intangible assets are based on a number of factors including the effects of obsolescence, demand, competition, and other economic factors (such as the stability of the industry, and known technological advances), and the level of maintenance expenditures required to obtain the expected future cash flows from the asset.

We evaluate intangible assets for recoverability whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying value of the assets exceeds the fair value of the assets.

In evaluating goodwill and intangible assets for impairment, we may seek the assistance of independent valuation experts, perform internal valuation analyses and consider other information that is publicly available. The results of our evaluation may be dependent on a number of factors including estimates of future market growth and trends, forecasted revenue and costs, discount rates and other variables. While we use assumptions which we believe are fair and reasonable, actual future results may differ from the estimates arrived at using the assumptions.

Off-balance sheet arrangements

None

Risk factors

This Quarterly Report contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those set forth in the following risk factors and elsewhere in this Quarterly Report.

Risks related to our company and our industry

*Our revenues and expenses are difficult to predict and can vary significantly from period to period, which could cause our share price to decline.*

Our revenues and profitability have grown rapidly in recent years and are likely to vary significantly in the future from period to period. Therefore, we believe that period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as an indication of our future performance. It is possible that in the future some of our results of operations may be below the expectations of market analysts and our investors, which could cause the share price of our equity shares and our ADSs to decline significantly.

Factors which affect the fluctuation of our operating results include:

- the size, timing and profitability of significant projects;
- changes in our pricing policies or those of our competitors;
- the proportion of services that we perform outside India as opposed to at our development centers in India;
- the effect of wage pressures, seasonal hiring patterns and the time required to train and productively utilize new employees, particularly information technology, or IT, professionals;
- the size and timing of facilities expansion;
- unanticipated cancellations, contract terminations or deferrals of projects; and
- unanticipated variations in the duration, size and scope of our projects.

A significant part of our total operating expenses, particularly expenses related to personnel and facilities, are fixed in advance of any particular period. As a result, unanticipated variations in the number and timing of our projects or employee utilization rates, or the accuracy of our estimates of the resources required to complete ongoing projects, may cause significant variations in our operating results in any particular period.

There are also a number of factors, other than our performance, that are not within our control that could cause fluctuations in our operating results from period to period. These include:

- the duration of tax holidays or exemptions and the availability of other Government of India incentives;
- currency exchange rate fluctuations, particularly when the rupee appreciates in value against the dollar since the majority of our revenues are in dollars and a significant part of our costs are in rupees; and
- other general economic factors.

*We have not been able to sustain our previous profit margins or levels of profitability.*

As a percentage of total revenues, net income decreased to 25.4% for fiscal 2004 from 25.8% for fiscal 2003. Net income decreased to 25.8% of revenues for fiscal 2003 from 30.2% of revenues for fiscal 2002. Net income was 25.2% of revenues for the six months ended September 30, 2004. As we have experienced declines in demand, pricing pressures for our services, volatility of the rupee against the dollar and increased wage pressures in India, we have not been able to sustain our historical levels of profitability. We also incurred substantially higher selling and marketing expenses to increase brand awareness among target clients and promote client loyalty and repeat business among

existing clients, and we expect to continue to incur substantially higher selling and marketing expenses in the future, which could result in declining profitability. While our Global Delivery Model allows us to manage costs efficiently, as the proportion of our services delivered at client sites increases, we may not be able to keep our operating costs as low in the future.

*The current economic environment, pricing pressure and rising wages in India have negatively impacted our revenues and operating results.*

Spending on IT products and services in most parts of the world has significantly decreased due to a challenging global economic environment. Some of our clients have cancelled, reduced or deferred expenditures for IT services. Pricing pressures from our clients, wage pressures in India and an increase in our sales and marketing expenditures have also negatively impacted our operating results. For example, clients often expect that as we do more business with them, they will receive volume discounts. Additionally, clients may ask for fixed-price arrangements or reduced rates.

If the current economic recovery does not continue, our utilization and billing rates for our IT professionals could be adversely affected which may result in lower gross and operating profits.

*Any inability to manage our growth could disrupt our business and reduce our profitability.*

We have grown significantly in recent periods. Between March 31, 1999 and March 31, 2004 our total employees grew from approximately 3,800 to approximately 23,800 representing a compound annual growth rate of 44.3%. In addition, Progeon had approximately 1,900 employees as of March 31, 2004. We had approximately 32,900 employees as of September 30, 2004 including 2,700 employees in Progeon. In addition, in the last five fiscal years we have undertaken major expansions of our existing facilities, as well as the construction of new facilities.

We expect our growth to place significant demands on our management and other resources. It will require us to continue to develop and improve our operational, financial and other internal controls, both in India and elsewhere. In particular, continued growth increases the challenges involved in:

- recruiting, training and retaining sufficient skilled technical, marketing and management personnel;
- adhering to our high quality and process execution standards;
- preserving our culture, values and entrepreneurial environment;
- developing and improving our internal administrative infrastructure, particularly our financial, operational, communications and other internal systems; and
- maintaining high levels of client satisfaction.

Our growth strategy also relies on the expansion of our operations to other parts of the world, including Europe, Australia and other parts of Asia. In April 2004, we announced the formation of a U.S. subsidiary focused on consulting and announced our intention to hire aggressively in the United States. The costs involved in entering these markets may be higher than expected and we may face significant competition in these regions. Our inability to manage growth in these regions may have an adverse effect on our business, results of operations and financial condition.

*We may face difficulties in providing end-to-end business solutions for our clients, which could lead to clients discontinuing their work with us, which in turn could harm our business.*

Over the past three years, we have been expanding the nature and scope of our engagements by extending the breadth of services we offer. We have recently added new service offerings, such as IT consulting, business process management, systems integration and IT outsourcing. The success of these service offerings is dependent, in part, upon continued demand for such services by our existing and new clients and our ability to meet this demand in a cost-competitive and effective manner. In addition, our ability to effectively offer a wider breadth of end-to-end business solutions depends on our ability to attract existing or new clients to these service offerings. To obtain engagements for such end-to-end solutions, we also are more likely to compete with large, well-established international consulting firms, resulting in increased competition and marketing costs. Accordingly, we cannot be certain that our new service offerings will effectively meet client needs or that we will be able to attract existing and new clients to these service offerings.

The increased breadth of our service offerings may result in larger and more complex projects with our clients. This will require us to establish closer relationships with our clients and a thorough understanding of their operations. Our ability to establish such relationships will depend on a number of factors including the proficiency of our IT professionals and our management personnel.

Larger projects may involve multiple engagements or stages, and there is a risk that a client may choose not to retain us for additional stages or may cancel or delay additional planned engagements. These terminations, cancellations or delays may result from the business or financial condition of our clients or the economy generally, as opposed to factors related to the quality of our services. Such cancellations or delays make it difficult to plan for project resource requirements, and inaccuracies in such resource planning may have a negative impact on our profitability. While our Global Delivery Model allows us to manage costs efficiently, as the proportion of our services delivered at client sites increases, we may not be able to keep our operating costs as low in the future.

*Intense competition in the market for IT services could affect our cost advantages, which could reduce our share of business from clients and decrease our revenues.*

The IT services market is highly competitive. Our competitors include large consulting firms, divisions of large multinational technology firms, IT outsourcing firms, Indian IT services firms, software firms and in-house IT departments of large corporations.

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The IT services industry is experiencing rapid changes that are affecting the competitive landscape, including recent divestitures and acquisitions that have resulted in consolidation within the industry. These changes may result in larger competitors with significant resources. In addition, some of our competitors have added or announced plans to add cost-competitive offshore capabilities to their service offerings. Many of these competitors are substantially larger than us and have significant experience with international operations, and we may face competition from them in countries in which we currently operate, as well as in countries in which we expect to expand our operations. We also expect additional competition from IT services firms with current operations in other countries, such as China and the Philippines. While we believe that we are well positioned in our markets relative to our competitors, such competitors may be able to offer services using offshore and onshore models that are more effective than ours.

Many of our competitors, including Accenture, EDS and IBM, have significantly greater financial, technical and marketing resources, generate greater revenues and have greater name recognition than we do. We cannot be reasonably certain that we will be able to compete successfully against such competitors, or that we will not lose clients to such competitors. Additionally, we believe that our ability to compete also depends in part on factors outside our control, such as the price at which our competitors offer comparable services, and the extent of our competitors responsiveness to their clients needs.

*Our revenues are highly dependent upon a small number of clients, and the loss of any one of our major clients could significantly impact our business.*

We have historically earned, and believe that in the future we will continue to earn, a significant portion of our revenues from a limited number of corporate clients. In fiscal 2004, 2003 and six months ended September 30, 2004, our largest client accounted for 5.0%, 5.8% and 5.4% of our total revenues, and our five largest clients together accounted for 22.6%, 23.4% and 21.6% of our total revenues for fiscal 2004, 2003 and the six months ended September 30, 2004. The volume of work we perform for specific clients is likely to vary from year to year, particularly since we historically have not been the exclusive external IT services provider for our clients. Thus, a major client in one year may not provide the same level of revenues in a subsequent year. However, in any given year, a limited number of clients tend to contribute a significant portion of our revenues.

There are a number of factors, other than our performance, that could cause the loss of a client and that may not be predictable. In certain cases, we have significantly reduced the services provided to a client when the client either changed its outsourcing strategy by moving more work in-house or replaced its existing software with packaged software supported by the licensor. Another circumstance which may result in our loss of a client is a reduction in spending on IT services due to a challenging economic environment. If we were to lose one of our major clients or have it significantly reduce its volume of business with us, our revenues and profitability could be reduced.

*Our revenues are highly dependent on clients primarily located in the United States, as well as clients concentrated in certain industries, and economic slowdowns, changes in U.S. law and other restrictions or factors that affect the economic health of the United States and these industries may affect our business.*

A significant portion of our revenues are derived from clients located in the United States, as well as clients in certain industries. In fiscal 2004, 2003 and the six months ended September 30, 2004, approximately 70.0%, 72.0% and 64.0% of our revenues were derived from the United States. For the same periods, we earned 36.6%, 37.6% and 34.5% of our revenues from the financial services industry, and 14.8%, 16.4% and 14.9% from the manufacturing industry. Consequently, if the current economic recovery in the United States does not continue, our clients may reduce or postpone their IT spending significantly, which may in turn lower the demand for our services and negatively affect our revenues and profitability. Further, any significant decrease in the growth of the financial services or other industry segments on which we focus may reduce the demand for our services and negatively affect our revenues and profitability.

Recently, some organizations have expressed concerns about a perceived association between offshore outsourcing and the loss of jobs in the United States. There has also been increasing political and media attention in the United States to the growth of offshore outsourcing. Within the last two years, some U.S. states have enacted legislation restricting government agencies from outsourcing their back office processes and IT solutions work to companies outside the United States. It is also possible that U.S. private sector companies that work with these states may be restricted from outsourcing their work related to government contracts. We currently do not have significant contracts with U.S. federal or state government entities. However, there can be no assurance that these restrictions will not extend to private companies, such as our clients. In the future, we may also enter into significant contracts with U.S. federal or state government entities. Any changes to existing laws or the enactment of new legislation restricting offshore outsourcing may adversely impact our ability to do business in the United States, particularly if these changes are widespread.

*Our success depends in large part upon our highly skilled IT professionals and our ability to attract and retain these personnel.*

Our ability to execute projects and to obtain new clients depends largely on our ability to attract, train, motivate and retain highly skilled IT professionals, particularly project managers and other mid-level professionals. If we cannot hire and retain additional qualified personnel, our ability to bid on and obtain new projects, and to continue to expand our business will be impaired and our revenues could decline. We believe that there is significant worldwide competition for IT professionals with the skills necessary to perform the services we offer. We may not be able to hire and retain enough skilled and experienced IT professionals to replace those who leave. Additionally, we may not be able to redeploy and retrain our IT professionals to keep pace with continuing changes in technology, evolving standards and changing client preferences. Our inability to attract and retain IT professionals may have a material adverse effect on our business, results of operations and financial condition.

*Our success depends in large part upon our management team and key personnel and our ability to attract and retain them.*

We are highly dependent on the senior members of our management team, including the continued efforts of our Chairman, our Chief Executive Officer, our Chief Operating Officer, our Chief Financial Officer, other executive members of the board and the management council, which consists of executive and other officers. Our future performance will be affected by any disruptions in the continued service of these persons. We do not maintain key man life insurance for any of the senior members of our management team or other key personnel. Competition for senior management in our industry is intense, and we may not be able to retain such senior management personnel or attract and retain new senior management personnel in the future. The loss of any members of our senior management or other key personnel may have a material adverse effect on our business, results of operations and financial condition.

*Our failure to complete fixed-price, fixed-time frame contracts on budget and on time may negatively affect our profitability.*

As an element of our business strategy, we offer a portion of our services on a fixed-price, fixed-time frame basis, rather than on a time-and-materials basis. In fiscal 2004, 2003 and six months ended September 30, 2004, revenues from fixed-price, fixed-time frame projects accounted for 33.7%, 36.7% and 29.7% of our total services revenues. Although we use our software engineering methodologies and processes and past project experience to reduce the risks associated with estimating, planning and performing fixed-price, fixed-time frame projects, we bear the risk of cost overruns, completion delays and wage inflation in connection with these projects. If we fail to estimate accurately the resources and time required for a project, future wage inflation rates, or currency exchange rates, or if we fail to complete our contractual obligations within the contracted time frame, our profitability may suffer.

*Our client contracts can typically be terminated without cause and with little or no notice or penalty, which could negatively impact our revenues and profitability.*

Our clients typically retain us on a non-exclusive, project-by-project basis. Most of our client contracts, including those that are on a fixed-price, fixed-time frame basis, can be terminated with or without cause, with between zero and 90 days notice and without termination-related penalties. Additionally, our contracts with clients are typically limited to discrete projects without any commitment to a specific volume of business or future work. Our business is dependent on the decisions and actions of our clients, and there are a number of factors relating to our clients that are outside our control that might result in the termination of a project or the loss of a client, including:

- financial difficulties for a client;
- a change in strategic priorities, resulting in a reduced level of IT spending;
- a demand for price reductions;
- a change in outsourcing strategy by moving more work to client in-house IT departments or to our competitors; and
- the replacement by our clients of existing software with packaged software supported by licensors.

*Our client contracts are often conditioned upon our performance, which, if unsatisfactory, could result in less revenue generated than anticipated.*

A number of our contracts have incentive-based or other pricing terms that condition some or all of our fees on our ability to meet defined goals. Our failure to meet these goals or a client s expectations in such performance-based contracts may result in a less profitable or an unprofitable engagement.

*Our business will suffer if we fail to anticipate and develop new services and enhance existing services in order to keep pace with rapid changes in technology and the industries on which we focus.*

The IT services market is characterized by rapid technological change, evolving industry standards, changing client preferences and new product and service introductions. Our future success will depend on our ability to anticipate these advances and develop new product and service offerings to meet client needs. We may not be successful in anticipating or responding to these advances in a timely basis, or, if we do respond, the services or technologies we develop may not be successful in the marketplace. Further, products, services or technologies that are developed by our competitors may render our services non-competitive or obsolete.



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*Disruptions in telecommunications, system failures, or virus attacks could harm our service delivery model, which could result in client dissatisfaction and a reduction of our revenues.*

A significant element of our distributed project management methodology, which we refer to as our Global Delivery Model is to continue to leverage and expand our global development centers. We currently have 31 global development centers located in various countries around the world. Our global development centers are linked with a network architecture that uses multiple service providers and various satellite and optical links with alternate routing. We may not be able to maintain active voice and data communications between our various global development centers and between our global development centers and our clients sites at all times due to disruptions in telecommunications, system failures or virus attacks. Any significant loss in our ability to communicate could result in a disruption in business, which could hinder our performance or our ability to complete client projects on time. This, in turn, could lead to client dissatisfaction and a material adverse effect on our business, results of operations and financial condition.

*We may be liable to our clients for damages caused by system failures, which could damage our reputation and cause us to lose clients.*

Many of our contracts involve projects that are critical to the operations of our clients businesses, and provide benefits which may be difficult to quantify. Any failure in a client s system or breaches of security could result in a claim for substantial damages against us, regardless of our responsibility for such failure. Although we attempt to limit our contractual liability for consequential damages in rendering our services, we cannot be assured that the limitations on liability we provide for in our service contracts will be enforceable in all cases, or that they will otherwise be sufficient to protect us from liability for damages. We maintain general liability insurance coverage, including coverage for errors or omissions, however, we cannot be assured that such coverage will continue to be available on reasonable terms or will be available in sufficient amounts to cover one or more large claims, or that the insurer will not disclaim coverage as to any future claim. A successful assertion of one or more large claims against us that exceeds our available insurance coverage or changes in our insurance policies, including premium increases or the imposition of a large deductible or co-insurance requirement, could adversely affect our operating results.

*We are investing substantial cash assets in new facilities, and our profitability could be reduced if our business does not grow proportionately.*

As of September 30, 2004, we had contractual commitments of approximately $57 million for capital expenditures. Although we have successfully developed new facilities in the past, we may still encounter cost overruns or project delays in connection with new facilities. Additionally, future financing for additional facilities, whether within India or elsewhere, may not be available on attractive terms or at all. Such expansions will significantly increase our fixed costs. If we are unable to grow our business and revenues proportionately, our profitability will be reduced.

*We may be unable to recoup our investment costs to develop our software products.*

In fiscal 2004, 2003 and the six months ended September 30, 2004, we earned 2.8%, 4.6% and 2.7% of our total revenue from the sale of software products. The development of our software products requires significant investments. The markets for our primary suite of software products that we call Finacle® are competitive. Our current software products or any new software products that we develop may not be commercially successful and the costs of developing such new products may not be recouped. Since software product revenues typically occur in periods subsequent to the periods in which the costs are incurred for the development of such software products, delayed revenues may cause periodic fluctuations of our operating results.

*Our insiders are significant shareholders, are able to exercise significant control over the election of our board and may have interests which conflict with those of our other shareholders or holders of our ADSs.*

Our executive officers and directors, together with members of their immediate families, beneficially owned, in the aggregate, approximately 22.3% of our issued equity shares as of September 30, 2004. As a result, acting together, this group has the ability to exercise significant control over most matters requiring our shareholders approval, including the election and removal of directors and significant corporate transactions.

*We may engage in acquisitions, strategic investments, strategic partnerships or alliances or other ventures that may or may not be successful.*

We may acquire or make strategic investments in complementary businesses, technologies, services or products, or enter into strategic partnerships or alliances with third parties in order to enhance our business. For example, we recently acquired Expert Information Services Pty. Limited, Australia and established Infosys Technologies (Shanghai) Co. Limited and Infosys Consulting, Inc. It is possible that we may not identify suitable acquisition, strategic investment or strategic partnership candidates, or if we do identify suitable candidates, we may not complete those transactions on terms commercially acceptable to us or at all. The inability to identify suitable acquisition targets or investments or the inability to complete such transactions may affect our competitiveness and our growth prospects.

If we acquire a company, we could have difficulty in assimilating that company s personnel, operations, technology and software. In addition, the key personnel of the acquired company may decide not to work for us. In some cases, we could have difficulty in integrating the acquired products, services or technologies into our operations. These difficulties could disrupt our ongoing business, distract our management and employees and increase our expenses. As of the date of this Report, we have no agreements to enter into any material acquisition, investment, partnership, alliance or other joint venture transaction.

We make strategic investments in new technology start-up companies in order to gain experience in or exploit niche technologies. As of September 30, 2004, we have invested an aggregate amount of approximately $11 million in strategic investments. However, our investments may not be successful. The lack of profitability of any of our investments could have a material adverse effect on our operating results. In fiscal 2004 and 2003, we made loss provisions of $2 million and $3 million related to investments.

*Our earnings may be adversely affected if we are required to change our accounting policies with respect to the expensing of stock options.*

We do not currently deduct the expense of employee stock option grants from our income based on the fair value method. The Financial Accounting Standards Board has issued an exposure draft, which if adopted, would require companies to change their accounting policies to record the fair value of stock options issued to employees as an expense. Many companies have or are in the process of voluntarily changing their accounting policies to expense the fair value of stock options. Stock options are an important component of our employee compensation package. If we change our accounting policy with respect to the treatment of employee stock option grants, our earnings could be adversely affected. We have adopted the pro forma disclosure provisions of SFAS No. 123, Accounting for Stock-Based Compensation. Had compensation cost for our stock-based compensation plan been determined in a manner consistent with the fair value approach described in SFAS No. 123, our net income as reported would have been reduced to the pro forma amounts of approximately $223 million, $137 million and $164 million in fiscal 2004, 2003 and the six months ended September 30, 2004.

Risks related to investments in Indian companies and international operations generally

*Our net income would decrease if the Government of India reduces or withdraws tax benefits and other incentives it provides to us.*

Currently, we benefit from the tax holidays the Government of India gives to the export of IT services from specially designated software technology parks in India. As a result of these incentives, which include a 10-year tax holiday from Indian corporate income taxes for the operation of most of our Indian facilities, our operations have been subject to relatively low tax liabilities. These tax incentives resulted in a decrease in our income tax expense of $78 million, $51 million and $56 million for fiscal 2004, 2003 and the six months ended September 30, 2004 compared to the effective tax rates that we estimate would have applied if these incentives had not been available.

The Finance Act, 2000 phases out the 10-year tax holiday over a ten-year period from fiscal 2000 through fiscal 2009. Additionally, the Finance Act, 2002 required that ten percent of all income derived from services performed in software technology parks be subject to income tax for a one-year period which ended March 31, 2003. When our tax holiday expire or terminate, our tax expense will materially increase, reducing our profitability.

*Wage pressures in India may prevent us from sustaining our competitive advantage and may reduce our profit margins.*

Wage costs in India have historically been significantly lower than wage costs in the United States and Europe for comparably skilled professionals, which has been one of our competitive strengths. However, wage increases in India may prevent us from sustaining this competitive advantage and may negatively affect our profit margins. Wages in India are increasing at a faster rate than in the United States, which could result in increased costs for IT professionals, particularly project managers and other mid-level professionals. We may need to increase the levels of our employee compensation more rapidly than in the past to remain competitive. Compensation increases may result in a material adverse effect on our business, results of operations and financial condition.

*Terrorist attacks or a war could adversely affect our business, results of operations and financial condition.*

Terrorist attacks, such as the attacks of September 11, 2001 in the United States and other acts of violence or war, such as the recent conflict in Iraq, have the potential to have a direct impact on our clients. To the extent that such attacks affect or involve the United States, our business may be significantly impacted, as the majority of our revenues are derived from clients located in the United States. In addition, such attacks may make travel more difficult, may make it more difficult to obtain work visas for many of our IT professionals who are required to work in the United States, and may effectively curtail our ability to deliver our services to our clients. Such obstacles to business may increase our expenses and negatively affect the results of our operations. Many of our clients, in particular for our newer services, such as business process management and IT outsourcing, visit several IT services firms prior to reaching a decision on vendor selection. Terrorist threats, attacks or war could make travel more difficult and delay, postpone or cancel decisions to use our services.

*Regional conflicts in South Asia could adversely affect the Indian economy, disrupt our operations and cause our business to suffer.*

South Asia has from time to time experienced instances of civil unrest and hostilities among neighboring countries, including between India and Pakistan. In recent years there have been military confrontations between India and Pakistan that have occurred in the region of Kashmir and along the India-Pakistan border. Military activity or terrorist attacks in the future could influence the Indian economy by disrupting communications and making travel more difficult and such political tensions could create a greater perception that investments in Indian companies involve higher degrees of risk. This, in turn, could have a material adverse effect on the market for securities of Indian companies, including our equity shares and our ADSs, and on the market for our services.

*Restrictions on immigration may affect our ability to compete for and provide services to clients in the United States, which could hamper our growth and cause our revenues to decline.*

The vast majority of our employees are Indian nationals. The ability of our IT professionals to work in the United States, Europe and in other countries depends on the ability to obtain the necessary visas and work permits. As of September 30, 2004, the majority of our IT professionals in the United States held H-1B visas (approximately 3,500 persons), allowing the employee to remain in the United States during the term of the work permit, and work as long as he or she remains an employee of the sponsoring firm, or L-1 visas (approximately 700 persons), allowing for the employee to stay in the United States only temporarily. Although there is no limit to new L-1 visas, there is a limit to the aggregate number of new H-1B visas that the U.S. Citizenship and Immigration Services, or CIS, may approve in any government fiscal year. In 2000, the United States temporarily increased the annual limit for H-1B visas to 195,000, however this increase expired in 2003 and the limit was returned to 65,000 annually. Further, in response to the terrorist attacks in the United States, the CIS has increased the level of scrutiny in granting visas. This may also lead to limits on the number of L-1 visas granted. The U.S. immigration laws may also require us to meet certain levels of compensation, and to comply with other legal requirements, as a condition to obtaining or maintaining work visas for our IT professionals working in the United States. The CIS announced on October 1, 2004 that it had received on the first day of the new government fiscal year sufficient applications to fill up all 65,000 visas that were available for the year.

Immigration laws in the United States and in other countries are subject to legislative change, as well as to variations in standards of application and enforcement due to political forces and economic conditions. It is difficult to predict the political and economic events that could affect immigration laws, or the restrictive impact they could have on obtaining or monitoring work visas for our IT professionals. Our reliance on work visas for a significant number of IT professionals makes us particularly vulnerable to such changes and variations as it affects our ability to staff projects with IT professionals who are not citizens of the country where the work is to be performed. As a result, we may not be able to obtain a sufficient number of visas for our IT professionals or may encounter delays or additional costs in obtaining or maintaining the condition of such visas.

*Changes in the policies of the Government of India or political instability could delay the further liberalization of the Indian economy and adversely affect economic conditions in India generally, which could impact our business and prospects.*

Since 1991, successive Indian governments have pursued policies of economic liberalization, including significantly relaxing restrictions on the private sector. Nevertheless, the role of the Indian central and state governments in the Indian economy as producers, consumers and regulators has remained significant. The current Government of India, formed in May 2004 has announced policies and taken initiatives that support the continued economic liberalization policies that have been pursued by previous governments. However, these liberalization policies may not continue in the future. The rate of economic liberalization could change, and specific laws and policies affecting technology

companies, foreign investment, currency exchange and other matters affecting investment in our securities could change as well. A significant change in India s economic liberalization and deregulation policies could adversely affect business and economic conditions in India generally, and our business in particular.

Political instability could also delay the reform of the Indian economy and could have a material adverse effect on the market for securities of Indian companies, including our equity shares and our ADSs, and on the market for our services.

*Currency exchange rate fluctuations may affect the value of our ADSs.*

Our functional currency is the Indian rupee although we transact a major portion of our business in foreign currencies and accordingly face foreign currency exposure through our sales in the United States and elsewhere and purchases from overseas suppliers in dollars. Historically, we have held a substantial majority of our cash funds in rupees. Accordingly, changes in exchange rates may have a material adverse effect on our revenues, cost of services sold, gross margin and net income, which may in turn have a negative impact on our business, operating results and financial condition. The exchange rate between the rupee and the dollar has changed substantially in recent years and may fluctuate substantially in the future. We expect that a majority of our revenues will continue to be generated in U.S. dollars for the foreseeable future and that a significant portion of our expenses, including personnel costs, as well as capital and operating expenditures, will continue to be denominated in Indian rupees. Consequently, the results of our operations are adversely affected as the rupee appreciates against the dollar.

We have sought to reduce the effect of exchange rate fluctuations on our operating results by purchasing foreign exchange forward contracts to cover a portion of outstanding accounts receivable. As of March 31, 2004 and September 30, 2004, we had outstanding forward contracts in the amount of $149 million and $188 million. This increase is primarily attributable to our decision to actively hedge our foreign currency exposure in light of the recent volatility of the Indian rupee against the U.S. dollar. We may not purchase contracts adequate to insulate ourselves from foreign exchange currency risks. Additionally, the policies of the Reserve Bank of India may change from time to time which may limit our ability to hedge our foreign currency exposures adequately.

Fluctuations in the exchange rate between the rupee and the dollar will also affect the dollar conversion by Deutsche Bank Trust Company Americas, the Depositary, of any cash dividends paid in rupees on the equity shares represented by the ADSs. In addition, these fluctuations will affect the dollar equivalent of the rupee price of equity shares on the Indian stock exchanges and, as a result, the prices of our ADSs in the United States, as well as the dollar value of the proceeds a holder would receive upon the sale in India of any equity shares withdrawn from the Depositary under the Depositary Agreement. Holders may not be able to convert rupee proceeds into dollars or any other currency, and there is no guarantee of the rate at which any such conversion will occur, if at all.

*Our international expansion plans subject us to risks inherent in doing business on an international level.*

Currently, we have global development centers in six countries around the world. The majority of our global development centers are located in India. We intend to establish new development facilities, potentially in Southeast Asia, Africa, Latin America and Europe. In April 2004, we announced the formation of a consulting subsidiary in the United States. Because of our limited experience with facilities outside of India, we are subject to additional risks related to our international expansion strategy, including risks related to complying with a wide variety of national and local laws, restrictions on the import and export of certain technologies and multiple and possibly overlapping tax structures. In addition, we may face competition in other countries from companies that may have more experience with operations in such countries or with international operations generally. We may also face difficulties integrating new facilities in different countries into our existing operations, as well as integrating employees that we hire in different countries into our existing corporate culture. In 2003, China experienced an outbreak of Severe Acute Respiratory Syndrome, or SARS. As a result travel restrictions to the region were heightened. Our international expansion strategy in China may face difficulty resulting from a potential outbreak of SARS recurring again. Our

international expansion plans may not be successful and we may not be able to compete effectively in other countries.

*It may be difficult for you to enforce any judgment obtained in the United States against us or our affiliates.*

We are incorporated under the laws of India and many of our directors and executive officers reside outside the United States. Virtually all of our assets and the assets of many of these persons are located outside the United States. As a result, you may be unable to effect service of process upon us outside India or upon such persons outside their jurisdiction of residence. In addition, you may be unable to enforce against us in courts outside of India, or against these persons outside the jurisdiction of their residence, judgments obtained in courts of the United States, including judgments predicated solely upon the federal securities laws of the United States.

We have been advised by our Indian counsel that the United States and India do not currently have a treaty providing for reciprocal recognition and enforcement of judgments (other than arbitration awards) in civil and commercial matters. Therefore, a final judgment for the payment of money rendered by any federal or state court in the United States on civil liability, whether or not predicated solely upon the federal securities laws of the United States, would not be enforceable in India. However, the party in whose favor such final judgment is rendered may bring a new suit in a competent court in India based on a final judgment that has been obtained in the United States. The suit must be brought in India within three years from the date of the judgment in the same manner as any other suit filed to enforce a civil liability in India. It is unlikely that a court in India would award damages on the same basis as a foreign court if an action is brought in India. Furthermore, it is unlikely that an Indian court would enforce foreign judgments if it viewed the amount of damages awarded as excessive or inconsistent with Indian practice. A party seeking to enforce a foreign judgment in India is required to obtain approval from the Reserve Bank of India under the Foreign Exchange Management Act, 1999, to execute such a judgment or to repatriate any amount recovered.

*The laws of India do not protect intellectual property rights to the same extent as those of the United States, and we may be unsuccessful in protecting our intellectual property rights. We may also be subject to third party claims of intellectual property infringement.*

We rely on a combination of patent, copyright, trademark and design laws, trade secrets, confidentiality procedures and contractual provisions to protect our intellectual property. However, the laws of India do not protect proprietary rights to the same extent as laws in the United States. Therefore, our efforts to protect our intellectual property may not be

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adequate. Our competitors may independently develop similar technology or duplicate our products or services. Unauthorized parties may infringe upon or misappropriate our products, services or proprietary information.

The misappropriation or duplication of our intellectual property could disrupt our ongoing business, distract our management and employees, reduce our revenues and increase our expenses. We may need to litigate to enforce our intellectual property rights or to determine the validity and scope of the proprietary rights of others. Any such litigation could be time consuming and costly. For instance, on September 9, 2004 the Intellectual Property Appellate Board of India (IPAB) upheld an application made by an infringer of the INFOSYS trademark, Jupiter International Limited (formerly called Jupiter Infosys Limited), and ordered the cancellation of the company s registration of the INFOSYS trademark in classes 7, 9 and 16. The company moved a Special Leave Petition before the Supreme Court of India to stay the order of the IPAB. On October 12, 2004 the Supreme Court of India stayed the order of the IPAB temporarily. Based on its present knowledge management believes that the company will prevail in this action and that the action will not have any material impact on the results of operations or financial position of the company. As the number of patents, copyrights and other intellectual property rights in our industry increases, and as the coverage of these rights increase, we believe that companies in our industry will face more frequent infringement claims. Defense against these claims, even if not meritorious, could be expensive and divert our attention and resources from operating our company.

Although there are currently no material pending or threatened intellectual property claims against us, infringement claims may be asserted against us in the future. However, if we become liable to third parties for infringing their intellectual property rights, we could be required to pay a substantial damage award and be forced to develop non-infringing technology, obtain a license or cease selling the applications or products that contain the infringing technology. We may be unable to develop non-infringing technology or to obtain a license on commercially reasonable terms, or at all.

*Our ability to acquire companies organized outside India depends on the approval of the Government of India and/or the Reserve Bank of India and failure to obtain this approval could negatively impact our business.*

Generally, the Reserve Bank of India must approve any acquisition by us of any company organized outside of India. The Reserve Bank of India has recently permitted acquisitions of companies organized outside of India without approval where the transaction value is:

- if in cash, up to 100% of the proceeds from an ADS offering or up to 100% of the net worth of the company; and
- if in stock, up to the greater of $100 million or ten times the acquiring company s previous fiscal year s export earnings.

Any required approval from the Reserve Bank of India and the Ministry of Finance of the Government of India or any other government agency may not be obtained. Our failure to obtain approvals for acquisitions of companies organized outside India may restrict our international growth, which could negatively affect our business and prospects.

*Indian law limits our ability to raise capital outside India and may limit the ability of others to acquire us, which could prevent us from operating our business or entering into a transaction that is in the best interests of our shareholders.*

Indian law relating to foreign exchange management constrains our ability to raise capital outside India through the issuance of equity or convertible debt securities. Generally, any foreign investment in, or acquisition of, an Indian company requires approval from relevant government authorities in India, including the Reserve Bank of India. There are, however, certain exceptions to this approval requirement for IT companies on which we are able to rely. Changes

to such policies may create restrictions on our capital raising abilities. For example, a limit on the foreign equity ownership of Indian IT companies may constrain our ability to seek and obtain additional equity investment by foreign investors. In addition, these restrictions, if applied to us, may prevent us from entering into certain transactions, such as an acquisition by a non-Indian company, which might otherwise be beneficial for us and the holders of our equity shares and ADSs.

Additionally, under current Indian law, the sale of an IT services company can result in the loss of the tax benefits for specially designed software technology parks in India. The potential loss of this tax benefit may discourage others from acquiring us or entering into a transaction with us that is in the best interest of our shareholders.

Risks related to the ADSs

*Indian law imposes foreign investment restrictions that limit a holder s ability to convert equity shares into ADSs, which may cause our ADSs to trade at a premium or discount to the market price of our equity shares.*

Except under limited circumstances, the Reserve Bank of India must approve the sale of equity shares underlying ADSs by a non-resident of India to a resident of India. Since foreign exchange controls are in effect in India, the Reserve Bank of India will also approve the price at which equity shares are transferred based on a specified formula, and a higher price per share may not be permitted. Additionally, except under certain limited circumstances, if an investor seeks to convert the rupee proceeds from a sale of equity shares in India into foreign currency and then repatriate that foreign currency from India, he or she will have to obtain an additional Reserve Bank of India approval for each transaction. Required approval from the Reserve Bank of India or any other government agency may not be obtained on terms favorable to a non-resident investor or at all.

Investors who exchange ADSs for the underlying equity shares and are not holders of record will be required to declare to us details of the holder of record, and the holder of record will be required to disclose the details of the beneficial owner. Any investor who fails to comply with this requirement may be liable for a fine of up to Rs. 1,000 for each day such failure continues. Such restrictions on foreign ownership of the underlying equity shares may cause our ADSs to trade at a premium or discount to the equity shares.

*An investor in our ADSs may not be able to exercise preemptive rights for additional shares and may thereby suffer dilution of his or her equity interest in us.*

Under the Indian Companies Act, a company incorporated in India must offer its holders of equity shares preemptive rights to subscribe and pay for a proportionate number of shares to maintain their existing ownership percentages prior to the issuance of any new equity shares, unless such preemptive rights have been waived by three-fourths of the shares voting on the resolution to waive such rights. Holders of ADSs may be unable to exercise preemptive rights for equity shares underlying ADSs unless a registration statement under the Securities Act is effective with respect to such rights or an exemption from the registration requirements of the Securities Act is available. We are not obligated to prepare and file such a registration statement and our decision to do so will depend on the costs and potential liabilities associated with any such registration statement, as well as the perceived benefits of enabling the holders of ADSs to exercise their preemptive rights, and any other factors we consider appropriate at the time. No assurance can be given that we would file a registration statement under these circumstances. If we issue any such securities in the future, such securities may be issued to the Depositary, which may sell such securities for the benefit of the holders of the ADSs. There can be no assurance as to the value, if any, the Depositary would receive upon the sale of such securities. To the extent that holders of ADSs are unable to exercise preemptive rights granted in respect of the equity shares represented by their ADSs, their proportional interests in us would be reduced.

*ADS holders may be restricted in their ability to exercise voting rights.*

At our request, the Depositary will mail to you any notice of shareholders meeting received from us together with information explaining how to instruct the Depositary to exercise the voting rights of the securities represented by ADSs. If the Depositary receives voting instructions from you in time, relating to matters that have been forwarded to you, it will endeavor to vote the securities represented by your ADSs in accordance with such voting instructions. However, the ability of the Depositary to carry out voting instructions may be limited by practical and legal limitations and the terms of the securities on deposit. We cannot assure that you will receive voting materials in time to enable you to return voting instructions to the Depositary in a timely manner. Securities for which no voting instructions have been received will not be voted. There may be other communications, notices or offerings that we only make to holders of our equity shares, which will not be forwarded to holders of ADSs. Accordingly, you may not be able to participate in all offerings, transactions or votes that are made available to holders of our equity shares.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

3.1 Foreign Currency Market Risk

This information is set forth under the caption Exchange Rate Risk under the Components of Market Risk above, and is incorporated herein by reference.

Item 4. Controls and Procedures

Based on their evaluation as of the end of the period covered by this quarterly report, our Chief Executive Officer and Chief Financial Officer believe, based on an evaluation performed under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, that the design and operation of our disclosure controls and procedures (as defined in Rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934, as amended) are effective to ensure that material information relating to Infosys is made known to them by others within our Company during the period in which this Quarterly Report was being prepared. There have been no material changes in our internal controls over financial reporting that occurred during the period covered by the quarterly report which materially affected, or would be reasonably likely to affect, our internal control over financial reporting.

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Part II Other information

Item 1. Legal proceedings

The company is subject to legal proceedings and claims, which have arisen, in the ordinary course of its business. Legal actions, when ultimately concluded and determined, will not, in the opinion of management, have a material effect on the results of operations or the financial position of the company.

In the year ended March 31, 2004, Ms. Jennifer Griffith, a former employee, filed a lawsuit against the company and its former director, Mr. Phaneesh Murthy. The lawsuit was served on the company during the quarter ended December 31, 2003. The trial of the lawsuit is scheduled shortly. Based on its present knowledge of facts, management estimates that the lawsuit will not have a material impact on the results of operations or financial position of the company.

On September 9, 2004 the Intellectual Property Appellate Board of India (IPAB) upheld an application made by an infringer of the INFOSYS trademark, Jupiter International Limited (formerly called Jupiter Infosys Limited), and ordered the cancellation of the company's registration of the INFOSYS trademark in classes 7, 9 and 16. The company moved a Special Leave Petition before the Supreme Court of India to stay the order of the IPAB. On October 12, 2004 the Supreme Court of India stayed the order of the IPAB temporarily. Based on its present knowledge management believes that the company will prevail in this action and that the action will not have any material impact on the results of operations or financial position of the company.

Item 2. Changes in securities and use of proceeds

None

Item 3. Default upon senior securities

None

Item 4. Submission of matters to a vote of security holders

None

Item 5. Other information

None

Item 6. Exhibits and reports

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly organized.

Dated: October 28, 2004

INFOSYS TECHNOLOGIES LIMITED
/s/ NANDAN M. NILEKANI
Nandan M. Nilekani
*Chief Executive Officer, President*
*and Managing Director*

EXHIBIT INDEX

| Exhibit Number | Description of Document |
|---|---|
| 31.1 | Certification of Chief Executive Officer and Chief Financial Officer under Section 302 of the Sarbanes Oxley Act. |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer under Section 906 of the Sarbanes Oxley Act. |

TD align="right">333

Talbot other interest
(16) 59
Talbot third party FAL facility
2,748

**Total**
$16,361 $13,218 $30,362 $28,369

(a) Includes finance expenses attributable to noncontrolling interest.

***(b) $250,000 2010 Senior Notes due 2040***

On January 21, 2010, the Company offered and sold $250,000 of Senior Notes due 2040 (the 2010 Senior Notes ) in a registered public offering. The 2010 Senior Notes mature on January 26, 2040, and are redeemable at the Company s option in whole any time or in part from time to time at a make-whole redemption price. The Company may redeem the notes in whole, but not in part, at any time upon the occurrence of certain tax events as described in the notes prospectus supplement. The 2010 Senior Notes bear interest at the rate of 8.875% per annum from January 26, 2010 to maturity or early redemption. Interest on the 2010 Senior Notes is payable semi-annually in arrears on January 26 and July 26 of each year, commencing on July 26, 2010. The net proceeds of $243,967 from the sale of the 2010 Senior Notes, after the deduction of commissions paid to the underwriters in the transaction and other expenses, was used by the Company for general corporate purposes, which included the repurchase of its outstanding capital stock and payment of dividends to shareholders. Debt issuance costs of $2,808 were deferred as an asset and amortized over the life of the 2010 Senior Notes.

The 2010 Senior Notes are unsecured and unsubordinated obligations of the Company and rank equally in right of payment with all of the Company s existing and future unsecured and unsubordinated indebtedness. The 2010 Senior Notes will be effectively junior to all of the Company s future secured debt, to the extent of the value of the collateral securing such debt, and will rank senior to all our existing and future subordinated debt. The 2010 Senior Notes will be structurally subordinated to all obligations of the Company s subsidiaries.

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**Validus Holdings, Ltd.**
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except share and per share information)

Future expected payments of interest on the 2010 Senior Notes are as follows:

| | |
|---|---|
| 2011 | $ 11,094 |
| 2012 | 22,188 |
| 2013 | 22,188 |
| 2014 | 22,188 |
| 2015 and thereafter | 565,780 |
| **Total minimum future payments** | $ 643,438 |

***(c) Junior subordinated deferrable debentures***

On June 15, 2006, the Company participated in a private placement of $150,000 of junior subordinated deferrable interest debentures due 2036 (the 2006 Junior Subordinated Deferrable Debentures ). The 2006 Junior Subordinated Deferrable Debentures mature on June 15, 2036, are redeemable at the Company s option at par beginning June 15, 2011, and require quarterly interest payments by the Company to the holders of the 2006 Junior Subordinated Deferrable Debentures. Interest is payable at 9.069% per annum through June 15, 2011, and thereafter at a floating rate of three-month LIBOR plus 355 basis points, reset quarterly. The proceeds of $150,000 from the sale of the 2006 Junior Subordinated Deferrable Debentures, after the deduction of commissions paid to the placement agents in the transaction and other expenses, were used by the Company to fund Validus Re segment operations and for general working capital purposes. Debt issuance costs of $3,750 were deferred as an asset and are amortized to income over the five year optional redemption period.

On June 21, 2007, the Company participated in a private placement of $200,000 of junior subordinated deferrable interest debentures due 2037 (the 2007 Junior Subordinated Deferrable Debentures ). The 2007 Junior Subordinated Deferrable Debentures mature on June 15, 2037, are redeemable at the Company s option at par beginning June 15, 2012, and require quarterly interest payments by the Company to the holders of the 2007 Junior Subordinated Deferrable Debentures. Interest will be payable at 8.480% per annum through June 15, 2012, and thereafter at a floating rate of three-month LIBOR plus 295 basis points, reset quarterly. The proceeds of $200,000 from the sale of the 2007 Junior Subordinated Deferrable Debentures, after the deduction of commissions paid to the placement agents in the transaction and other expenses, were used by the Company to fund the purchase of Talbot Holdings Ltd. Debt issuance costs of $2,000 were deferred as an asset and are amortized to income over the five year optional redemption period.

During 2008 and 2009 the Company repurchased from an unaffiliated financial institution $60,200 principal amount of its 2007 Junior Subordinated Deferrable Debentures due 2037.

Future expected payments of interest and principal on the 2006 and 2007 Junior Subordinated Deferrable Debentures are as follows:

| | |
|---|---|
| 2011 | $ 5,928 |
| 2012 | 5,928 |
| 2013 | |
| 2014 | |
| 2015 and thereafter | 289,800 |
| **Total minimum future payments** | $ 301,656 |

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**Validus Holdings, Ltd.**
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except share and per share information)

***(d) Credit facilities***

***(i) $340,000 syndicated unsecured letter of credit facility, $60,000 bilateral unsecured letter of credit facility and $500,000 secured letter of credit facility***

On March 12, 2010, the Company entered into a three-year $340,000 syndicated unsecured letter of credit facility and a $60,000 bilateral unsecured letter of credit facility which provide for letter of credit availability for Validus Re and the Company s other subsidiaries and revolving credit availability for the Company (the Three Year Facilities ) (the full $400,000 of which is available for letters of credit and/or revolving loans).

On March 12, 2007, the Company entered into a $500,000 five-year secured letter of credit facility, as subsequently amended on October 25, 2007, July 24, 2009, and March 12, 2010, which provides for letter of credit availability for Validus Re and the Company s other subsidiaries (the Five Year Facility and, together with the Three Year Facilities, the Credit Facilities ). The Credit Facilities were provided by a syndicate of commercial banks arranged by J.P. Morgan Securities Inc. and Deutsche Bank Securities Inc. On October 25, 2007, the Company entered into the First Amendment to the Credit Facilities to provide for, among other things, additional capacity to incur up to $100,000 under a new Funds at Lloyd s Letter of Credit Facility (as described below) to support underwriting capacity provided to Talbot 2002 Underwriting Ltd through Syndicate 1183 at Lloyd s of London for the 2008 and 2009 underwriting years of account. The amendment also modified certain provisions in the Credit Facilities in order to permit dividend payments on existing and future preferred and hybrid securities notwithstanding certain events of default.

On September 4, 2009, the Company announced that it had entered into Amendments to its $500,000 five-year secured letter of credit facility and its then outstanding $200,000 three-year unsecured facility and $100,000 Talbot FAL Facility to amend a specific investment restriction clause in order to permit the completion of the IPC Acquisition. The amendment also modified and updated certain pricing and covenant terms.

As amended, the Credit Facilities contain covenants that include, among other things, (i) the requirement that the Company initially maintain a minimum level of consolidated net worth of at least 70% of consolidated net worth ($2,925,590) and, commencing with the end of the fiscal quarter ending December 31, 2009 to be increased quarterly by an amount equal to 50% of its consolidated net income (if positive) for such quarter plus 50% of any net proceeds received from any issuance of common shares during such quarter, (ii) the requirement that the Company maintain at all times a consolidated total debt to consolidated total capitalization ratio not greater than 0.35:1.00, and (iii) the requirement that Validus Re and any other material insurance subsidiaries maintain a financial strength rating by A.M. Best of not less than B++ (Fair). For purposes of covenant compliance (i) net worth is calculated with investments carried at amortized cost and (ii) consolidated total debt does not include the Company s junior subordinated deferrable debentures. The credit facilities also contain restrictions on our ability to pay dividends and other payments in respect of equity interests at any time that we are otherwise in default with respect to certain provisions under the credit facilities, make investments, incur debt at our subsidiaries, incur liens, sell assets and merge or consolidate with others.

As of June 30, 2011, there was $277,679 in outstanding letters of credit under the Five Year Facility (December 31, 2010: $268,944) and $nil outstanding under the Three Year Facilities (December 31, 2010: $nil).

As of June 30, 2011, and throughout the reporting periods presented, the Company was in compliance with all covenants and restrictions under the Credit Facilities.

***(ii) Talbot FAL Facility***

On November 28, 2007, Talbot entered into a $100,000 standby Letter of Credit facility (the Talbot FAL Facility ) to provide Funds at Lloyd s for the 2008 and 2009 underwriting years of account; this facility is guaranteed by the Company and is secured against the assets of Validus Re. The Talbot FAL Facility was provided by a syndicate of commercial banks arranged by Lloyds TSB Bank plc and ING Bank N.V., London Branch.

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**Validus Holdings, Ltd.**
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except share and per share information)

On November 19, 2009, the Company entered into an Amendment and Restatement of the Talbot FAL Facility to reduce the commitment from $100,000 to $25,000, and to extend the support to the 2010 and 2011 underwriting years of account.

As amended, the Talbot FAL Facility contains affirmative covenants that include, among other things, (i) the requirement that we initially maintain a minimum level of consolidated net worth of at least 70% of consolidated net worth ($2,607,219), and commencing with the end of the fiscal quarter ending September 30, 2009 to be increased quarterly by an amount equal to 50% of our consolidated net income (if positive) for such quarter plus 50% of any net proceeds received from any issuance of common shares during such quarter, and (ii) the requirement that we maintain at all times a consolidated total debt to consolidated total capitalization ratio not greater than 0.35:1.00.

The Talbot FAL Facility also contains restrictions on our ability to incur debt at our subsidiaries, incur liens, sell assets and merge or consolidate with others. Other than in respect of existing and future preferred and hybrid securities, the payment of dividends and other payments in respect of equity interests are not permitted at any time that we are in default with respect to certain provisions under the Credit Facilities. As of June 30, 2011, the Company had $25,000 in outstanding letters of credit under this facility.

As of June 30, 2011, and throughout the reporting periods presented, the Company was in compliance with all covenants and restrictions under the Talbot FAL Facility.

***(iii) IPC Syndicated Facility and IPC Bi-Lateral Facility***

IPC obtained letters of credit through the IPC Syndicated Facility and the IPC Bi-Lateral Facility (the IPC Facilities ). In July, 2009, certain terms of these facilities were amended including suspending IPC s ability to increase existing letters of credit or to issue new letters of credit. Effective March 31, 2010, the IPC Syndicated Facility was closed. As of June 30, 2011, $63,284 of outstanding letters of credit were issued under the IPC Bi-Lateral Facility (December 31, 2010: $68,063).

As of June 30, 2011, and throughout the reporting periods presented, the Company was in compliance with all covenants and restrictions under the IPC Bi-Lateral Facility.

**11. Commitments and contingencies**

***a) Concentrations of credit risk***

The Company s investments are managed following prudent standards of diversification. The Company attempts to limit its credit exposure by purchasing high quality fixed income investments to maintain an average portfolio credit quality of AA- or higher with mortgage and commercial mortgage-backed issues having an aggregate weighted average credit quality of triple-A. In addition, the Company limits its exposure to any single issuer to 3% or less, excluding treasury and agency securities. With the exception of the Company s bank loan portfolio, the minimum credit rating of any security purchased is Baa3/BBB- and where investments are downgraded, the Company permits a holding of up to 2% in aggregate market value, or 10% with written pre-authorization.

**Validus Holdings, Ltd.**
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except share and per share information)
At June 30, 2011, 1.0% of the portfolio, excluding bank loans, had a split rating below Baa3/BBB- and the Company did not have an aggregate exposure to any single issuer of more than 1.1% of its investment portfolio, other than with respect to government and agency securities.

***b) Funds at Lloyd s***

The amounts provided under the Talbot FAL Facility would become a liability of the Company in the event of Syndicate 1183 declaring a loss at a level which would call on this arrangement.

Talbot operates in Lloyd s through a corporate member, Talbot 2002 Underwriting Capital Ltd ( T02 ), which is the sole participant in Syndicate 1183. Lloyd s sets T02 s required capital annually based on syndicate 1183 s business plan, rating environment, reserving environment together with input arising from Lloyd s discussions with, inter alia, regulatory and rating agencies. Such capital, called Funds at Lloyd s ( FAL ), comprises: cash, investments and undrawn letters of credit provided by various banks. The amounts of cash, investments and letters of credit at June 30, 2011 amounted to $441,000 (December 31, 2010: $441,000) of which $25,000 is provided under the Talbot FAL Facility (December 31, 2010: $25,000).

***c) Lloyd s Central Fund***

Whenever a member of Lloyd s is unable to pay its debts to policyholders, such debts may be payable by the Lloyd s Central Fund. If Lloyd s determines that the Central Fund needs to be increased, it has the power to assess premium levies on current Lloyd s members up to 3% of a member s underwriting capacity in any one year. The Company does not believe that any assessment is likely in the foreseeable future and has not provided any allowance for such an assessment. However, based on the Company s 2011 estimated premium income at Lloyd s of £560,000, the June 30, 2011 exchange rate of £1 equals $1.6018 and assuming the maximum 3% assessment, the Company would be assessed approximately $26,910.

**12. Related party transactions**

The transactions listed below are classified as related party transactions as each counterparty has either a direct or indirect shareholding in the Company.

a) On December 8, 2005, the Company entered into agreements with Goldman Sachs Asset Management and its affiliates ( GSAM ) under which GSAM provides investment management services for a portion of the Company s investment portfolio. For the three and six months ended June 30, 2010, GSAM was deemed to be a related party due to a combination of GSAM being a shareholder in the Company and having an employee on the Company s Board of Directors during this period. For the three and six months ended June 30, 2011, GSAM was no longer a related party due to the resignation of Sumit Rajpal from the Board of Directors effective February 7, 2011. Investment management fees earned by GSAM for the three and six months ended June 30, 2010 were $241 and $733, respectively. Management believes that the fees charged were consistent with those that would have been charged in arm s-length transactions with unrelated third parties.

b) Aquiline Capital Partners, LLC and its related companies ( Aquiline ), which own 6,255,943 shares in the Company, hold warrants to purchase 2,756,088 shares, and have two employees on the Company s Board of Directors who do not receive compensation from the Company, are shareholders of Group Ark Insurance Holdings Ltd. ( Group Ark ). Christopher E. Watson, a director of the Company, also serves as a director of Group Ark. Pursuant to reinsurance agreements with a subsidiary of Group Ark, the Company recognized gross premiums written during the three and six months ended June 30, 2011 of $900 (2010: $601) and $1,411 (2010: $1,341), respectively, of which $1,038 was included in premiums receivable at June 30, 2011 (December 31, 2010: $378). The Company also recognized reinsurance premiums ceded during the three and six months ended June 30, 2011 of $nil (2010: $nil) and $163 (2010: $606), respectively, of which $49 was included in reinsurance balances payable at June 30, 2011 (December 31, 2010: $132). Earned premium adjustments of $344 (2010: $213) and $678 (2010: $881) were incurred during the three and six months ended June 30, 2011.

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**Validus Holdings, Ltd.**
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except share and per share information)

c) Aquiline is also a shareholder of Tiger Risk Partners LLC ( Tiger Risk ). Christopher E. Watson, a director of the Company serves as a director of Tiger Risk. Pursuant to certain reinsurance contracts, the Company recognized brokerage expenses paid to Tiger Risk for the three and six months ended June 30, 2011 of $628 (2010: $1,432) and $1,081 (2010: $1,469), respectively, of which $829 was included in accounts payable and accrued expenses at June 30, 2011 (December 31, 2010: $792).

d) On November 24, 2009, the Company entered into an Investment Management Agreement with Conning, Inc. ( Conning ) to manage a portion of the Company s investment portfolio. Aquiline acquired Conning on June 16, 2009. John J. Hendrickson and Jeffrey W. Greenberg, directors of the Company, each serve as a director of Conning Holdings Corp., the parent company of Conning and Michael Carpenter, the Chairman of Talbot Holdings, Ltd. serves as a director of a subsidiary company of Conning Holdings Corp. Investment management fees earned by Conning for the three and six months ended June 30, 2011 were $234 (2010: $100) and $380 (2010: $186), respectively, of which $203 (December 31, 2010: $97) was included in accounts payable and accrued expenses at June 30, 2011.

**13. Earnings per share**

The following table sets forth the computation of basic and diluted earnings (loss) per share available (attributable) to common shareholders for the three and six months ended June 30, 2011 and 2010:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | **June 30, 2011** | **June 30, 2010** | **June 30, 2011** | **June 30, 2010** |
| **Basic earnings per share** | | | | |
| Income (loss) available (attributable) to Validus | $ 109,884 | $ 179,782 | $ (62,480) | $ 61,404 |
| less: Dividends and distributions declared on outstanding warrants | (1,966) | (1,749) | (3,950) | (3,498) |
| Income (loss) available (attributable) to common shareholders | $ 107,918 | $ 178,033 | $ (66,430) | $ 57,906 |
| Weighted average number of common shares outstanding | 98,385,924 | 121,009,553 | 98,165,132 | 123,821,415 |
| **Basic earnings (loss) per share available (attributable) to common shareholders** | **$ 1.10** | **$ 1.47** | **$ (0.68)** | **$ 0.47** |
| **Diluted earnings per share** | | | | |
| Income (loss) available (attributable) to Validus | $ 109,884 | $ 179,782 | $ (62,480) | $ 61,404 |
| less: Dividends and distributions declared on outstanding warrants | | | (3,950) | (3,498) |
| | $ 109,884 | $ 179,782 | $ (66,430) | $ 57,906 |

| | | | | |
|---|---|---|---|---|
| Income (loss) available (attributable) to common shareholders | | | | |
| Weighted average number of common shares outstanding | 98,385,924 | 121,009,553 | 98,165,132 | 123,821,415 |
| Share equivalents: | | | | |
| Warrants | 3,561,096 | 2,339,922 | | |
| Stock options | 908,590 | 794,625 | | 840,067 |
| Unvested restricted shares | 1,706,840 | 1,008,200 | | 1,000,247 |
| Weighted average number of common shares outstanding | 104,562,450 | 125,152,300 | 98,165,132 | 125,661,729 |
| **Diluted earnings (loss) per share available (attributable) to common shareholders** | **$ 1.05** | **$ 1.44** | **$ (0.68)** | **$ 0.46** |

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**Validus Holdings, Ltd.**
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except share and per share information)

Share equivalents that would result in the issuance of common shares of 479,104 (2010: 218,497) and 247,550 (2010: 194,812) were outstanding for the three and six months ended June 30, 2011, but were not included in the computation of diluted earnings per share because the effect would be antidilutive.

**14. Subsequent events**

*Transatlantic Acquisition Proposal*

On June 12, 2011, Transatlantic Holdings, Inc. ( Transatlantic ) and Allied World Assurance Company Holdings, AG ( Allied World ) entered into an Agreement and Plan of Merger (the Transatlantic-Allied World Merger Agreement ).

On July 12, 2011, the Company announced that it had delivered to the Board of Directors of Transatlantic a proposal to merge the businesses of the Company and Transatlantic. Pursuant to the proposal, Transatlantic stockholders would receive 1.5564 Validus voting common shares in the merger and $8.00 in cash per share pursuant to a one-time special dividend from Transatlantic immediately prior to closing of the merger for each share of Transatlantic common stock they own.

On July 20, 2011, the Company filed a preliminary proxy statement with the SEC in connection with the special meeting of stockholders of Transatlantic, urging the Transatlantic shareholders to vote against the Transatlantic-Allied World Merger Agreement.

On July 25, 2011, the Company commenced an exchange offer for all of the outstanding shares of common stock of Transatlantic. Under the terms of the exchange offer, Transatlantic stockholders would receive 1.5564 Validus voting common shares and $8.00 in cash for each share of Transatlantic common stock they own. The terms and conditions of the exchange offer are set forth in the offering documents that the Company has filed with the SEC.

**Validus Holdings, Ltd.**
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except share and per share information)

*Quarterly Dividend*

On August 3, 2011, the Company announced a quarterly cash dividend of $0.25 per each common share and $0.25 per common share equivalent for which each outstanding warrant is exercisable, payable on September 30, 2011 to holders of record on September 15, 2011.

**15. Segment information**

The Company conducts its operations worldwide through two wholly-owned subsidiaries, Validus Reinsurance, Ltd. and Talbot Holdings Ltd. from which two operating segments have been determined under U.S. GAAP segment reporting. The Company s operating segments are strategic business units that offer different products and services. They are managed and have capital allocated separately because each business requires different strategies.

**Validus Re**

The Validus Re segment is focused on short-tail lines of reinsurance. The primary lines in which the segment conducts business are property, marine and specialty which includes agriculture, aerospace and aviation, financial lines of business, nuclear, terrorism, life, accident & health, workers compensation, crisis management and motor.

**Talbot**

The Talbot segment focuses on a wide range of marine and energy, war, political violence, commercial property, financial institutions, contingency, bloodstock, accident & health and aviation classes of business on an insurance or facultative reinsurance basis and principally property, aerospace and marine classes of business on a treaty reinsurance basis.

**Corporate and other reconciling items**

The Company has a Corporate function, which includes the activities of the parent company, and which carries out certain functions for the group. Corporate includes non-core underwriting expenses, predominantly general and administrative and stock compensation expenses. Corporate also denotes the activities of certain key executives such as the Chief Executive Officer and Chief Financial Officer. For internal reporting purposes, Corporate is reflected separately, however Corporate is not considered an operating segment under these circumstances. Other reconciling items include, but are not limited to, the elimination of intersegment revenues and expenses and unusual items that are not allocated to segments.

**Validus Holdings, Ltd.**
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except share and per share information)

The following tables summarize the results of our operating segments and corporate segment:

| Three Months Ended June 30, 2011 | Validus Re | Talbot | Corporate & Eliminations | Total |
|---|---|---|---|---|
| **Underwriting income** | | | | |
| Gross premiums written | $ 341,651 | $ 276,886 | $ (13,150) | $ 605,387 |
| Reinsurance premiums ceded | (98,218) | (47,278) | 13,150 | (132,346) |
| Net premiums written | 243,433 | 229,608 | | 473,041 |
| Change in unearned premiums | (10,755) | (36,646) | | (47,401) |
| **Net premiums earned** | 232,678 | 192,962 | | 425,640 |
| **Underwriting deductions** | | | | |
| Losses and loss expenses | 94,035 | 113,272 | | 207,307 |
| Policy acquisition costs | 35,769 | 42,307 | 154 | 78,230 |
| General and administrative expenses | 15,458 | 34,718 | 10,665 | 60,841 |
| Share compensation expenses | 1,823 | 2,026 | 3,779 | 7,628 |
| **Total underwriting deductions** | 147,085 | 192,323 | 14,598 | 354,006 |
| **Underwriting income (loss)** | $ 85,593 | $ 639 | $ (14,598) | $ 71,634 |
| Net investment income | 22,389 | 6,372 | (2,267) | 26,494 |
| Other income | 854 | 1,967 | (2,226) | 595 |
| Finance expenses | (4,502) | | (11,859) | (16,361) |
| **Operating income (loss) before taxes** | 104,334 | 8,978 | (30,950) | 82,362 |
| Tax (expense) benefit | (4) | (208) | 241 | 29 |
| **Net operating income (loss)** | $ 104,330 | $ 8,770 | $ (30,709) | $ 82,391 |
| Net realized gains on investments | 9,552 | 2,000 | | 11,552 |
| Net unrealized gains on investments | 14,557 | 3,969 | | 18,526 |
| Foreign exchange (losses) gains | (5,337) | 3,410 | (64) | (1,991) |
| **Net income (loss)** | $ 123,102 | $ 18,149 | $ (30,773) | $ 110,478 |
| Net income attributable to noncontrolling interest | (594) | | | (594) |
| **Net income available (attributable) to Validus** | $ 122,508 | $ 18,149 | $ (30,773) | $ 109,884 |

| | | | | |
|---|---|---|---|---|
| **Selected ratios:** | | | | |
| Net premiums written / Gross premiums written | 71.3% | 82.9% | | 78.1% |
| Losses and loss expenses | 40.4% | 58.7% | | 48.7% |
| Policy acquisition costs | 15.4% | 21.9% | | 18.4% |
| General and administrative expenses (a) | 7.4% | 19.0% | | 16.1% |
| Expense ratio | 22.8% | 40.9% | | 34.5% |
| Combined ratio | 63.2% | 99.6% | | 83.2% |
| **Total assets** | $ **5,411,663** | **$ 2,759,850** | **$ 88,275** | **$ 8,259,788** |

(a) Ratios are based on net premiums earned. The general and administrative expense ratio includes share compensation expenses.

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**Validus Holdings, Ltd.**
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except share and per share information)

| Three Months Ended June 30, 2010 | Validus Re | Talbot | Corporate & Eliminations | Total |
|---|---|---|---|---|
| **Underwriting income** | | | | |
| Gross premiums written | $ 284,328 | $ 253,710 | $ (21,177) | $ 516,861 |
| Reinsurance premiums ceded | (41,175) | (47,728) | 21,177 | (67,726) |
| Net premiums written | 243,153 | 205,982 | | 449,135 |
| Change in unearned premiums | 18,888 | (30,079) | | (11,191) |
| **Net premiums earned** | 262,041 | 175,903 | | 437,944 |
| **Underwriting deductions** | | | | |
| Losses and loss expenses | 123,793 | 71,101 | | 194,894 |
| Policy acquisition costs | 37,979 | 38,647 | (2,500) | 74,126 |
| General and administrative expenses | 10,983 | 24,960 | 16,436 | 52,379 |
| Share compensation expenses | 1,749 | 1,468 | 3,629 | 6,846 |
| **Total underwriting deductions** | 174,504 | 136,176 | 17,565 | 328,245 |
| **Underwriting income (loss)** | $ 87,537 | $ 39,727 | $ (17,565) | $ 109,699 |
| Net investment income | 29,914 | 7,251 | (2,356) | 34,809 |
| Other income | 1,477 | 3,084 | (1,864) | 2,697 |
| Finance expenses | (1,107) | 105 | (12,216) | (13,218) |
| **Operating income (loss) before taxes** | 117,821 | 50,167 | (34,001) | 133,987 |
| Tax (expense) benefit | (94) | (4,094) | 1 | (4,187) |
| **Net operating income (loss)** | $ 117,727 | $ 46,073 | $ (34,000) | $ 129,800 |
| Net realized gains on investments | 10,363 | 2,078 | | 12,441 |
| Net unrealized gains on investments | 35,697 | 5,943 | | 41,640 |
| Foreign exchange (losses) | (843) | (3,243) | (13) | (4,099) |
| **Net income (loss)** | $ 162,944 | $ 50,851 | $ (34,013) | $ 179,782 |
| Net income attributable to noncontrolling interest | | | | |
| **Net income (loss) available (attributable) to Validus** | $ 162,944 | $ 50,851 | $ (34,013) | $ 179,782 |

| **Selected ratios:** | | | | |
|---|---|---|---|---|
| Net premiums written / Gross premiums written | 85.5% | 81.2% | | 86.9% |
| Losses and loss expenses | 47.2% | 40.4% | | 44.5% |
| Policy acquisition costs | 14.5% | 22.0% | | 16.9% |
| General and administrative expenses (a) | 4.9% | 15.0% | | 13.5% |
| Expense ratio | 19.4% | 37.0% | | 30.4% |
| Combined ratio | 66.6% | 77.4% | | 74.9% |
| **Total assets** | $ **5,057,693** | $ **2,507,586** | $ **49,344** | $ **7,614,623** |

(a) Ratios are based on net premiums earned. The general and administrative expense ratio includes share compensation expenses.

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**Validus Holdings, Ltd.**
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except share and per share information)

| **Six Months Ended June 30, 2011** | **Validus Re** | **Talbot** | **Corporate & Eliminations** | **Total** |
|---|---|---|---|---|
| **Underwriting income** | | | | |
| Gross premiums written | $ 952,889 | $ 539,943 | $ (37,549) | $ 1,455,283 |
| Reinsurance premiums ceded | (145,023) | (134,692) | 37,549 | (242,166) |
| Net premiums written | 807,866 | 405,251 | | 1,213,117 |
| Change in unearned premiums | (322,879) | (35,065) | | (357,944) |
| **Net premiums earned** | 484,987 | 370,186 | | 855,173 |
| **Underwriting deductions** | | | | |
| Losses and loss expenses | 404,579 | 278,926 | | 683,505 |
| Policy acquisition costs | 75,835 | 79,523 | 168 | 155,526 |
| General and administrative expenses | 26,115 | 63,440 | 19,763 | 109,318 |
| Share compensation expenses | 4,928 | 4,745 | 10,004 | 19,677 |
| **Total underwriting deductions** | 511,457 | 426,634 | 29,935 | 968,026 |
| **Underwriting (loss)** | $ (26,470) | $ (56,448) | $ (29,935) | $ (112,853) |
| Net investment income | 48,040 | 12,962 | (4,533) | 56,469 |
| Other income | 2,287 | 4,984 | (5,070) | 2,201 |
| Finance expenses | (6,215) | (63) | (24,084) | (30,362) |
| **Operating income (loss) before taxes** | 17,642 | (38,565) | (63,622) | (84,545) |
| Tax (expense) benefit | (6) | 1,585 | (91) | 1,488 |
| **Net operating income (loss)** | $ 17,636 | $ (36,980) | $ (63,713) | $ (83,057) |
| Net realized gains on investments | 13,471 | 4,460 | | 17,931 |
| Net unrealized gains (losses) on investments | 6,042 | (344) | | 5,698 |
| Foreign exchange (losses) gains | (9,697) | 7,311 | (72) | (2,458) |
| **Net income (loss)** | $ 27,452 | $ (25,553) | $ (63,785) | $ (61,886) |
| Net income attributable to noncontrolling interest | (594) | | | (594) |
| **Net income (loss) available (attributable) to Validus** | $ 26,858 | $ (25,553) | $ (63,785) | $ (62,480) |

| | | | | |
|---|---|---|---|---|
| **Selected ratios:** | | | | |
| Net premiums written / Gross premiums written | 84.8% | 75.1% | | 83.4% |
| Losses and loss expenses | 83.4% | 75.3% | | 79.9% |
| Policy acquisition costs | 15.6% | 21.5% | | 18.2% |
| General and administrative expenses (a) | 6.4% | 18.4% | | 15.1% |
| Expense ratio | 22.0% | 39.9% | | 33.3% |
| Combined ratio | 105.4% | 115.2% | | 113.2% |
| **Total assets** | $ **5,411,663** | **$ 2,759,850** | **$ 88,275** | $ 8,259,788 |

(a) Ratios are based on net premiums earned. The general and administrative expense ratio includes share compensation expenses.

**Validus Holdings, Ltd.**
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except share and per share information)

| **Six Months Ended June 30, 2010** | **Validus Re** | **Talbot** | **Corporate & Eliminations** | **Total** |
|---|---|---|---|---|
| **Underwriting income** | | | | |
| Gross premiums written | $ 924,623 | $ 524,251 | $ (61,079) | $ 1,387,795 |
| Reinsurance premiums ceded | (54,285) | (165,259) | 61,079 | (158,465) |
| Net premiums written | 870,338 | 358,992 | | 1,229,330 |
| Change in unearned premiums | (324,376) | (9,316) | | (333,692) |
| **Net premiums earned** | 545,962 | 349,676 | | 895,638 |
| **Underwriting deductions** | | | | |
| Losses and loss expenses | 472,713 | 200,712 | | 673,425 |
| Policy acquisition costs | 81,482 | 73,592 | (4,772) | 150,302 |
| General and administrative expenses | 27,295 | 50,508 | 28,145 | 105,948 |
| Share compensation expenses | 3,378 | 3,027 | 7,017 | 13,422 |
| **Total underwriting deductions** | 584,868 | 327,839 | 30,390 | 943,097 |
| **Underwriting (loss) income** | $ (38,906) | $ 21,837 | $ (30,390) | $ (47,459) |
| Net investment income | 59,159 | 14,571 | (4,622) | 69,108 |
| Other income | 2,555 | 5,059 | (4,029) | 3,585 |
| Finance expenses | (2,400) | (3,140) | (22,829) | (28,369) |
| **Operating income (loss) before taxes** | 20,408 | 38,327 | (61,870) | (3,135) |
| Tax (expense) | (185) | (3,299) | (6) | (3,490) |
| **Net operating income (loss)** | $ 20,223 | $ 35,028 | $ (61,876) | $ (6,625) |
| Net realized gains on investments | 20,142 | 3,697 | | 23,839 |
| Net unrealized gains (losses) on investments | 47,892 | 9,161 | | 57,053 |
| Foreign exchange (losses) | (5,982) | (6,842) | (39) | (12,863) |
| **Net income (loss)** | $ 82,275 | $ 41,044 | $ (61,915) | $ 61,404 |
| Net income attributable to noncontrolling interest | | | | |
| **Net income (loss) available (attributable) to Validus** | $ 82,275 | $ 41,044 | $ (61,915) | $ 61,404 |

| | | | | |
|---|---|---|---|---|
| **Selected ratios:** | | | | |
| Net premiums written / Gross premiums written | 94.1% | 68.5% | | 88.6% |
| Losses and loss expenses | 86.6% | 57.4% | | 75.2% |
| Policy acquisition costs | 14.9% | 21.0% | | 16.8% |
| General and administrative expenses (a) | 5.6% | 15.3% | | 13.3% |
| Expense ratio | 20.5% | 36.3% | | 30.1% |
| Combined ratio | 107.1% | 93.7% | | 105.3% |
| **Total assets** | $ **5,057,693** | $ **2,507,586** | $ **49,344** | $ **7,614,623** |

(a) Ratios are based on net premiums earned. The general and administrative expense ratio includes share compensation expenses.

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**Validus Holdings, Ltd.**
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except share and per share information)

The Company s exposures are generally diversified across geographic zones. The following tables set forth the gross premiums written allocated to the territory of coverage exposure for the periods indicated:

| | Three Months Ended June 30, 2011 Gross premiums written | | | | |
|---|---|---|---|---|---|
| | **Validus Re** | **Talbot** | **Eliminations** | **Total** | **%** |
| United States | $ 261,364 | $ 34,181 | $ (2,307) | $ 293,238 | 48.5% |
| Worldwide excluding United States (a) | 2,580 | 57,204 | (257) | 59,527 | 9.8% |
| Europe | 10,729 | 18,935 | (59) | 29,605 | 4.9% |
| Latin America and Caribbean | 11,432 | 22,265 | (8,942) | 24,755 | 4.1% |
| Japan | 23,871 | 2,216 | | 26,087 | 4.3% |
| Canada | 10 | 2,443 | (10) | 2,443 | 0.4% |
| Rest of the world (b) | 8,939 | | | 8,939 | 1.5% |
| Sub-total, non United States | 57,561 | 103,063 | (9,268) | 151,356 | 25.0% |
| Worldwide including United States (a) | 12,584 | 15,506 | (40) | 28,050 | 4.6% |
| Marine and Aerospace (c) | 10,142 | 124,136 | (1,535) | 132,743 | 21.9% |
| **Total** | $ 341,651 | $ 276,886 | $ (13,150) | $ 605,387 | 100.0% |

| | Three Months Ended June 30, 2010 Gross premiums written | | | | |
|---|---|---|---|---|---|
| | **Validus Re** | **Talbot** | **Eliminations** | **Total** | **%** |
| United States | $ 186,653 | $ 29,691 | $ (2,020) | $ 214,324 | 41.5% |
| Worldwide excluding United States (a) | 4,830 | 58,806 | (2,086) | 61,550 | 11.9% |
| Europe | 10,757 | 12,832 | (504) | 23,085 | 4.4% |
| Latin America and Caribbean | 15,036 | 29,368 | (12,766) | 31,638 | 6.1% |
| Japan | 19,250 | 2,901 | (72) | 22,079 | 4.3% |
| Canada | 72 | 3,367 | (72) | 3,367 | 0.7% |
| Rest of the world (b) | 25,168 | | | 25,168 | 4.9% |
| Sub-total, non United States | 75,113 | 107,274 | (15,500) | 166,887 | 32.3% |
| Worldwide including United States (a) | 2,032 | 15,911 | (504) | 17,439 | 3.3% |
| Marine and Aerospace (c) | 20,530 | 100,834 | (3,153) | 118,211 | 22.9% |
| **Total** | $ 284,328 | $ 253,710 | $ (21,177) | $ 516,861 | 100.0% |

(a) Represents risks in two or more geographic zones.

(b) Represents risks in one geographic zone.

(c) Not classified as geographic area as marine and aerospace risks can span multiple geographic areas and are not fixed locations in some instances.

**Validus Holdings, Ltd.**
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except share and per share information)

The Company s exposures are generally diversified across geographic zones. The following tables set forth the gross premiums written allocated to the territory of coverage exposure for the periods indicated:

| | Six Months Ended June 30, 2011 Gross premiums written | | | | |
|---|---|---|---|---|---|
| | Validus Re | Talbot | Eliminations | Total | % |
| United States | $ 453,729 | $ 62,012 | $ (4,204) | $ 511,537 | 35.2% |
| Worldwide excluding United States (a) | 29,558 | 125,171 | (2,969) | 151,760 | 10.4% |
| Europe | 69,695 | 34,944 | (561) | 104,078 | 7.2% |
| Latin America and Caribbean | 36,551 | 40,533 | (22,571) | 54,513 | 3.7% |
| Japan | 34,069 | 2,756 | (100) | 36,725 | 2.5% |
| Canada | 110 | 6,251 | (110) | 6,251 | 0.4% |
| Rest of the world (b) | 44,996 | | | 44,996 | 3.1% |
| Sub-total, non United States | 214,979 | 209,655 | (26,311) | 398,323 | 27.3% |
| Worldwide including United States (a) | 80,780 | 26,036 | (542) | 106,274 | 7.3% |
| Marine and Aerospace (c) | 203,401 | 242,240 | (6,492) | 439,149 | 30.2% |
| **Total** | $ 952,889 | $ 539,943 | $ (37,549) | $ 1,455,283 | 100.0% |

| | Six Months Ended June 30, 2010 Gross premiums written | | | | |
|---|---|---|---|---|---|
| | Validus Re | Talbot | Eliminations | Total | % |
| United States | $ 420,220 | $ 54,974 | $ (5,491) | $ 469,703 | 33.8% |
| Worldwide excluding United States (a) | 44,594 | 134,824 | (5,918) | 173,500 | 12.5% |
| Europe | 91,233 | 28,370 | (961) | 118,642 | 8.5% |
| Latin America and Caribbean | 43,775 | 46,595 | (28,553) | 61,817 | 4.5% |
| Japan | 19,900 | 3,609 | (137) | 23,372 | 1.7% |
| Canada | 137 | 7,003 | (137) | 7,003 | 0.5% |
| Rest of the world (b) | 25,168 | | | 25,168 | 1.8% |
| Sub-total, non United States | 224,807 | 220,401 | (35,706) | 409,502 | 29.5% |
| Worldwide including United States (a) | 78,267 | 28,687 | (2,234) | 104,720 | 7.6% |
| Marine and Aerospace (c) | 201,329 | 220,189 | (17,648) | 403,870 | 29.1% |
| **Total** | $ 924,623 | $ 524,251 | $ (61,079) | $ 1,387,795 | 100.0% |

(a) Represents risks in two or more geographic zones.

(b) Represents risks in one geographic zone.

(c) Not classified as geographic area as marine and aerospace risks can span multiple geographic areas and are not fixed locations in some instances.



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## ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion and analysis of the Company s consolidated results of operations for the three and six months ended June 30, 2011 and 2010 and the Company s consolidated financial condition, liquidity and capital resources at June 30, 2011 and December 31, 2010. This discussion and analysis should be read in conjunction with the audited consolidated financial statements and related notes for the fiscal year ended December 31, 2010, the discussions of critical accounting policies and the qualitative and quantitative disclosure about market risk contained in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2010.

For a variety of reasons, the Company s historical financial results may not accurately indicate future performance. See Cautionary Note Regarding Forward-Looking Statements. The Risk Factors set forth in Item 1A of the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2010 present a discussion of important factors that could cause actual results to differ materially from the results described in or implied by the forward-looking statements contained herein.

### Executive Overview

The Company underwrites from two distinct global operating segments, Validus Reinsurance, Ltd. ( Validus Re ) and Talbot Holdings Ltd. ( Talbot ). Validus Re, the Company s principal reinsurance operating segment, operates as a Bermuda-based provider of short-tail reinsurance products on a global basis. Talbot, the Company s principal insurance operating segment, operates through its two underwriting platforms: Talbot Underwriting Ltd, which manages Syndicate 1183 at Lloyd s of London ( Lloyd s ) and which writes short-tail insurance products on a worldwide basis, and Underwriting Risk Services Ltd, which is an underwriting agency writing primarily yacht and onshore energy business on behalf of the Talbot syndicate and others.

The Company s strategy has been to concentrate primarily on short-tail risks, which has been an area where management believes current prices and terms provide an attractive risk adjusted return and the management team has proven expertise. The Company s profitability in any given period is based upon premium and investment revenues, less net losses and loss expenses, acquisition expenses and operating expenses. Financial results in the insurance and reinsurance industry are influenced by the frequency and/or severity of claims and losses, including as a result of catastrophic events, changes in interest rates, financial markets and general economic conditions, the supply of insurance and reinsurance capacity and changes in legal, regulatory and judicial environments.

On September 4, 2009, the Company acquired all of the outstanding shares of IPC (the IPC Acquisition ) in exchange for common shares and cash. IPC s operations focused on short-tail lines of reinsurance. The primary lines in which IPC conducted business were property catastrophe reinsurance and, to a limited extent, property-per-risk excess, aviation (including satellite) and other short-tail reinsurance on a worldwide basis. The IPC Acquisition was undertaken to increase the Company s capital base and gain a strategic advantage in the then current reinsurance market. This acquisition created a leading Bermuda carrier in the short-tail reinsurance market that facilitates stronger relationships with major reinsurance intermediaries.

On May 25, 2011, the Company joined with other investors in capitalizing AlphaCat Re 2011, a new special purpose sidecar reinsurer formed for the purpose of writing collateralized reinsurance and retrocessional reinsurance. Validus Re has an equity interest in AlphaCat Re 2011 and as Validus Re holds a majority of AlphaCat Re 2011 s outstanding voting rights, the financial statements of AlphaCat Re 2011 are included in the consolidated financial statements of the Company. The portion of AlphaCat Re 2011 s earnings attributable to third party investors for the three months ended June 30, 2011 is recorded in the consolidated statement of operations and comprehensive income as net income attributable to noncontrolling interest.

### Business Outlook and Trends

We underwrite global specialty property insurance and reinsurance and have large aggregate exposures to natural and man-made disasters. The occurrence of claims from catastrophic events results in substantial volatility, and can have material adverse effects on the Company s financial condition and results and ability to write new business.

This volatility affects results for the period in which the loss occurs because U.S. accounting principles do not permit reinsurers to reserve for such catastrophic events until they occur. Catastrophic events of significant magnitude historically have been relatively infrequent, although management believes the property catastrophe reinsurance market has experienced a higher level of worldwide catastrophic losses in terms of both frequency and severity in the period from 1992 to the present. We also expect that increases in the values and concentrations of insured property will increase the severity of such occurrences in the future. The Company seeks to reflect these trends when pricing contracts.

Property and other reinsurance premiums have historically risen in the aftermath of significant catastrophic losses. As loss reserves are established, industry surplus is depleted and the industry s capacity to write new business diminishes. At the same time, management believes that there is a heightened awareness of exposure to natural catastrophes on the part of cedants, rating agencies and catastrophe modeling firms, resulting in an increase in the demand for reinsurance protection.

The global property and casualty insurance and reinsurance industry has historically been highly cyclical. The Company was formed in October 2005 in response to the supply/demand imbalance resulting from the large industry losses in 2004 and 2005. In the aggregate, the Company observed substantial increases in premium rates in 2006 compared to 2005 levels. During the years ended December 31, 2007 and 2008, the Company experienced increased competition in most lines of business. Capital provided by new entrants or by the commitment of additional capital by existing insurers and reinsurers increased the supply of insurance and reinsurance which resulted in a softening of rates in most lines. However, during 2008, the insurance and reinsurance industry incurred material losses and capital declines due to Hurricanes Ike and Gustav and the global financial crisis. In the wake of these events, the January 2009 renewal season saw decreased competition and increased premium rates due to relatively scarce capital and increased demand. During 2009, the Company observed reinsurance demand stabilization and industry capital recovery from investment portfolio gains. In 2009, there were few notable large losses affecting the worldwide (re)insurance industry and no major hurricanes making landfall in the United States. During 2010, the Company continued to see increased competition and decreased premium rates in most classes of business with the exception of offshore energy, Latin America, financial institutions and political risk lines. During 2010 there was an increased level of catastrophe activity, principally the Chilean earthquake and the Deepwater Horizon events.

During the January 2011 renewal season, Validus Re increased gross premiums written on the U.S. Cat XOL lines and decreased gross premiums written in the proportional lines. In addition, Validus Re decreased gross premiums written in the International Property lines as market conditions dictated. In the aftermath of 2010 s Deepwater Horizon loss, Validus Re saw additional opportunities and rate increases in the marine lines. Within its specialty lines, Validus Re increased gross premiums written in the terrorism lines among other sub-classes. During the first quarter of 2011, premiums in Talbot have been relatively stable with rate increases occurring on renewals that have suffered losses but rate reductions continuing elsewhere, as a result of good experience and excess capacity in the market. Talbot is receiving improved pricing in the energy, property and political risk lines as a result of recent loss events. The significant worldwide elevated loss activity since the beginning of 2010, in conjunction with changes to certain commercial vendors catastrophe models, is resulting in improved pricing and demand for catastrophe reinsurance. Rate levels in both the U.S. and International property catastrophe business continued to improve for mid-year 2011 renewals due to the magnitude of the worldwide loss activity.

**Financial Measures**

The Company believes the following financial indicators are important in evaluating performance and measuring the overall growth in value generated for shareholders:

*Annualized return on average equity* represents the level of net income available to shareholders generated from the average shareholders equity during the period. Annualized return on average equity is calculated by dividing the net income for the period by the average shareholders equity during the period. Average shareholders equity is the average of the beginning, ending and intervening quarter end shareholders equity balances. Percentages for the quarter and interim periods are annualized. The Company s objective is to generate superior returns on capital that appropriately reward shareholders for the risks assumed and to grow premiums written only when returns meet or exceed internal requirements. Details of annualized return on average equity are provided below.

| | Three Months Ended June 30, 2011 | Three Months Ended June 30, 2010 | Year Ended December 31, 2010 |
|---|---|---|---|
| Annualized return on average equity | 13.1% | 19.5% | 10.8% |

The decrease in annualized return on average equity for the three months ended June 30, 2011 was driven primarily by a reduction in net income. Net income available to Validus for the three months ended June 30, 2011 decreased by $69.9 million, or 38.9% compared to the three months ended June 30, 2010. This unfavorable movement was primarily due to large loss events coupled with an unfavorable movement in unrealized gains on investments.

*Diluted book value per common share* is considered by management to be an appropriate measure of our returns to common shareholders, as we believe growth in our book value on a diluted basis ultimately translates into growth of our stock price. Diluted book value per common share decreased by $1.07, or 3.2%, from $32.98 at December 31, 2010 to $31.91 at June 30, 2011. The decrease was due to the loss generated in the six months ended June 30, 2011. Diluted book value per common share is a Non-GAAP financial measure. The most comparable U.S. GAAP financial measure is book value per common share. Diluted book value per common share is calculated based on total shareholders equity plus the assumed proceeds from the exercise of outstanding options and warrants, divided by the sum of common shares, unvested restricted shares, options and warrants outstanding (assuming their exercise). A reconciliation of diluted book value per common share to book value per common share is presented below in the section entitled Non-GAAP Financial Measures.

*Cash dividends per common share* are an integral part of the value created for shareholders. On August 3, 2011, the Company announced a quarterly cash dividend of $0.25 per each common share and $0.25 per common share equivalent for which each outstanding warrant is exercisable, payable on September 30, 2011 to holders of record on September 15, 2011.

*Underwriting income (loss)* measures the performance of the Company s core underwriting function, excluding revenues and expenses such as net investment income (loss), other income, finance expenses, net realized and unrealized gains (losses) on investments and foreign exchange gains (losses). The Company believes the reporting of underwriting income enhances the understanding of our results by highlighting the underlying profitability of the Company s core insurance and reinsurance operations. Underwriting income for the three months ended June 30, 2011 and 2010 was $71.6 million and $109.7 million, respectively. Underwriting income (loss) is a Non-GAAP financial measure as described in detail and reconciled in the section below entitled Underwriting Income.

**Critical Accounting Policies and Estimates**

There are certain accounting policies that the Company considers to be critical due to the judgment and uncertainty inherent in the application of those policies. In calculating financial statement estimates, the use of different assumptions could produce materially different estimates. The Company believes the following critical accounting policies affect significant estimates used in the preparation of our consolidated financial statements:

Reserve for losses and loss expenses;

Premiums;

Reinsurance premiums ceded and reinsurance recoverable; and

Investment valuation.

Critical accounting policies and estimates are discussed further in Item 7, Management s Discussion and Analysis of Results of Operations and Financial Condition in the Company s Annual Report on Form 10-K for the year ended December 31, 2010.

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**Segment Reporting**

Management has determined that the Company operates in two reportable segments. The two significant operating segments are Validus Re and Talbot.

**Results of Operations**

Validus Re commenced operations on December 16, 2005. The Company s fiscal year ends on December 31. Financial statements are prepared in accordance with generally accepted accounting principles in the United States of America ( U.S. GAAP ) for interim financial information.

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The following table presents results of operations for the three and six months ended June 30, 2011 and 2010:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(Dollars in thousands)** | **2011** | **2010** | **2011** | **2010** |
| Gross premiums written | $ 605,387 | $ 516,861 | $ 1,455,283 | $ 1,387,795 |
| Reinsurance premiums ceded | (132,346) | (67,726) | (242,166) | (158,465) |
| Net premiums written | 473,041 | 449,135 | 1,213,117 | 1,229,330 |
| Change in unearned premiums | (47,401) | (11,191) | (357,944) | (333,692) |
| **Net premiums earned** | 425,640 | 437,944 | 855,173 | 895,638 |
| Losses and loss expenses | 207,307 | 194,894 | 683,505 | 673,425 |
| Policy acquisition costs | 78,230 | 74,126 | 155,526 | 150,302 |
| General and administrative expenses | 60,841 | 52,379 | 109,318 | 105,948 |
| Share compensation expenses | 7,628 | 6,846 | 19,677 | 13,422 |
| **Total underwriting deductions** | 354,006 | 328,245 | 968,026 | 943,097 |
| **Underwriting income (loss) (a)** | 71,634 | 109,699 | (112,853) | (47,459) |
| Net investment income | 26,494 | 34,809 | 56,469 | 69,108 |
| Other income | 595 | 2,697 | 2,201 | 3,585 |
| Finance expenses | (16,361) | (13,218) | (30,362) | (28,369) |
| **Operating income (loss) before taxes** | 82,362 | 133,987 | (84,545) | (3,135) |
| Tax benefit (expense) | 29 | (4,187) | 1,488 | (3,490) |
| **Net operating income (loss) (a)** | 82,391 | 129,800 | (83,057) | (6,625) |
| Net realized gains on investments | 11,552 | 12,441 | 17,931 | 23,839 |
| Net unrealized gains on investments | 18,526 | 41,640 | 5,698 | 57,053 |
| Foreign exchange (losses) | (1,991) | (4,099) | (2,458) | (12,863) |
| **Net income (loss)** | 110,478 | 179,782 | (61,886) | 61,404 |
| Net income attributable to noncontrolling interest | (594) | | (594) | |
| **Net income (loss) available (attributable) to Validus** | $ 109,884 | $ 179,782 | $ (62,480) | $ 61,404 |
| **Selected ratios:** | | | | |
| Net premiums written / Gross premiums written | 78.1% | 86.9% | 83.4% | 88.6% |

| | | | | |
|---|---|---|---|---|
| Losses and loss expenses | 48.7% | 44.5% | 79.9% | 75.2% |
| Policy acquisition costs | 18.4% | 16.9% | 18.2% | 16.8% |
| General and administrative expenses (b) | 16.1% | 13.5% | 15.1% | 13.3% |
| Expense ratio | 34.5% | 30.4% | 33.3% | 30.1% |
| Combined ratio | 83.2% | 74.9% | 113.2% | 105.3% |

a) Non-GAAP Financial Measures: In presenting the Company s results, management has included and discussed underwriting income and operating income that are not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other companies. These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. A reconciliation of underwriting income to net income, the most comparable U.S. GAAP financial measure, is presented in the section below entitled Underwriting Income.

b) The general and administrative ratio includes share compensation expenses.

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| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| **Validus Re** | | | | |
| Gross premiums written | $ 341,651 | $ 284,328 | $ 952,889 | $ 924,623 |
| Reinsurance premiums ceded | (98,218) | (41,175) | (145,023) | (54,285) |
| Net premiums written | 243,433 | 243,153 | 807,866 | 870,338 |
| Change in unearned premiums | (10,755) | 18,888 | (322,879) | (324,376) |
| **Net premiums earned** | 232,678 | 262,041 | 484,987 | 545,962 |
| Losses and loss expenses | 94,035 | 123,793 | 404,579 | 472,713 |
| Policy acquisition costs | 35,769 | 37,979 | 75,835 | 81,482 |
| General and administrative expenses | 15,458 | 10,983 | 26,115 | 27,295 |
| Share compensation expenses | 1,823 | 1,749 | 4,928 | 3,378 |
| **Total underwriting deductions** | 147,085 | 174,504 | 511,457 | 584,868 |
| **Underwriting income (loss) (a)** | 85,593 | 87,537 | (26,470) | (38,906) |
| **Talbot** | | | | |
| Gross premiums written | $ 276,886 | $ 253,710 | $ 539,943 | $ 524,251 |
| Reinsurance premiums ceded | (47,278) | (47,728) | (134,692) | (165,259) |
| Net premiums written | 229,608 | 205,982 | 405,251 | 358,992 |
| Change in unearned premiums | (36,646) | (30,079) | (35,065) | (9,316) |
| **Net premiums earned** | 192,962 | 175,903 | 370,186 | 349,676 |
| Losses and loss expenses | 113,272 | 71,101 | 278,926 | 200,712 |
| Policy acquisition costs | 42,307 | 38,647 | 79,523 | 73,592 |
| General and administrative expenses | 34,718 | 24,960 | 63,440 | 50,508 |
| Share compensation expenses | 2,026 | 1,468 | 4,745 | 3,027 |
| **Total underwriting deductions** | 192,323 | 136,176 | 426,634 | 327,839 |
| **Underwriting income (loss) (a)** | 639 | 39,727 | (56,448) | 21,837 |
| **Corporate & Eliminations** | | | | |
| Gross premiums written | $ (13,150) | $ (21,177) | $ (37,549) | $ (61,079) |
| Reinsurance premiums ceded | 13,150 | 21,177 | 37,549 | 61,079 |
| Net premiums written | | | | |

| | | | | |
|---|---|---|---|---|
| Change in unearned premiums | | | | |
| **Net premiums earned** | | | | |
| Losses and loss expenses | | | | |
| Policy acquisition costs | 154 | (2,500) | 168 | (4,772) |
| General and administrative expenses | 10,665 | 16,436 | 19,763 | 28,145 |
| Share compensation expenses | 3,779 | 3,629 | 10,004 | 7,017 |
| **Total underwriting deductions** | 14,598 | 17,565 | 29,935 | 30,390 |
| **Underwriting (loss) (a)** | (14,598) | (17,565) | (29,935) | (30,390) |
| **Total underwriting income (loss) (a)** | $ 71,634 | $ 109,699 | $ (112,853) | $ (47,459) |

a) Non-GAAP Financial Measures. In presenting the Company s results, management has included and discussed underwriting income that is not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other companies. These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. A reconciliation of this measure to net income, the most comparable U.S. GAAP financial measure, is presented in the section below entitled Underwriting Income.

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**Three Months Ended June 30, 2011 compared to Three Months Ended June 30, 2010**

Net income available to Validus for the three months ended June 30, 2011 was $109.9 million compared to $179.8 million for the three months ended June 30, 2010, a decrease of $69.9 million or 38.9%. The primary factors driving the decrease in net income were:

Decrease in underwriting income of $38.1 million due to:

A $12.3 million decrease in net premiums earned.

A $13.3 million increase in other underwriting deductions including policy acquisition costs, general and administrative expenses and share compensation expenses.

A $12.4 million increase in loss and loss expenses due to increased catastrophe losses.

An unfavorable movement of $23.1 million in net unrealized (losses) gains on investments.

Decrease in net investment income of $8.3 million.

The change in net income available to Validus for the three months ended June 30, 2011 of $69.9 million as compared to the three months ended June 30, 2010 is described in the following table:

| | Three Months Ended June 30, 2011 Increase (Decrease) Over the Three Months Ended June 30, 2010 | | | |
|---|---|---|---|---|
| **(Dollars in thousands)** | **Validus Re** | **Talbot** | **Corporate and Eliminations** | **Total** |
| Notable losses (increase) decrease in net loss and loss expenses (a) | $ (2,852) | $ (16,952) | $ | $ (19,804) |
| Less: Notable losses (decrease) increase in net reinstatement premiums (a) | (1,452) | 5,087 | | 3,635 |
| Other underwriting income (loss) | 2,360 | (27,223) | 2,967 | (21,896) |
| Underwriting (loss) income (b) | (1,944) | (39,088) | 2,967 | (38,065) |
| Net investment income | (7,525) | (879) | 89 | (8,315) |
| Other income | (623) | (1,117) | (362) | (2,102) |
| Finance expenses | (3,395) | (105) | 357 | (3,143) |
| | (13,487) | (41,189) | 3,051 | (51,625) |
| Taxes | 90 | 3,886 | 240 | 4,216 |
| | (13,397) | (37,303) | 3,291 | (47,409) |
| Net realized (losses) on investments | (811) | (78) | | (889) |
| Net unrealized (losses) on investments | (21,140) | (1,974) | | (23,114) |
| Net foreign exchange (losses) gains | (4,494) | 6,653 | (51) | 2,108 |
| **Net (loss) income** | (39,842) | (32,702) | 3,240 | (69,304) |
| | (594) | | | (594) |

| | | | | |
|---|---|---|---|---|
| Net income attributable to noncontrolling interest | | | | |
| **Net (loss) income (attributable) available to Validus** | $ (40,436) | $ (32,702) | $ 3,240 | $ (69,898) |

(a) Notable losses for the three months ended June 30, 2011 include: Cat 46, Cat 48 and Jupiter 1. Notable losses for the three months ended June 30, 2010 include Deepwater Horizon, Aban Pearl, Bangkok riots and Perth hailstorm. Excludes the reserve for potential development on 2010 and 2011 notable loss events.

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(b) Non-GAAP Financial Measures. In presenting the Company s results, management has included and discussed underwriting income (loss) that is not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other companies. These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. A reconciliation of this measure to net income, the most comparable U.S. GAAP financial measure, is presented in the section below entitled Underwriting Income.

**Gross Premiums Written**

Gross premiums written for the three months ended June 30, 2011 were $605.4 million compared to $516.9 million for the three months ended June 30, 2010, an increase of $88.5 million or 17.1%. Gross premiums written on the property lines increased by $68.5 million, while the marine and specialty lines increased by $4.9 million and $15.2 million, respectively. Details of gross premiums written by line of business are provided below.

| | Three Months Ended June 30, 2011 | | Three Months Ended June 30, 2010 | | |
|---|---|---|---|---|---|
| (Dollars in thousands) | Gross Premiums Written | Gross Premiums Written (%) | Gross Premiums Written | Gross Premiums Written (%) | % Change |
| Property | $ 408,785 | 67.5% | $ 340,290 | 65.8% | 20.1% |
| Marine | 97,243 | 16.1% | 92,380 | 17.9% | 5.3% |
| Specialty | 99,359 | 16.4% | 84,191 | 16.3% | 18.0% |
| **Total** | $ 605,387 | 100.0% | $ 516,861 | 100.0% | 17.1% |

*Validus Re*. Validus Re gross premiums written for the three months ended June 30, 2011 were $341.7 million compared to $284.3 million for the three months ended June 30, 2010, an increase of $57.3 million or 20.2%. Details of Validus Re gross premiums written by line of business are provided below.

| | Three Months Ended June 30, 2011 | | Three Months Ended June 30, 2010 | | |
|---|---|---|---|---|---|
| (Dollars in thousands) | Gross Premiums Written | Gross Premiums Written (%) | Gross Premiums Written | Gross Premiums Written (%) | % Change |
| Property | $ 323,108 | 94.6% | $ 261,568 | 92.0% | 23.5% |
| Marine | 4,846 | 1.4% | 15,410 | 5.4% | (68.6)% |
| Specialty | 13,697 | 4.0% | 7,350 | 2.6% | 86.4% |
| **Total** | $ 341,651 | 100.0% | $ 284,328 | 100.0% | 20.2% |

The increase in gross premiums written in the property lines of $61.5 million was due primarily to $42.6 million of gross premiums written by AlphaCat Re 2011 and a $23.8 million increase in catastrophe excess of loss gross premiums written. The increase in catastrophe excess of loss premiums written was due primarily to an improving US property rate environment increasing premiums on existing business and providing attractive opportunities that resulted in growth. The decrease in gross premiums written of $10.6 million in the marine lines was due primarily to a $5.1 million decrease in estimated premium income adjustments and a $5.8 milllion decrease in reinstatement premiums due to higher losses in 2010 attributable to the Deepwater Horizon loss. The increase in gross premiums written in the specialty lines of $6.3 million was primarily due to a $6.2 million increase in gross premiums written on a proportional basis.

Gross premiums written under the quota share, surplus treaty and excess of loss contracts between Validus Re and Talbot for three months ended June 30, 2011 decreased by $8.0 million as compared to the three months ended June 30, 2010. The decrease in premiums written was due to a $6.7 million decrease in the property lines and a $1.3 million decrease in the marine lines. These reinsurance agreements with Talbot are eliminated upon consolidation.

*Talbot*. Talbot gross premiums written for the three months ended June 30, 2011 were $276.9 million compared to $253.7 million for the three months ended June 30, 2010, an increase of $23.2 million or 9.1%. The $276.9 million of gross premiums written translated at 2010 rates of exchange would have been $273.9 million during the three months ended June 30, 2011, giving an effective increase of $20.2 million or 8.0%. Details of Talbot gross premiums written by line of business are provided below.

| (Dollars in thousands) | Three Months Ended June 30, 2011 Gross Premiums Written | Three Months Ended June 30, 2011 Gross Premiums Written (%) | Three Months Ended June 30, 2010 Gross Premiums Written | Three Months Ended June 30, 2010 Gross Premiums Written (%) | % Change |
|---|---|---|---|---|---|
| Property | $ 97,732 | 35.3% | $ 97,529 | 38.4% | 0.2% |
| Marine | 93,492 | 33.8% | 79,355 | 31.3% | 17.8% |
| Specialty | 85,662 | 30.9% | 76,826 | 30.3% | 11.5% |
| **Total** | $ 276,886 | 100.0% | $ 253,710 | 100.0% | 9.1% |

The increase in gross premiums written in the marine lines of $14.1 million was due primarily to a $9.8 million increase in premiums written in the marine liability lines and a $5.2 million increase in premiums written in the cargo lines. The increase in gross premiums written in the specialty lines of $8.8 million was primarily due to a $6.3 million increase in premiums written in the political violence lines.

**Reinsurance Premiums Ceded**

Reinsurance premiums ceded for the three months ended June 30, 2011 were $132.3 million compared to $67.7 million for the three months ended June 30, 2010, an increase of $64.6 million or 95.4%. Details of reinsurance premiums ceded by line of business are provided below.

| (Dollars in thousands) | Three Months Ended June 30, 2011 Reinsurance Premiums Ceded | Three Months Ended June 30, 2011 Reinsurance Premiums Ceded (%) | Three Months Ended June 30, 2010 Reinsurance Premiums Ceded | Three Months Ended June 30, 2010 Reinsurance Premiums Ceded (%) | % Change |
|---|---|---|---|---|---|
| Property | $ 112,299 | 84.9% | $ 53,828 | 79.5% | 108.6% |
| Marine | 16,034 | 12.1% | 10,923 | 16.1% | 46.8% |
| Specialty | 4,013 | 3.0% | 2,975 | 4.4% | 34.9% |
| **Total** | $ 132,346 | 100.0% | $ 67,726 | 100.0% | 95.4% |

*Validus Re.* Validus Re reinsurance premiums ceded for the three months ended June 30, 2011 were $98.2 million compared to $41.2 million for the three months ended June 30, 2010, an increase of $57.0 million or 138.5%. Details of Validus Re reinsurance premiums ceded by line of business are provided below.

| (Dollars in thousands) | Three Months Ended June 30, 2011 Reinsurance Premiums Ceded | Three Months Ended June 30, 2011 Reinsurance Premiums Ceded (%) | Three Months Ended June 30, 2010 Reinsurance Premiums Ceded | Three Months Ended June 30, 2010 Reinsurance Premiums Ceded (%) | % Change |
|---|---|---|---|---|---|
| Property | $ 85,389 | 86.9% | $ 33,933 | 82.4% | 151.6% |
| Marine | 12,829 | 13.1% | 7,242 | 17.6% | 77.1% |
| **Total** | $ 98,218 | 100.0% | $ 41,175 | 100.0% | 138.5% |

Reinsurance premiums ceded in the property lines increased by $51.5 million, due primarily to the purchase of $60.4 million of additional retrocessional coverage on the U.S. catastrophe portfolio, partially offset by a $4.8 million decrease in non-proportional retrocessional coverage on the worldwide catastrophe portfolio. The additional U.S. retrocessional coverage was purchased to ensure that the Company would be well positioned to take advantage of opportunities in a post loss environment.

Reinsurance premiums ceded in the marine lines increased by $5.6 million, due primarily to $5.1 million of additional retrocessional coverage purchased in the three months ended June 30, 2011.

*Talbot.* Talbot reinsurance premiums ceded for the three months ended June 30, 2011 were $47.3 million compared to $47.7 million for the three months ended June 30, 2010, a decrease of $0.5 million or 0.9%. Details of Talbot reinsurance premiums ceded by line of business are provided below.

| | Three Months Ended June 30, 2011 | | Three Months Ended June 30, 2010 | | |
|---|---|---|---|---|---|
| **(Dollars in thousands)** | **Reinsurance Premiums Ceded** | **Reinsurance Premiums Ceded (%)** | **Reinsurance Premiums Ceded** | **Reinsurance Premiums Ceded (%)** | **% Change** |
| Property | $ 38,965 | 82.4% | $ 38,702 | 81.1% | 0.7% |
| Marine | 4,300 | 9.1% | 6,066 | 12.7% | (29.1)% |
| Specialty | 4,013 | 8.5% | 2,960 | 6.2% | 35.6% |
| **Total** | $ 47,278 | 100.0% | $ 47,728 | 100.0% | (0.9)% |

Reinsurance premiums ceded across the property, marine and specialty lines are generally consistent with the three months ended June 30, 2010. There was a reduction in reinsurance premiums ceded to Validus Re, which is described above. This reduction was offset by an increase of $7.6 million in reinsurance premiums ceded to third parties.

**Net Premiums Written**

Net premiums written for the three months ended June 30, 2011 were $473.0 million compared to $449.1 million for the three months ended June 30, 2010, an increase of $23.9 million, or 5.3%. The ratios of net premiums written to gross premiums written for the three months ended June 30, 2011 and 2010 were 78.1% and 86.9%, respectively. Details of net premiums written by line of business are provided below.

| | Three Months Ended June 30, 2011 | | Three Months Ended June 30, 2010 | | |
|---|---|---|---|---|---|
| **(Dollars in thousands)** | **Net Premiums Written** | **Net Premiums Written (%)** | **Net Premiums Written** | **Net Premiums Written (%)** | **% Change** |
| Property | $ 296,486 | 62.7% | $ 286,463 | 63.8% | 3.5% |
| Marine | 81,209 | 17.2% | 81,455 | 18.1% | (0.3)% |
| Specialty | 95,346 | 20.1% | 81,217 | 18.1% | 17.4% |
| **Total** | $ 473,041 | 100.0% | $ 449,135 | 100.0% | 5.3% |

*Validus Re.* Validus Re net premiums written for the three months ended June 30, 2011 were $243.4 million compared to $243.2 million for the three months ended June 30, 2010, an increase of $0.3 million or 0.1%. Details of Validus Re net premiums written by line of business are provided below.

| | Three Months Ended June 30, 2011 | | Three Months Ended June 30, 2010 | |
|---|---|---|---|---|
| **(Dollars in thousands)** | **Net Premiums Written** | **Net Premiums** | **Net Premiums Written** | **Net Premiums** |

| | | Written (%) | | Written (%) | % Change |
|---|---|---|---|---|---|
| Property | $ 237,719 | 97.7% | $ 227,635 | 93.6% | 4.4% |
| Marine | (7,983) | (3.3)% | 8,168 | 3.4% | (197.7)% |
| Specialty | 13,697 | 5.6% | 7,350 | 3.0% | 86.4% |
| **Total** | $ 243,433 | 100.0% | $ 243,153 | 100.0% | 0.1% |

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The increase in Validus Re net premiums written was driven by the factors highlighted above in respect of gross premiums written and reinsurance premiums ceded. Negative net written premiums in the marine lines is the result of premium adjustments on gross premiums written and the timing of purchases of retrocessional coverage. The ratios of net premiums written to gross premiums written were 71.3% and 85.5% for the three months ended June 30, 2011 and 2010, respectively, reflecting the increase in reinsurance premiums ceded as a result of the purchase of additional retrocessional coverage described above.

*Talbot.* Talbot net premiums written for the three months ended June 30, 2011 were $229.6 million compared to $206.0 million for the three months ended June 30, 2010, an increase of $23.6 million or 11.5%. Details of Talbot net premiums written by line of business are provided below.

| | Three Months Ended June 30, 2011 | | Three Months Ended June 30, 2010 | | |
|---|---|---|---|---|---|
| **(Dollars in thousands)** | **Net Premiums Written** | **Net Premiums Written (%)** | **Net Premiums Written** | **Net Premiums Written (%)** | **% Change** |
| Property | $ 58,767 | 25.6% | $ 58,827 | 28.5% | (0.1)% |
| Marine | 89,192 | 38.8% | 73,289 | 35.6% | 21.7% |
| Specialty | 81,649 | 35.6% | 73,866 | 35.9% | 10.5% |
| **Total** | $ 229,608 | 100.0% | $ 205,982 | 100.0% | 11.5% |

The increase in net premiums written was driven by the factors highlighted above in respect of gross premiums written and reinsurance premiums ceded. The ratios of net premiums written to gross premiums written for the three months ended June 30, 2011 and 2010 were 82.9% and 81.2%, respectively.

**Change in Unearned Premiums**

Net change in unearned premiums for the three months ended June 30, 2011 was ($47.4) million compared to ($11.2) million for the three months ended June 30, 2010, a change of $36.2 million or 323.6%.

| **(Dollars in thousands)** | **Three Months Ended June 30, 2011 Change in Unearned Premiums** | **Three Months Ended June 30, 2010 Change in Unearned Premiums** | **% Change** |
|---|---|---|---|
| Change in gross unearned premium | $ (109,608) | $ (93,012) | 17.8% |
| Change in prepaid reinsurance premium | 62,207 | 81,821 | (24.0)% |
| **Net change in unearned premium** | $ (47,401) | $ (11,191) | 323.6% |

*Validus Re.* Validus Re s net change in unearned premiums for the three months ended June 30, 2011 were ($10.8) million compared to $18.9 million for the three months ended June 30, 2010, a change of $29.6 million or 156.9%.

| | **Three Months Ended June 30, 2011 Change in Unearned** | **Three Months Ended June 30, 2010 Change in Unearned** |
|---|---|---|

| **(Dollars in thousands)** | | **Premiums** | | **Premiums** | **% Change** |
|---|---|---|---|---|---|
| Change in gross unearned premium | $ | (83,079) | $ | (75,680) | 9.8% |
| Change in prepaid reinsurance premium | | 72,324 | | 94,568 | (23.5)% |
| **Net change in unearned premium** | $ | (10,755) | $ | 18,888 | (156.9)% |

The Validus Re net change in unearned premium has decreased for the three months ended June 30, 2011 due primarily to the timing differences in purchases of retrocessional coverage during the three months ended June 30, 2011 compared to the three months ended June 30, 2010.

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*Talbot.* The Talbot net change in unearned premiums for the three months ended June 30, 2011 was ($36.6) million compared to ($30.1) million for the three months ended June 30, 2010, a change of $6.6 million or 21.8%.

| (Dollars in thousands) | Three Months Ended June 30, 2011 Change in Unearned Premiums | Three Months Ended June 30, 2010 Change in Unearned Premiums | % Change |
|---|---|---|---|
| Change in gross unearned premium | $ (26,529) | $ (17,332) | 53.1% |
| Change in prepaid reinsurance premium | (10,117) | (12,747) | (20.6)% |
| **Net change in unearned premium** | $ (36,646) | $ (30,079) | 21.8% |

The Talbot net change in unearned premium is generally consistent for the three months ended June 30, 2011 compared to the three months ended June 30, 2010.

**Net Premiums Earned**

Net premiums earned for the three months ended June 30, 2011 were $425.6 million compared to $437.9 million for the three months ended June 30, 2010, a decrease of $12.3 million or 2.8%. The decrease in net premiums earned was driven by a decrease in net premiums earned of $29.4 million in the Validus Re segment, partially offset by an increase of $17.1 million in the Talbot segment. Details of net premiums earned by line of business are provided below.

| | Three Months Ended June 30, 2011 | | Three Months Ended June 30, 2010 | | |
|---|---|---|---|---|---|
| (Dollars in thousands) | Net Premiums Earned | Net Premiums Earned (%) | Net Premiums Earned | Net Premiums Earned (%) | % Change |
| Property | $ 204,624 | 48.1% | $ 223,596 | 51.0% | (8.5)% |
| Marine | 125,496 | 29.5% | 111,567 | 25.5% | 12.5% |
| Specialty | 95,520 | 22.4% | 102,781 | 23.5% | (7.1)% |
| **Total** | $ 425,640 | 100.0% | $ 437,944 | 100.0% | (2.8)% |

*Validus Re.* Validus Re net premiums earned for the three months ended June 30, 2011 were $232.7 million compared to $262.0 million for the three months ended June 30, 2010, a decrease of $29.4 million or 11.2%. Details of Validus Re net premiums earned by line of business are provided below.

| | Three Months Ended June 30, 2011 | | Three Months Ended June 30, 2010 | | |
|---|---|---|---|---|---|
| (Dollars in thousands) | Net Premiums Earned | Net Premiums Earned (%) | Net Premiums Earned | Net Premiums Earned (%) | % Change |
| Property | $ 166,779 | 71.7% | $ 186,444 | 71.1% | (10.5)% |
| Marine | 46,549 | 20.0% | 48,154 | 18.4% | (3.3)% |
| Specialty | 19,350 | 8.3% | 27,443 | 10.5% | (29.5)% |

| **Total** | $ 232,678 | 100.0% | $ 262,041 | 100.0% | (11.2)% |
|---|---|---|---|---|---|

The decrease in net premiums earned is consistent with the relevant patterns of net written premiums influencing the earned premiums for the three months ended June 30, 2011 compared to the three months ended June 30, 2010.

*Talbot*. Talbot net premiums earned for the three months ended June 30, 2011 were $193.0 million compared to $175.9 million for the three months ended June 30, 2010, an increase of $17.1 million or 9.7%. Details of Talbot net premiums earned by line of business are provided below.

| (Dollars in thousands) | Three Months Ended June 30, 2011 Net Premiums Earned | Three Months Ended June 30, 2011 Net Premiums Earned (%) | Three Months Ended June 30, 2010 Net Premiums Earned | Three Months Ended June 30, 2010 Net Premiums Earned (%) | % Change |
|---|---|---|---|---|---|
| Property | $ 37,845 | 19.6% | $ 37,152 | 21.1% | 1.9% |
| Marine | 78,947 | 40.9% | 63,413 | 36.1% | 24.5% |
| Specialty | 76,170 | 39.5% | 75,338 | 42.8% | 1.1% |
| **Total** | $ 192,962 | 100.0% | $ 175,903 | 100.0% | 9.7% |

The increase in net premiums earned is consistent with the relevant patterns of net written premiums influencing the earned premium for the three months ended June 30, 2011, as compared to the three months ended June 30, 2010, as discussed above.

**Losses and Loss Expenses**

Losses and loss expenses for the three months ended June 30, 2011 were $207.3 million compared to $194.9 million for the three months ended June 30, 2010, an increase of $12.4 million or 6.4%. The loss ratios, defined as losses and loss expenses divided by net premiums earned, for the three months ended June 30, 2011 and 2010 were 48.7% and 44.5%, respectively. Details of loss ratios by line of business are provided below.

| | Three Months Ended June 30, 2011 | Three Months Ended June 30, 2010 | Percentage Point Change |
|---|---|---|---|
| Property | 52.8% | 31.3% | 21.5 |
| Marine | 59.5% | 76.0% | (16.5) |
| Specialty | 25.8% | 38.9% | (13.1) |
| **All lines** | 48.7% | 44.5% | 4.2 |

For the three months ended June 30, 2011, the Company incurred $90.3 million from notable loss events, which represented 21.2 percentage points of the loss ratio as described below. Net of $6.9 million of reinstatement premiums, the effect of these events on net income was $83.4 million. For the three months ended June 30, 2010, the Company incurred $70.5 million from notable loss events, which represented 16.1 percentage points of the loss ratio, excluding reserve for development on notable loss events, as described below. Net of $3.3 million of reinstatement premiums, the effect of these events on net income was $67.2 million. The Company s loss ratio, excluding prior year development and notable loss events for the three months ended June 30, 2011 and 2010 was 33.5% and 39.7%, respectively.

| Second Quarter 2011 Notable Loss Events (a) | | Three months ended June 30, 2011 (Dollars in thousands) | | | | | |
|---|---|---|---|---|---|---|---|
| | | Validus Re | | Talbot | | Total | |
| Description | | Net Losses and Loss Expenses (b) | % of NPE | Net Losses and Loss Expenses (b) | % of NPE | Net Losses and Loss Expenses (b) | % of NPE |
| Cat 46 | Tornado | $ 36,584 | 15.7% | $ 7,222 | 3.7% | $ 43,806 | 10.3% |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Cat 48 | Tornado | 20,869 | 9.0% | 10,612 | 5.5% | 31,481 | 7.4% |
| Jupiter 1 | Platform failure | 4,970 | 2.1% | 10,038 | 5.2% | 15,008 | 3.5% |
| **Total** | | $ 62,423 | 26.8% | $ 27,872 | 14.4% | $ 90,295 | 21.2% |

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| Second Quarter 2010 Notable Loss Events (a) | | Three months ended June 30, 2010 (Dollars in thousands) | | | | | |
|---|---|---|---|---|---|---|---|
| | | Validus Re | | Talbot | | Total | |
| Description | | Net Losses and Loss Expenses (b) | % of NPE | Net Losses and Loss Expenses (b) | % of NPE | Net Losses and Loss Expenses (b) | % of NPE |
| Deepwater Horizon | Oil rig and spill | $ 33,681 | 12.9% | $ 10,420 | 5.9% | $ 44,101 | 10.1% |
| Aban Pearl | Oil rig | 10,000 | 3.8% | 500 | 0.3% | 10,500 | 2.4% |
| Bangkok riots | Terrorism | 7,500 | 2.9% | | | 7,500 | 1.7% |
| Perth hailstorm | Hailstorm | 8,390 | 3.1% | | | 8,390 | 1.9% |
| **Total** | | $ 59,571 | 22.7% | $ 10,920 | 6.2% | $ 70,491 | 16.1% |

(a) These notable loss event amounts exclude the reserve for potential development on 2010 and 2011 notable loss events and are based on management s estimates following a review of the Company s potential exposure and discussions with certain clients and brokers. Given the magnitude and recent occurrence of these events, and other uncertainties inherent in loss estimation, meaningful uncertainty remains regarding losses from these events and the Company s actual ultimate net losses from these events may vary materially from these estimates.

(b) Net of reinsurance but not net of reinstatement premiums. Total reinstatement premiums were $6.9 million for the three months ended June 30, 2011 and $3.3 million for the three months ended June 30, 2010.

| | Three Months Ended June 30, | | |
|---|---|---|---|
| | 2011 | 2010 | Percentage Point Change |
| Property current period excluding notable losses | 21.9% | 38.0% | (16.1) |
| Property current period notable losses | 33.7% | 3.8% | 29.9 |
| Property change in prior accident years | (2.8)% | (10.5)% | 7.7 |
| Property loss ratio | 52.8% | 31.3% | 21.5 |
| Marine current period excluding notable losses | 50.9% | 40.1% | 10.8 |
| Marine current period notable losses | 16.5% | 48.9% | (32.4) |
| Marine change in prior accident years | (7.9)% | (13.0)% | 5.1 |
| Marine loss ratio | 59.5% | 76.0% | (16.5) |
| Specialty current period excluding notable losses | 35.8% | 43.0% | (7.2) |
| Specialty current period notable losses | 0.6% | 7.3% | (6.7) |

| | | | |
|---|---|---|---|
| Specialty change in prior accident years | (10.6)% | (11.3)% | 0.7 |
| Specialty loss ratio | 25.8% | 38.9% | (13.2) |
| All lines current period excluding notable losses | 33.5% | 39.7% | (6.2) |
| All lines current period notable losses | 21.2% | 16.1% | 5.1 |
| All lines change in prior accident years | (6.0)% | (11.3)% | 5.3 |
| **All lines loss ratio** | 48.7% | 44.5% | 4.2 |

*Validus Re.* Validus Re losses and loss expenses for the three months ended June 30, 2011 were $94.0 million compared to $123.8 million for the three months ended June 30, 2010, a decrease of $29.8 million or 24.0%. The loss ratio, defined as losses and loss expenses divided by net premiums earned, was 40.4% and 47.2% for the three months ended June 30, 2011 and 2010, respectively. For the three months ended June 30, 2011, favorable loss development on prior years totaled $12.3 million and benefited the Validus Re loss ratio by 5.3 percentage points. For the three months ended June 30, 2010, favorable loss development on prior years totaled $17.9 million and benefited the Validus Re loss ratio by 6.9 percentage points.

For the three months ended June 30, 2011, Validus Re incurred notable loss events as identified above of $62.4 million, which represented 26.8 percentage points of the loss ratio. Net of reinstatement premiums of $6.3 million, the effect of these events on Validus Re segment income was $56.1 million. For the three months ended June 30, 2010, Validus Re incurred notable loss events as identified above of $59.6 million, which represented 22.7 percentage points of the loss ratio, excluding the reserve for potential development on notable loss events. Net of reinstatement premiums of $7.7 million, the effect of these events on Validus Re segment income was $51.9 million. Validus Re segment loss ratios, excluding prior year development and notable loss events identified above, for the three months ended June 30, 2011 and 2010 were 18.9% and 31.4%, respectively. Details of loss ratios by line of business and period of occurrence are provided below.

| | Three Months Ended June 30, | | |
|---|---|---|---|
| | **2011** | **2010** | **Percentage Point Change** |
| Property current period excluding notable losses | 13.4% | 36.1% | (22.7) |
| Property current period notable losses | 34.4% | 4.5% | 29.9 |
| Property change in prior accident years | (3.9)% | (7.3)% | 3.4 |
| Property loss ratio | 43.9% | 33.3% | 10.6 |
| Marine current period excluding notable losses | 41.7% | 26.8% | 14.9 |
| Marine current period notable losses | 10.7% | 90.7% | (80.0) |
| Marine change in prior accident years | (9.7)% | (7.5)% | (2.2) |
| Marine loss ratio | 42.7% | 110.0% | (67.3) |
| Specialty current period excluding notable losses | 11.3% | 7.0% | 4.3 |
| Specialty current period notable losses | 0.0% | 27.3% | (27.3) |
| Specialty change in prior accident years | (6.6)% | (2.3)% | (4.3) |
| Specialty loss ratio | 4.7% | 32.0% | (27.3) |
| All lines current period excluding notable losses | 18.9% | 31.4% | (12.5) |
| All lines current period notable losses | 26.8% | 22.7% | 4.1 |
| All lines change in prior accident years | (5.3)% | (6.9)% | 1.6 |
| **All lines loss ratio** | 40.4% | 47.2% | (6.8) |

For the three months ended June 30, 2011, Validus Re property lines losses and loss expenses include $79.8 million related to current year losses and $6.5 million of favorable development relating to prior accident years. This favorable development is attributable to lower than expected claims development. For the three months ended June 30, 2010, Validus Re property lines losses and loss expenses included $75.7 million related to current year losses and $13.6 million of favorable development relating to prior accident years. This favorable development is attributable to reduced loss estimates for the U.K. flood loss and windstorm Kyrill, as well as lower than expected claim development elsewhere.

For the three months ended June 30, 2011, Validus Re s property lines incurred $57.4 million of notable losses, which represented 34.4 percentage points of the property lines loss ratio. For the three months ended June 30, 2010, Validus Re s property lines incurred $8.4 million of notable losses, which represented 4.5 percentage points of the property lines loss ratio, excluding reserve for potential development on notable loss events. Validus Re property lines loss ratios, excluding prior year development and notable loss events identified above, for the three months ended

June 30, 2011 and 2010 were 13.4% and 36.1%, respectively.

For the three months ended June 30, 2011, Validus Re marine lines losses and loss expenses include $24.4 million related to current year losses and $4.5 million of favorable development relating to prior accident years. For the three months ended June 30, 2010, Validus Re marine lines losses and loss expenses included $56.6 million related to current year losses and $3.7 million of favorable development relating to prior accident years.

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For the three months ended June 30, 2011, Validus Re s marine lines incurred $5.0 million of notable losses which represented 10.7 percentage points of the marine lines loss ratio. For the three months ended June 30, 2010, Validus Re s marine lines incurred $43.7 million of notable losses, which represented 90.7 percentage points of the marine lines loss ratio, excluding the reserve for potential development on notable loss events. Validus Re marine lines loss ratios, excluding prior year development and notable loss events identified above, for the three months ended June 30, 2011 and 2010 were 41.7% and 26.8%, respectively.

For the three months ended June 30, 2011, Validus Re specialty lines losses and loss expenses include $2.1 million related to current year losses and $1.3 million of favorable development relating to prior accident years. For the three months ended June 30, 2010, Validus Re specialty lines losses and loss expenses included $9.4 million related to current year losses and $0.6 million of favorable development relating to prior accident years.

For the three months ended June 30, 2011, Validus Re s specialty lines did not incur any notable losses. For the three months ended June 30, 2010, Validus Re s specialty lines incurred $7.5 million of notable losses, which represented 27.3 percentage points of the specialty lines loss ratio. Validus Re specialty lines loss ratios, excluding prior year development, for the three months ended June 30, 2011 and 2010 were 11.3% and 7.0%, respectively.

*Talbot.* Talbot losses and loss expenses for the three months ended June 30, 2011 were $113.3 million compared to $71.1 million for the three months ended June 30, 2010, an increase of $42.2 million or 59.3%. The Talbot loss ratio was 58.7% and 40.4% for the three months ended June 30, 2011 and 2010, respectively. For the three months ended June 30, 2011, Talbot incurred losses of $126.7 million related to current year losses and $13.4 million in favorable development relating to prior accident years. For the three months ended June 30, 2010, Talbot incurred losses of $102.8 million related to current year losses and $31.7 million in favorable development relating to prior accident years.

For the three months ended June 30, 2011, Talbot incurred $27.9 million of notable losses, which represented 14.4 percentage points of the loss ratio. Net of reinstatement premiums of $0.7 million, the effect of these events on Talbot segment income is $27.2 million. For the three months ended June 30, 2010, Talbot incurred $10.9 million of notable losses, which represented 6.2 percentage points of the Talbot loss ratio. Net of reinstatement premiums of ($4.4) million, the effect of these events on Talbot segment income was $15.3 million. Talbot loss ratios, excluding prior year loss development and notable loss events identified above, for the three months ended June 30, 2011 and 2010 were 51.2% and 52.2%, respectively. Details of loss ratios by line of business and period of occurrence are provided below.

| | Three Months Ended June 30, | | |
|---|---|---|---|
| | **2011** | **2010** | **Percentage Point Change** |
| Property current period excluding notable losses | 58.9% | 48.0% | 10.9 |
| Property current period notable losses | 30.5% | 0.0% | 30.5 |
| Property change in prior accident years | 2.3% | (26.5)% | 28.8 |
| Property loss ratio | 91.7% | 21.5% | 70.2 |
| Marine current period excluding notable losses | 56.3% | 50.1% | 6.2 |
| Marine current period notable losses | 20.0% | 17.2% | 2.8 |
| Marine change in prior accident years | (6.8)% | (17.0)% | 10.2 |
| Marine loss ratio | 69.5% | 50.3% | 19.2 |
| Specialty current period excluding notable losses | 42.0% | 56.1% | (14.1) |
| Specialty current period notable losses | 0.7% | 0.0% | 0.7 |
| Specialty change in prior accident years | (11.6)% | (14.7)% | 3.1 |

| | | | |
|---|---|---|---|
| Specialty loss ratio | 31.1% | 41.4% | (10.3) |
| All lines current period excluding notable losses | 51.2% | 52.2% | (1.0) |
| All lines current period notable losses | 14.4% | 6.2% | 8.2 |
| All lines change in prior accident years | (6.9)% | (18.0)% | 11.1 |
| **All lines loss ratio** | 58.7% | 40.4% | 18.3 |

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For the three months ended June 30, 2011, Talbot property lines losses and loss expenses include $33.8 million related to current year losses and $0.9 million of adverse development relating to prior accident years. The prior year adverse development is attributable to higher than expected claims development on the onshore energy lines, largely offset by lower than expected claims on the property treaty and property facultative lines. For the three months ended June 30, 2010, Talbot property lines losses and loss expenses included $17.8 million related to current year losses and $9.8 million of favorable development relating to prior accident years. The prior year favorable development was attributable to lower than expected claim development on the property facultative and binder accounts, together with favorable development on hurricanes Katrina and Ike.

For the three months ended June 30, 2011, Talbot s property lines incurred $11.5 million of notable losses, which represented 30.5 percentage points of the property lines loss ratio. For the three months ended June 30, 2010, Talbot s property lines did not incur any notable losses. Talbot property line loss ratio, excluding prior year development and notable loss events identified above for the three months ended June 30, 2011 and 2010 were 58.9% and 48.0%, respectively.

For the three months ended June 30, 2011, Talbot marine lines losses and loss expenses include $60.3 million related to current year losses and $5.4 million of favorable development relating to prior accident years. The prior year favorable development is due primarily to lower than expected claims development across most lines of business, partially offset by adverse claims development on the offshore energy lines. For the three months ended June 30, 2010, Talbot marine lines losses and loss expenses included $42.7 million related to current year losses and $10.8 million of favorable development relating to prior accident years. The prior year favorable development was primarily due to lower than expected loss development on the Hull lines.

For the three months ended June 30, 2011, Talbot s marine lines incurred $15.8 million of notable losses, which represented 20.0 percentage points of the marine lines loss ratio. For the three months ended June 30, 2010, Talbot s marine lines incurred $10.9 million of notable losses, which represented 17.2 percentage points of the marine lines loss ratio. Talbot marine lines loss ratios, excluding prior year development and notable loss events identified above, for the three months ended June 30, 2011 and 2010 were 56.3% and 50.1%, respectively.

For the three months ended June 30, 2011, Talbot specialty lines losses and loss expenses include $32.6 million relating to current year losses and $8.9 million of favorable development relating to prior accident years. The prior year favorable development is due primarily to lower than expected claims development across most lines of business, partially offset by adverse claims development on the financial institutions lines. For the three months ended June 30, 2010, Talbot specialty lines losses and loss expenses included $42.3 million relating to current year losses and $11.0 million of favorable development relating to prior accident years. The prior year favorable development was primarily due to lower than expected claims across most specialty sub classes.

For the three months ended June 30, 2011, Talbot s specialty lines incurred $0.6 million of notable losses, which represented 0.7 percentage points of the specialty lines loss ratio. For the three months ended June 30, 2010, Talbot s specialty lines did not incur any notable losses. Talbot specialty lines loss ratios, excluding prior year development and notable loss events identified above for the three months ended June 30, 2011 and 2010 were 42.0% and 56.1%, respectively.

At June 30, 2011 and 2010, gross and net reserves for losses and loss expenses were estimated using the methodology as outlined in the critical accounting policies and estimates as discussed in Item 7, Management s Discussion and Analysis of Results of Operations and Financial Condition in the Company s Annual Report on Form 10-K for the year ended December 31, 2010. The Company did not make any significant changes in the assumptions or methodology used in its reserving process for the three months ended June 30, 2011.

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| (Dollars in thousands) | As at June 30, 2011<br>Gross Case Reserves | Gross IBNR | Total Gross Reserve for Losses and Loss Expenses |
|---|---|---|---|
| Property | $ 757,858 | $ 556,685 | $ 1,314,543 |
| Marine | 404,886 | 372,778 | 777,664 |
| Specialty | 236,659 | 291,494 | 528,153 |
| **Total** | $ 1,399,403 | $ 1,220,957 | $ 2,620,360 |

| (Dollars in thousands) | As at June 30, 2011<br>Net Case Reserves | Net IBNR | Total Net Reserve for Losses and Loss Expenses |
|---|---|---|---|
| Property | $ 544,165 | $ 522,391 | $ 1,066,556 |
| Marine | 328,987 | 356,046 | 685,033 |
| Specialty | 184,767 | 244,199 | 428,966 |
| **Total** | $ 1,057,919 | $ 1,122,636 | $ 2,180,555 |

The following table sets forth a reconciliation of gross and net reserves for losses and loss expenses by segment for the three months ended June 30, 2011:

| (Dollars in thousands) | Three Months Ended June 30, 2011<br>Validus Re | Talbot | Eliminations | Total |
|---|---|---|---|---|
| Gross reserves at period beginning | $ 1,340,418 | $ 1,324,967 | $ (130,970) | $ 2,534,415 |
| Losses recoverable | (216,300) | (368,371) | 130,970 | (453,701) |
| Net reserves at period beginning | 1,124,118 | 956,596 | | 2,080,714 |
| Incurred losses- current year | 106,347 | 126,665 | | 233,012 |
| Change in prior accident years | (12,312) | (13,393) | | (25,705) |
| Incurred losses | 94,035 | 113,272 | | 207,307 |
| Foreign exchange | 14,050 | (470) | | 13,580 |
| Paid losses | (38,070) | (82,976) | | (121,046) |
| Net reserves at period end | 1,194,133 | 986,422 | | 2,180,555 |
| Losses recoverable | 182,306 | 384,268 | (126,769) | 439,805 |

| | | | | |
|---|---|---|---|---|
| Gross reserves at period end | $ 1,376,439 | $ 1,370,690 | $ (126,769) | $ 2,620,360 |

The amount of recorded reserves represents management s best estimate of expected losses and loss expenses on premiums earned. For the three months ended June 30, 2011, favorable loss reserve development on prior years totaled $25.7 million. Of this $12.3 million of the favorable loss reserve development related to the Validus Re segment and $13.4 million related to the Talbot segment. Favorable loss reserve development benefited the Company s loss ratio by 6.0 percentage points for the three months ended June 30, 2011. For the three months ended June 30, 2010, favorable loss reserve development on prior years totaled $49.6 million. Of this $17.9 million related to the Validus Re segment and $31.7 million related to the Talbot segment. Favorable loss reserve development benefited the Company s loss ratio by 11.3 percentage points for the three months ended June 30, 2010.

Management of insurance and reinsurance companies use significant judgment in the estimation of reserves for losses and loss expenses. Given the magnitude of recent loss events and other uncertainties inherent in loss estimation, meaningful uncertainty remains regarding the estimation for recent notable loss events. The Company s actual ultimate net loss may vary materially from these estimates. Validus Re ultimate losses for notable loss events are estimated through detailed review of contracts which are identified by the Company as potentially exposed to the specific notable loss event.

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However, there can be no assurance that the ultimate loss amount estimated for a specific contract will be accurate, or that all contracts with exposure to a specific notable loss event will be identified in a timely manner. Potential losses in excess of the estimated ultimate loss assigned to a contract on the basis of a specific review, or loss amounts from contracts not specifically included in the detailed review are reserved for in the reserve for potential development on notable loss events. As at March 31, 2011, the total reserve for development on both 2010 and 2011 events was $83.4 million. During the three months ended June 30, 2011 $8.9 million, $20.1 million and $20.2 million of the reserve for potential development on 2010 and 2011 notable loss events was allocated to the Deepwater Horizon loss, the Tohoku earthquake and the Christchurch earthquake, respectively. Therefore as at June 30, 2011 the total reserve for potential development on both 2010 and 2011 events was $34.2 million.

**Policy Acquisition Costs**

Policy acquisition costs for the three months ended June 30, 2011 were $78.2 million compared to $74.1 million for the three months ended June 30, 2010, an increase of $4.1 million or 5.5%. Policy acquisition costs as a percent of net premiums earned for the three months ended June 30, 2011 and 2010 were 18.4% and 16.9%, respectively. The changes in policy acquisition costs are due to the factors provided below.

| | Three Months Ended June 30, 2011 | | | Three Months Ended June 30, 2010 | | | |
|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Policy Acquisition Costs | Policy Acquisition Costs (%) | Acquisition Cost Ratio | Policy Acquisition Costs | Policy Acquisition Costs (%) | Acquisition Cost Ratio | % Change |
| Property | $ 30,032 | 38.4% | 14.7% | $ 30,614 | 41.3% | 13.7% | (1.9)% |
| Marine | 26,977 | 34.5% | 21.5% | 22,982 | 31.0% | 20.6% | 17.4% |
| Specialty | 21,221 | 27.1% | 22.2% | 20,530 | 27.7% | 20.0% | 3.4% |
| **Total** | $ 78,230 | 100.0% | 18.4% | $ 74,126 | 100.0% | 16.9% | 5.5% |

*Validus Re.* Validus Re policy acquisition costs for the three months ended June 30, 2011 were $35.8 million compared to $38.0 million for the three months ended June 30, 2010, a decrease of $2.2 million or 5.8%.

| | Three Months Ended June 30, 2011 | | | Three Months Ended June 30, 2010 | | | |
|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Policy Acquisition Costs | Policy Acquisition Costs (%) | Acquisition Cost Ratio | Policy Acquisition Costs | Policy Acquisition Costs (%) | Acquisition Cost Ratio | % Change |
| Property | $ 22,546 | 63.0% | 13.5% | $ 27,182 | 71.6% | 14.6% | (17.1)% |
| Marine | 10,147 | 28.4% | 21.8% | 7,707 | 20.3% | 16.0% | 31.7% |
| Specialty | 3,076 | 8.6% | 15.9% | 3,090 | 8.1% | 11.3% | (0.5)% |
| **Total** | $ 35,769 | 100.0% | 15.4% | $ 37,979 | 100.0% | 14.5% | (5.8)% |

Policy acquisition costs include brokerage, commission and excise tax, are generally driven by contract terms and are normally a set percentage of premiums and are also net of ceding commission income on retrocessions. Items such as ceded premium, earned premium adjustments and reinstatement premiums that are recognized in the period have an effect on policy acquisition costs. Validus Re policy acquisition costs as a percent of net premiums earned for the three months ended June 30, 2011 and 2010 were 15.4% and 14.5%, respectively. The policy acquisition cost ratio in the marine lines increased by 5.8 percentage points due primarily to the three months ended June 30, 2010 containing substantially more reinstatement premiums, which have no associated policy acquisition costs. The policy acquisition

cost ratio in the specialty line has increased by 4.6 percentage points due primarily to negative earned premium adjustments in the three months ended June 30, 2011.

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*Talbot.* Talbot policy acquisition costs for the three months ended June 30, 2011 were $42.3 million compared to $38.6 million for the three months ended June 30, 2010, an increase of $3.7 million or 9.5%.

| | Three Months Ended June 30, 2011 | | | Three Months Ended June 30, 2010 | | | |
|---|---|---|---|---|---|---|---|
| **(Dollars in thousands)** | **Policy Acquisition Costs** | **Policy Acquisition Costs (%)** | **Acquisition Cost Ratio** | **Policy Acquisition Costs** | **Policy Acquisition Costs (%)** | **Acquisition Cost Ratio** | **% Change** |
| Property | $ 7,217 | 17.0% | 19.1% | $ 5,824 | 15.1% | 15.7% | 23.9% |
| Marine | 16,834 | 39.8% | 21.3% | 15,314 | 39.6% | 24.1% | 9.9% |
| Specialty | 18,256 | 43.2% | 24.0% | 17,509 | 45.3% | 23.2% | 4.3% |
| **Total** | $ 42,307 | 100.0% | 21.9% | $ 38,647 | 100.0% | 22.0% | 9.5% |

Policy acquisition costs as a percent of net premiums earned for the three months ended June 30, 2011 and 2010 were 21.9% and 22.0%, respectively. The policy acquisition cost ratio in the Talbot property lines increased due to increased syndicate acquisition cost rates and a reduction in intercompany ceded premiums and the associated ceding commissions.

**General and Administrative Expenses**

General and administrative expenses for the three months ended June 30, 2011 were $60.8 million compared to $52.4 million for the three months ended June 30, 2010, an increase of $8.5 million or 16.2%. The increase was a result of increased expenses in the Validus Re and Talbot segments, offset by a decrease in the Corporate segment.

| | Three Months Ended June 30, 2011 | | Three Months Ended June 30, 2010 | | |
|---|---|---|---|---|---|
| **(Dollars in thousands)** | **General and Administrative Expenses** | **General and Administrative Expenses (%)** | **General and Administrative Expenses** | **General and Administrative Expenses (%)** | **% Change** |
| Validus Re | $ 15,458 | 25.4% | $ 10,983 | 21.0% | 40.7% |
| Talbot | 34,718 | 57.1% | 24,960 | 47.6% | 39.1% |
| Corporate & Eliminations | 10,665 | 17.5% | 16,436 | 31.4% | (35.1)% |
| **Total** | $ 60,841 | 100.0% | $ 52,379 | 100.0% | 16.2% |

General and administrative expenses of $60.8 million in the three months ended June 30, 2011 represents 14.3 percentage points of the expense ratio. Share compensation expense is discussed in the following section.

*Validus Re.* Validus Re general and administrative expenses for the three months ended June 30, 2011 were $15.5 million compared to $11.0 million for the three months ended June 30, 2010, an increase of $4.5 million or 40.7%. General and administrative expenses have increased due primarily to a $1.8 million increase in salaries and benefits driven by increased staff numbers and a $1.5 million increase in professional fees. General and administrative expenses include salaries and benefits, professional fees, rent and office expenses. Validus Re s general and administrative expenses as a percent of net premiums earned for the three months ended June 30, 2011 and 2010 were 6.6% and 4.2%, respectively.

*Talbot.* Talbot general and administrative expenses for the three months ended June 30, 2011 were $34.7 million compared to $25.0 million for the three months ended June 30, 2010, an increase of $9.8 million or 39.1%. To better align the Company s operating and reporting structure with its current strategy, there was an internal reallocation of

$2.1 million relating to the New York operations from the Corporate segment to the Talbot segment. Other factors contributing to the increase in general and administrative expenses are a $2.6 million increase in staff costs due to a higher staff count, a $2.5 million increase in bonus expense and a $1.4 million increase in syndicate costs. Talbot s general and administrative expenses as a percent of net premiums earned for the three months ended June 30, 2011 and 2010 were 18.0% and 14.2%, respectively.



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*Corporate & Eliminations.* Corporate general and administrative expenses for the three months ended June 30, 2011 were $10.7 million compared to $16.4 million for the three months ended June 30, 2010, a decrease of $5.8 million or 35.1%. To better align the Company s operating and reporting structure with its current strategy, there was an internal reallocation of $2.1 million relating to the New York operations from the Corporate segment to the Talbot segment. There was also an allocation of corporate expenses of $2.2 million to the operating segments relating to group wide costs. Corporate general and administrative expenses are comprised of executive and board expenses, internal and external audit expenses and other costs relating to the Company as a whole.

**Share Compensation Expenses**

Share compensation expenses for the three months ended June 30, 2011 were $7.6 million compared to $6.8 million for the three months ended June 30, 2010, an increase of $0.8 million or 11.4%. This expense is non-cash and has no net effect on total shareholders equity, as it is balanced by an increase in additional paid-in capital.

| | Three Months Ended June 30, 2011 | | Three Months Ended June 30, 2010 | | |
|---|---|---|---|---|---|
| (Dollars in thousands) | Share Compensation Expenses | Share Compensation Expenses (%) | Share Compensation Expenses | Share Compensation Expenses (%) | % Change |
| Validus Re | $ 1,823 | 23.9% | $ 1,749 | 25.6% | 4.2% |
| Talbot | 2,026 | 26.6% | 1,468 | 21.4% | 38.0% |
| Corporate & Eliminations | 3,779 | 49.5% | 3,629 | 53.0% | 4.1% |
| **Total** | $ 7,628 | 100.0% | $ 6,846 | 100.0% | 11.4% |

Share compensation expenses of $7.6 million in the three months ended June 30, 2011 represents 1.8 percentage points of the general and administrative expense ratio.

*Validus Re.* Validus Re share compensation expenses for the three months ended June 30, 2011 were $1.8 million compared to $1.7 million for the three months ended June 30, 2010 an increase of $0.1 million or 4.2%. Share compensation expense as a percent of net premiums earned for the three months ended June 30, 2011 and 2010 were 0.8% and 0.7%, respectively.

*Talbot*. Talbot share compensation expenses for the three months ended June 30, 2011 was $2.0 million compared to $1.5 million for the three months ended June 30, 2010 an increase of $0.6 million or 38.0%. This increase was due primarily to an increase in restricted share awards as a part of the executive and non-executive long term incentive plan. Share compensation expense as a percent of net premiums earned for the three months ended June 30, 2011 and 2010 were 1.0% and 0.8%, respectively.

*Corporate & Eliminations.* Corporate share compensation expenses for the three months ended June 30, 2011 were $3.8 million compared to $3.6 million for the three months ended June 30, 2010, an increase of $0.2 million or 4.1%. This increase was due primarily to an increase in restricted share awards as a part of the executive and non-executive long term incentive plan.

**Selected Ratios**

The underwriting results of an insurance or reinsurance company are often measured by reference to its combined ratio, which is the sum of the loss ratio and the expense ratio. The net loss ratio is calculated by dividing losses and loss expenses incurred (including estimates for incurred but not reported losses) by net premiums earned. The expense ratio is calculated by dividing acquisition costs combined with general and administrative expenses (including share compensation expenses) by net premiums earned. The following table presents the losses and loss expenses ratio, policy acquisition cost ratio, general and administrative expense ratio, expense ratio and combined ratio for the three months ended June 30, 2011 and 2010.

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| | Three Months Ended June 30, 2011 | Three Months Ended June 30, 2010 | Percentage Point Change |
|---|---|---|---|
| Losses and loss expense ratio | 48.7% | 44.5% | 4.2 |
| Policy acquisition cost ratio | 18.4% | 16.9% | 1.5 |
| General and administrative expense ratio (a) | 16.1% | 13.5% | 2.6 |
| **Expense ratio** | 34.5% | 30.4% | 4.1 |
| **Combined ratio** | 83.2% | 74.9% | 8.3 |

| *Validus Re* | Three Months Ended June 30, 2011 | Three Months Ended June 30, 2010 | Percentage Point Change |
|---|---|---|---|
| Losses and loss expense ratio | 40.4% | 47.2% | (6.8) |
| Policy acquisition cost ratio | 15.4% | 14.5% | 0.9 |
| General and administrative expense ratio (a) | 7.4% | 4.9% | 2.5 |
| **Expense ratio** | 22.8% | 19.4% | 3.4 |
| **Combined ratio** | 63.2% | 66.6% | (3.4) |

| *Talbot* | Three Months Ended June 30, 2011 | Three Months Ended June 30, 2010 | Percentage Point Change |
|---|---|---|---|
| Losses and loss expense ratio | 58.7% | 40.4% | 18.3 |
| Policy acquisition cost ratio | 21.9% | 22.0% | (0.1) |
| General and administrative expense ratio (a) | 19.0% | 15.0% | 4.0 |
| **Expense ratio** | 40.9% | 37.0% | 3.9 |
| **Combined ratio** | 99.6% | 77.4% | 22.2 |

(a) Includes general and administrative expenses and share compensation expenses.

General and administrative expense ratios for the three months ended June 30, 2011 and 2010 were 16.1% and 13.5%, respectively. General and administrative expense ratio is the sum of general and administrative expenses and share compensation expense divided by net premiums earned.

| | Three Months Ended June 30, 2011 | | Three Months Ended June 30, 2010 | |
|---|---|---|---|---|
| | | Expenses as % of | | Expenses as % of |

| (Dollars in thousands) | Expenses | Net Earned Premiums | Expenses | Net Earned Premiums |
|---|---|---|---|---|
| General and administrative expenses | $ 60,841 | 14.3% | $ 52,379 | 12.0% |
| Share compensation expenses | 7,628 | 1.8% | 6,846 | 1.5% |
| **Total** | $ 68,469 | 16.1% | $ 59,225 | 13.5% |

**Underwriting Income**

Underwriting income for the three months ended June 30, 2011 was $71.6 million compared to underwriting income of $109.7 million for the three months ended June 30, 2010, a decrease of $38.1 million, or 34.7%.

| (Dollars in thousands) | Three Months Ended June 30, 2011 | % of sub-total | Three Months Ended June 30, 2010 | % of sub-total | % Change |
|---|---|---|---|---|---|
| Validus Re | $ 85,593 | 99.3% | $ 87,537 | 68.8% | (2.2)% |
| Talbot | 639 | 0.7% | 39,727 | 31.2% | (98.4)% |
| Sub-total | 86,232 | 100.0% | 127,264 | 100.0% | (32.2)% |
| Corporate & Eliminations | (14,598) | | (17,565) | | (16.9)% |
| **Total** | $ 71,634 | | $ 109,699 | | (34.7)% |

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The underwriting results of an insurance or reinsurance company are also often measured by reference to its underwriting income, which is a non-GAAP financial measure. Underwriting income, as set out in the table below, is reconciled to net income (the most directly comparable GAAP financial measure) by the addition or subtraction of certain Consolidated Statement of Operations and Comprehensive Income (Loss) line items, as illustrated below.

| (Dollars in thousands) | Three Months Ended June 30, 2011 | Three Months Ended June 30, 2010 |
|---|---|---|
| Underwriting income | $ 71,634 | $ 109,699 |
| Net investment income | 26,494 | 34,809 |
| Other income | 595 | 2,697 |
| Finance expenses | (16,361) | (13,218) |
| Net realized gains on investments | 11,552 | 12,441 |
| Net unrealized gains on investments | 18,526 | 41,640 |
| Foreign exchange (losses) | (1,991) | (4,099) |
| **Net income before tax** | $ 110,449 | $ 183,969 |

Underwriting income indicates the performance of the Company s core underwriting function, excluding revenues and expenses such as the reconciling items in the table above. The Company believes the reporting of underwriting income enhances the understanding of our results by highlighting the underlying profitability of the Company s core insurance and reinsurance business. Underwriting profitability is influenced significantly by earned premium growth, adequacy of the Company s pricing and loss frequency and severity. Underwriting profitability over time is also influenced by the Company s underwriting discipline, which seeks to manage exposure to loss through favorable risk selection and diversification, its management of claims, its use of reinsurance and its ability to manage its expense ratio, which it accomplishes through its management of acquisition costs and other underwriting expenses. The Company believes that underwriting income provides investors with a valuable measure of profitability derived from underwriting activities.

The Company excludes the U.S. GAAP income statement line items noted above, from its calculation of underwriting income. Net realized and unrealized gains (losses) on investments are excluded because the amount of these gains and losses is heavily influenced by, and fluctuates in part, according to availability of investment market opportunities. The Company believes the other line items excluded are largely independent of its underwriting business and including them distorts the analysis of trends in its operations. In addition to presenting net income determined in accordance with U.S. GAAP, the Company believes that showing underwriting income enables investors, analysts, rating agencies and other users of its financial information to more easily analyze the Company s results of operations in a manner similar to how management analyzes the Company s underlying business performance. The Company uses underwriting income as a primary measure of underwriting results in its analysis of historical financial information and when performing its budgeting and forecasting processes. Analysts, investors and rating agencies who follow the Company request this non-GAAP financial information on a regular basis. In addition, underwriting income is one of the factors considered by the compensation committee of our Board of Directors in determining the bonus component of the total annual incentive compensation.

Underwriting income should not be viewed as a substitute for U.S. GAAP net income as there are inherent material limitations associated with the use of underwriting income as compared to using net income, which is the most directly comparable U.S. GAAP financial measure. The most significant limitation is the ability of users of the financial information to make comparable assessments of underwriting income with other companies, particularly as underwriting income may be defined or calculated differently by other companies. Therefore, the Company provides more prominence in this filing to the use of the most comparable U.S. GAAP financial measure, net income, which includes the reconciling items in the table above. The Company compensates for these limitations by providing both clear and transparent disclosure of net income and reconciliation of underwriting income to net income.

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**Net Investment Income**

Net investment income for the three months ended June 30, 2011 was $26.5 million compared to $34.8 million for the three months ended June 30, 2010, a decrease of $8.3 million or 23.9%. Net investment income decreased due to falling yields on fixed maturity investments. Net investment is comprised of accretion of premium or discount on fixed maturities, interest on coupon-paying bonds, short-term investments and cash and cash equivalents, partially offset by investment management fees. The components of net investment income for the three months ended June 30, 2011 and 2010 are as provided below.

| (Dollars in thousands) | Three Months Ended June 30, 2011 | Three Months Ended June 30, 2010 | % Change |
|---|---|---|---|
| Fixed maturities and short-term investments | $ 27,535 | $ 36,346 | (24.2)% |
| Cash and cash equivalents | 687 | 311 | 120.9% |
| Securities lending income | 8 | 49 | (83.7)% |
| Total gross investment income | 28,230 | 36,706 | (23.1)% |
| Investment expenses | (1,736) | (1,897) | 8.5% |
| Net investment income | $ 26,494 | $ 34,809 | (23.9)% |

Annualized effective investment yield is based on the weighted average investments held calculated on a simple period average and excludes net unrealized gains (losses), realized gains (losses) on investments, foreign exchange gains (losses) on investments and the foreign exchange effect of insurance balances. The Company s annualized effective investment yield was 1.76% and 2.37% for the three months ended June 30, 2011 and 2010, respectively, and the average duration of the portfolio at June 30, 2011 was 1.57 years (December 31, 2010 2.27 years).

**Other Income**

Other income for the three months ended June 30, 2011 was $0.6 million compared to $2.7 million for the three months ended June 30, 2010, a decrease of $2.1 million or 77.9%.

**Finance Expenses**

Finance expenses for the three months ended June 30, 2011 were $16.4 million compared to $13.2 million for the three months ended June 30, 2010, an increase of $3.1 million or 23.8%. Finance expenses also include the amortization of debt offering costs and discounts, and fees related to our credit facilities.

| | Three Months Ended June 30, | | |
|---|---|---|---|
| (Dollars in thousands) | 2011 | 2010 | % Change |
| 2006 Junior Subordinated Deferrable Debentures | $ 3,228 | $ 3,589 | (10.1)% |
| 2007 Junior Subordinated Deferrable Debentures | 3,028 | 3,028 | 0.0% |
| 2010 Senior Notes due 2040 | 5,597 | 5,597 | 0.0% |
| Credit facilities | 1,589 | 1,109 | 43.3% |
| AlphaCat Re 2011 fees (a) | 2,919 | | NM |
| Talbot FAL Facility | | (89) | NM |
| Talbot other interest | | (16) | NM |
| **Finance expenses** | $ 16,361 | $ 13,218 | 23.8% |

(a) Includes finance expenses attributable to noncontrolling interest.

NM: Not Meaningful

Capital in Lloyd s entities, whether personal or corporate, is required to be set annually for the prospective year and held by Lloyd s in trust ( Funds at Lloyd s or FAL ). For underwriting years up to and including 2007, Talbot s FAL has been provided both by Talbot and by third parties, thereafter Talbot s FAL has been provided exclusively by the Company.

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As all of the underwriting years up to and including 2007 are closed with effect from December 31, 2009, the FAL relating to these years has been returned to the third party providers. There were some costs paid in 2010, which are the final amounts payable under the Talbot third party FAL facility.

**Tax Benefit (Expense)**

Tax expense for the three months ended June 30, 2011 was $0.0 million compared to an expense of ($4.2) million for the three months ended June 30, 2010, a decrease of $4.2 million or 100.7%. The decrease is primarily due to adjustments to deferred tax balances in the Talbot segment following the reduction in the effective U.K. tax rate from 28.0% to 26.5% together with a reduction in U.K. taxable profits.

**Net Realized Gains on Investments**

Net realized gains on investments for the three months ended June 30, 2011 were $11.6 million compared to $12.4 million for the three months ended June 30, 2010, a decrease of $0.9 million or 7.1%.

**Net Unrealized Gains on Investments**

Net unrealized gains on investments for the three months ended June 30, 2011 were $18.5 million compared to $41.6 million for the three months ended June 30, 2010 a decrease of $23.1 million or 55.5%. The net unrealized gains in the three months ended June 30, 2011 were a result of a significant downward shift in rates as the two-year Treasury rate fell from 0.82% to 0.46% (36 bps) and the five-year rate decreased from 2.28% to 1.76% (52 bps) in the period.

Net unrealized gains on investments are recorded as a component of net income. The Company has adopted all authoritative guidance on U.S. GAAP fair value measurements in effect as of the balance sheet date. Consistent with these standards, certain market conditions allow for fair value measurements that incorporate unobservable inputs where active market transaction based measurements are unavailable. Certain non-Agency RMBS securities were previously identified as trading in inactive markets.

**Foreign Exchange (Losses)**

Foreign exchange losses for the three months ended June 30, 2011 were ($2.0) million compared to ($4.1) million for the three months ended June 30, 2010, a favorable movement of $2.1 million or 51.4%. The favorable movement in foreign exchange was due primarily to the increased value of assets denominated in foreign currencies relative to the U.S. dollar reporting currency for the three months ended June 30, 2011, as compared to the three months ended June 30, 2010. For the three months ended June 30, 2011, Validus Re recognized foreign exchange losses of ($5.3) million, Talbot recognized foreign exchange gains of $3.4 million. The Euro to U.S. dollar exchange rates were 1.41 and 1.44 at March 31, 2011 and June 30, 2011, respectively. The British pound sterling to U.S. dollar exchange rates were 1.60 and 1.60 at March 31, 2011 and June 30, 2011, respectively. During the quarter, the Euro appreciated by 2.1%, while the British pound remained stable.

For the three months ended June 30, 2011, Validus Re segment foreign exchange losses were ($5.3) million compared to losses of ($0.8) million for the three months ended June 30, 2010, an unfavorable movement of $4.5 million or 533.1%. The unfavorable movement in Validus Re foreign exchange losses was due primarily to losses incurred as a result of the Company having liabilities in both New Zealand dollars and Japanese Yen during a period when both of these currencies strengthened against the U.S. dollar.

For the three months ended June 30, 2011, Talbot segment foreign exchange gains were $3.4 million compared to losses of ($3.2) million for the three months ended June 30, 2010, a favorable movement of $6.7 million or 205.1%. The favorable movement in Talbot segment foreign exchange was due primarily to the valuation of funds held in Euros given the appreciation of the British pound sterling against the Euro during the three months ended June 30, 2011. Certain premiums receivable and liabilities for losses incurred in currencies other than the U.S. dollar are exposed to the risk of changes in value resulting from fluctuations in foreign exchange rates and may affect financial results in the future.

At June 30, 2011, Talbot s balance sheet includes net unearned premiums and deferred acquisition costs denominated in foreign currencies of approximately $103.7 million and $21.6 million, respectively. These balances consisted of British pound sterling and Canadian dollars of $73.0 million and $9.1 million, respectively.

Net unearned premiums and deferred acquisition costs are classified as non-monetary items and are translated at historic exchange rates. All of Talbot s other balance sheet items are classified as monetary items and are translated at period end exchange rates. Additional foreign exchange gains (losses) may be incurred on the translation of net unearned premiums and deferred acquisition costs arising from insurance and reinsurance premiums written in future periods.

**Net Income Attributable to Noncontrolling Interest**

On May 25, 2011, the Company joined with other investors in capitalizing AlphaCat Re 2011, a new special purpose sidecar reinsurer formed for the purpose of writing collateralized reinsurance and retrocessional reinsurance. Validus Re has an equity interest in AlphaCat Re 2011 and as Validus Re holds a majority of AlphaCat Re 2011 s outstanding voting rights, the financial statements of AlphaCat Re 2011 are included in the consolidated financial statements of the Company. The portion of AlphaCat Re 2011 s earnings attributable to third party investors for the three months ended June 30, 2011 is recorded in the consolidated statement of operations and comprehensive income as net income attributable to noncontrolling interest.

The following table presents results of operations for the three and six months ended June 30, 2011 and 2010:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **(Dollars in thousands)** | **2011** | **2010** | **2011** | **2010** |
| Gross premiums written | $ 605,387 | $ 516,861 | $ 1,455,283 | $ 1,387,795 |
| Reinsurance premiums ceded | (132,346) | (67,726) | (242,166) | (158,465) |
| Net premiums written | 473,041 | 449,135 | 1,213,117 | 1,229,330 |
| Change in unearned premiums | (47,401) | (11,191) | (357,944) | (333,692) |
| **Net premiums earned** | 425,640 | 437,944 | 855,173 | 895,638 |
| Losses and loss expenses | 207,307 | 194,894 | 683,505 | 673,425 |
| Policy acquisition costs | 78,230 | 74,126 | 155,526 | 150,302 |
| General and administrative expenses | 60,841 | 52,379 | 109,318 | 105,948 |
| Share compensation expenses | 7,628 | 6,846 | 19,677 | 13,422 |
| **Total underwriting deductions** | 354,006 | 328,245 | 968,026 | 943,097 |
| **Underwriting income (loss) (a)** | 71,634 | 109,699 | (112,853) | (47,459) |
| Net investment income | 26,494 | 34,809 | 56,469 | 69,108 |
| Other income | 595 | 2,697 | 2,201 | 3,585 |
| Finance expenses | (16,361) | (13,218) | (30,362) | (28,369) |
| **Operating income (loss) before taxes** | 82,362 | 133,987 | (84,545) | (3,135) |
| Tax benefit (expense) | 29 | (4,187) | 1,488 | (3,490) |
| **Net operating income (loss) (a)** | 82,391 | 129,800 | (83,057) | (6,625) |
| Net realized gains on investments | 11,552 | 12,441 | 17,931 | 23,839 |
| Net unrealized gains on investments | 18,526 | 41,640 | 5,698 | 57,053 |
| Foreign exchange (losses) | (1,991) | (4,099) | (2,458) | (12,863) |
| **Net income (loss)** | 110,478 | 179,782 | (61,886) | 61,404 |
| Net income attributable to noncontrolling interest | (594) | | (594) | |
| **Net income (loss) available (attributable) to Validus** | $ 109,884 | $ 179,782 | $ (62,480) | $ 61,404 |
| **Selected ratios:** | | | | |
| Net premiums written / Gross premiums written | 78.1% | 86.9% | 83.4% | 88.6% |

| | | | | |
|---|---|---|---|---|
| Losses and loss expenses | 48.7% | 44.5% | 79.9% | 75.2% |
| Policy acquisition costs | 18.4% | 16.9% | 18.2% | 16.8% |
| General and administrative expenses (b) | 16.1% | 13.5% | 15.1% | 13.3% |
| Expense ratio | 34.5% | 30.4% | 33.3% | 30.1% |
| Combined ratio | 83.2% | 74.9% | 113.2% | 105.3% |

a) Non-GAAP Financial Measures: In presenting the Company s results, management has included and discussed underwriting income and operating income that are not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other companies. These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. A reconciliation of underwriting income to net income, the most comparable U.S. GAAP financial measure, is presented in the section below entitled Underwriting Income.

b) The general and administrative ratio includes share compensation expenses.

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| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| **Validus Re** | | | | |
| Gross premiums written | $ 341,651 | $ 284,328 | $ 952,889 | $ 924,623 |
| Reinsurance premiums ceded | (98,218) | (41,175) | (145,023) | (54,285) |
| Net premiums written | 243,433 | 243,153 | 807,866 | 870,338 |
| Change in unearned premiums | (10,755) | 18,888 | (322,879) | (324,376) |
| **Net premiums earned** | 232,678 | 262,041 | 484,987 | 545,962 |
| Losses and loss expenses | 94,035 | 123,793 | 404,579 | 472,713 |
| Policy acquisition costs | 35,769 | 37,979 | 75,835 | 81,482 |
| General and administrative expenses | 15,458 | 10,983 | 26,115 | 27,295 |
| Share compensation expenses | 1,823 | 1,749 | 4,928 | 3,378 |
| **Total underwriting deductions** | 147,085 | 174,504 | 511,457 | 584,868 |
| **Underwriting income (loss) (a)** | 85,593 | 87,537 | (26,470) | (38,906) |
| **Talbot** | | | | |
| Gross premiums written | $ 276,886 | $ 253,710 | $ 539,943 | $ 524,251 |
| Reinsurance premiums ceded | (47,278) | (47,728) | (134,692) | (165,259) |
| Net premiums written | 229,608 | 205,982 | 405,251 | 358,992 |
| Change in unearned premiums | (36,646) | (30,079) | (35,065) | (9,316) |
| **Net premiums earned** | 192,962 | 175,903 | 370,186 | 349,676 |
| Losses and loss expenses | 113,272 | 71,101 | 278,926 | 200,712 |
| Policy acquisition costs | 42,307 | 38,647 | 79,523 | 73,592 |
| General and administrative expenses | 34,718 | 24,960 | 63,440 | 50,508 |
| Share compensation expenses | 2,026 | 1,468 | 4,745 | 3,027 |
| **Total underwriting deductions** | 192,323 | 136,176 | 426,634 | 327,839 |
| **Underwriting income (loss) (a)** | 639 | 39,727 | (56,448) | 21,837 |
| **Corporate & Eliminations** | | | | |
| Gross premiums written | $ (13,150) | $ (21,177) | $ (37,549) | $ (61,079) |
| Reinsurance premiums ceded | 13,150 | 21,177 | 37,549 | 61,079 |
| Net premiums written | | | | |

| | | | | |
|---|---|---|---|---|
| Change in unearned premiums | | | | |
| **Net premiums earned** | | | | |
| Losses and loss expenses | | | | |
| Policy acquisition costs | 154 | (2,500) | 168 | (4,772) |
| General and administrative expenses | 10,665 | 16,436 | 19,763 | 28,145 |
| Share compensation expenses | 3,779 | 3,629 | 10,004 | 7,017 |
| **Total underwriting deductions** | 14,598 | 17,565 | 29,935 | 30,390 |
| **Underwriting (loss) (a)** | (14,598) | (17,565) | (29,935) | (30,390) |
| **Total underwriting income (loss) (a)** | $ 71,634 | $ 109,699 | $ (112,853) | $ (47,459) |

a) Non-GAAP Financial Measures. In presenting the Company s results, management has included and discussed underwriting income that is not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other companies. These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. A reconciliation of this measure to net income, the most comparable U.S. GAAP financial measure, is presented in the section below entitled Underwriting Income.

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**Six Months Ended June 30, 2011 compared to Six Months Ended June 30, 2010**

Net loss attributable to Validus for the six months ended June 30, 2011 was ($62.5) million compared to net income available to Validus of $61.4 million for the six months ended June 30, 2010, a decrease of $123.9 million or 201.8%. The primary factors driving the decrease in net income were:

- Decrease in underwriting loss of $65.4 million due primarily to a $40.5 million decrease in net premiums earned, due primarily to increased reinsurance premiums ceded. Loss and loss expenses and other underwriting deductions also increased by $10.1 million and $14.8 million, respectively;
- Decrease in net unrealized gains on investments of $51.4 million;

The change in net income available to Validus for the six months ended June 30, 2011 of $123.9 million as compared to the six months ended June 30, 2010, is described in the following table:

| | Six Months Ended June 30, 2011 (Decrease) increase over the Six Months Ended June 30, 2011 | | | |
|---|---|---|---|---|
| **(Dollars in thousands)** | **Validus Re** | **Talbot** | **Corporate and other reconciling items** | **Total** |
| Notable losses decrease (increase) in net loss and loss expenses (a) | $ 40,039 | $ (47,264) | $ | $ (7,225) |
| Less: Notable losses increase (decrease) in net reinstatement premiums (a) | 10,539 | (2,732) | | 7,807 |
| Other underwriting (loss) income | (38,142) | (28,289) | 455 | (65,976) |
| Underwriting income (loss) (b) | 12,436 | (78,285) | 455 | (65,394) |
| Net investment income | (11,119) | (1,609) | 89 | (12,639) |
| Other income | (268) | (75) | (1,041) | (1,384) |
| Finance expenses | (3,815) | 3,077 | (1,255) | (1,993) |
| | (2,766) | (76,892) | (1,752) | (81,410) |
| Taxes | 179 | 4,884 | (85) | 4,978 |
| | (2,587) | (72,008) | (1,837) | (76,432) |
| Net realized (losses) gains on investments | (6,671) | 763 | | (5,908) |
| Net unrealized (losses) on investments | (41,850) | (9,505) | | (51,355) |
| Foreign exchange (losses) gains | (3,715) | 14,153 | (33) | 10,405 |
| **Net (loss)** | (54,823) | (66,597) | (1,870) | (123,290) |
| Net income attributable to noncontrolling interest | (594) | | | (594) |
| **Net (loss) attributable to Validus** | $ (55,417) | $ (66,597) | $ (1,870) | $ (123,884) |

(a) Notable losses for the six months ended June 30, 2011 include: Tohoku earthquake, Gryphon Alpha, Christchurch earthquake, Brisbane floods, CNRL Horizon, Cat 46, Cat 48 and Jupiter 1. Notable losses for the six months ended June 30, 2010 include: the Chilean earthquake, Melbourne hailstorm, windstorm Xynthia, Deepwater Horizon, Aban Pearl, Bangkok riots and the Perth hailstorm. Excludes reserve for potential development on 2010 and 2011 notable loss events.

(b) Non-Gaap Financial Measures. In presenting the Company s results, management has included and discussed underwriting income (loss) that is not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other companies. These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. A reconciliation of this measure to net income, the most comparable U.S. GAAP financial measure, is presented in the section below entitled Underwriting Income.

**Gross Premiums Written**

Gross premiums written for the six months ended June 30, 2011 were $1,455.3 million compared to $1,387.8 million for the six months ended June 30, 2010, an increase of $67.5 million or 4.9%. The property, marine and specialty lines increased by $10.5 million, $32.0 million and $25.0 million, respectively. Details of gross premiums written by line of business are provided below.

| | Six Months Ended June 30, 2011 | | Six Months Ended June 30, 2010 | | |
|---|---|---|---|---|---|
| **(Dollars in thousands)** | **Gross Premiums Written** | **Gross Premiums Written (%)** | **Gross Premiums Written** | **Gross Premiums Written (%)** | **% Change** |
| Property | $ 827,908 | 56.8% | $ 817,428 | 58.9% | 1.3% |
| Marine | 384,991 | 26.5% | 353,004 | 25.4% | 9.1% |
| Specialty | 242,384 | 16.7% | 217,363 | 15.7% | 11.5% |
| **Total** | $ 1,455,283 | 100.0% | $ 1,387,795 | 100.0% | 4.9% |

*Validus Re*. Validus Re gross premiums written for the six months ended June 30, 2011 were $952.9 million compared to $924.6 million for the six months ended June 30, 2010, an increase of $28.3 million or 3.1%. Details of Validus Re gross premiums written by line of business are provided below.

| | Six Months Ended June 30, 2011 | | Six Months Ended June 30, 2010 | | |
|---|---|---|---|---|---|
| **(Dollars in thousands)** | **Gross Premiums Written** | **Gross Premiums Written (%)** | **Gross Premiums Written** | **Gross Premiums Written (%)** | **% Change** |
| Property | $ 688,376 | 72.3% | $ 673,976 | 72.9% | 2.1% |
| Marine | 189,879 | 19.9% | 185,396 | 20.0% | 2.4% |
| Specialty | 74,634 | 7.8% | 65,251 | 7.1% | 14.4% |
| **Total** | $ 952,889 | 100.0% | $ 924,623 | 100.0% | 3.1% |

The increase in the Validus Re property lines of $14.4 million was due primarily to a $42.6 million increase in premiums written by AlphaCat Re 2011 and a $21.8 million increase in reinstatement premiums following the Tohoku earthquake, the Christchurch earthquake, Cat 46 and Cat 48. This was partially offset by a $35.0 million decrease in new and renewing premiums written on a proportional basis and an $11.0 million decrease in intercompany premiums written with Talbot. The increase in gross premiums written in the Validus Re marine lines of $4.5 million was due primarily to a $27.4 million increase in new and renewing business due to growth in proportional lines within the marine lines, offset by an $11.7 million decrease in premium adjustments and an $11.3 million decrease in intercompany business written with Talbot. The increase in gross premiums written in the Validus Re specialty lines of $9.4 million was due primarily to a $4.8 million increase in new and renewing business including a $2.0 million

increase in new business generated by Validus Re Singapore and $3.2 million increase in premium adjustments.

Gross premiums written under the quota share, surplus treaty and excess of loss contracts between Validus Re and Talbot for the six months ended June 30, 2011 decreased by $23.5 million as compared to the six months ended June 30, 2010. The decrease in premiums written was due to an $11.0 million decrease in the property lines, an $11.3 million decrease in the marine lines and a $1.2 million decrease in the specialty lines. These reinsurance agreements with Talbot are eliminated upon consolidation.

*Talbot.* Talbot gross premiums written for the six months ended June 30, 2011 were $539.9 million compared to $524.3 million for the six months ended June 30, 2010, an increase of $15.7 million or 3.0%. The $539.9 million of gross premiums written translated at second quarter 2010 rates of exchange would have been $532.8 million for the six months ended June 30, 2011, giving an effective increase of $8.5 million or 1.6%. Details of Talbot gross premiums written by line of business are provided below.

| | Six Months Ended June 30, 2011 | | Six Months Ended June 30, 2010 | | |
|---|---|---|---|---|---|
| **(Dollars in thousands)** | **Gross Premiums Written** | **Gross Premiums Written (%)** | **Gross Premiums Written** | **Gross Premiums Written (%)** | **% Change** |
| Property | $ 168,461 | 31.2% | $ 183,404 | 34.9% | (8.1)% |
| Marine | 198,427 | 36.7% | 182,227 | 34.8% | 8.9% |
| Specialty | 173,055 | 32.1% | 158,620 | 30.3% | 9.1% |
| **Total** | $ 539,943 | 100.0% | $ 524,251 | 100.0% | 3.0% |

Talbot gross premiums written decreased across the property lines by $14.9 million and increased across the marine and specialty lines by, $16.2 million and $14.4 million, respectively. The decrease in the property lines is due primarily to a $10.6 million decrease in premiums written by the onshore energy team and a $4.7 million decrease in reinstatement premiums in the property treaty lines. The increase in the marine lines is due primarily to a $17.3 million increase in gross premiums written across the offshore energy, marine liability and hull lines. The increase in the specialty lines is due primarily to a $14.2 million increase in the war, political risk and violence lines.

**Reinsurance Premiums Ceded**

Reinsurance premiums ceded for the six months ended June 30, 2011 were $242.2 million compared to $158.5 million for the six months ended June 30, 2010, an increase of $83.7 million, or 52.8%. Reinsurance premiums ceded on the property and marine lines increased by $85.0 million and $5.1 million, respectively. Reinsurance premiums ceded on the specialty lines decreased by $6.3 million. Details of reinsurance premiums ceded by line of business are provided below.

| | Six Months Ended June 30, 2011 | | Six Months Ended June 30, 2010 | | |
|---|---|---|---|---|---|
| **(Dollars in thousands)** | **Reinsurance Premiums Ceded** | **Reinsurance Premiums Ceded (%)** | **Reinsurance Premiums Ceded** | **Reinsurance Premiums Ceded (%)** | **% Change** |
| Property | $ 180,467 | 74.6% | $ 95,501 | 60.3% | 89.0% |
| Marine | 31,600 | 13.0% | 26,548 | 16.7% | 19.0% |
| Specialty | 30,099 | 12.4% | 36,416 | 23.0% | (17.3)% |
| **Total** | $ 242,166 | 100.0% | $ 158,465 | 100.0% | 52.8% |

*Validus Re.* Validus Re reinsurance premiums ceded for the six months ended June 30, 2011 were $145.0 million compared to $54.3 million for the six months ended June 30, 2010, an increase of $90.7 million, or 167.2%. Details of Validus Re reinsurance premiums ceded by line of business are provided below.

| Six Months Ended June 30, 2011 | Six Months Ended June 30, 2010 |
|---|---|

| (Dollars in thousands) | Reinsurance Premiums Ceded | Reinsurance Premiums Ceded (%) | Reinsurance Premiums Ceded | Reinsurance Premiums Ceded (%) | % Change |
|---|---|---|---|---|---|
| Property | $ 132,069 | 91.1% | $ 43,275 | 79.7% | 205.2% |
| Marine | 12,453 | 8.6% | 11,293 | 20.8% | 10.3% |
| Specialty | 501 | 0.3% | (283) | (0.5)% | 277.0% |
| **Total** | $ 145,023 | 100.0% | $ 54,285 | 100.0% | 167.2% |

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Reinsurance premiums ceded in the Validus Re property line increased by $88.8 million due primarily to the purchase of $89.8 million in additional and replacement retrocessional coverage on the worldwide catastrophe portfolio. The additional US retrocessional coverage was purchased to ensure that the Company would be well positioned to take advantage of opportunities in a post loss environment. Reinsurance premiums ceded on the Validus Re marine and specialty lines have remained generally consistent with the six months ended June 30, 2010.

*Talbot.* Talbot reinsurance premiums ceded for the six months ended June 30, 2011 were $134.7 million compared to $165.3 million for the six months ended June 30, 2010, a decrease of $30.6 million or 18.5%. Details of Talbot reinsurance premiums ceded by line of business are provided below.

| | Six Months Ended June 30, 2011 | | Six Months Ended June 30, 2010 | | |
|---|---|---|---|---|---|
| **(Dollars in thousands)** | **Reinsurance Premiums Ceded** | **Reinsurance Premiums Ceded (%)** | **Reinsurance Premiums Ceded** | **Reinsurance Premiums Ceded (%)** | **% Change** |
| Property | $ 77,327 | 57.4% | $ 92,178 | 55.8% | (16.1)% |
| Marine | 22,462 | 16.7% | 29,874 | 18.1% | (24.8)% |
| Specialty | 34,903 | 25.9% | 43,207 | 26.1% | (19.2)% |
| **Total** | $ 134,692 | 100.0% | $ 165,259 | 100.0% | (18.5)% |

Reinsurance premiums ceded in the Talbot property lines decreased by $14.9 million for the six months ended June 30, 2011. The decrease was due primarily to a $12.5 million decrease in premiums ceded in the onshore energy and property treaty lines as a direct result of lower written premiums and a $4.2 million decrease in reinstatement premiums, partially offset by a $1.8 million increase in premiums ceded in the property quota share lines. Reinsurance premiums ceded in the Talbot marine lines decreased by $7.4 million for the six months ended June 30, 2011 primarily due to $9.9 million decrease in marine treaty premiums ceded, partially offset by an increase of $2.3 million in reinstatement premiums. Reinsurance premiums ceded in the Talbot specialty lines decreased by $8.3 million for the six months ended June 30, 2011 due primarily to a $7.0 million decrease in premiums ceded in the aviation treaty lines due to timing changes on the inception of the program.

**Net Premiums Written**

Net premiums written for the six months ended June 30, 2011 were $1,213.1 million compared to $1,229.3 million for the six months ended June 30, 2010, a decrease of $16.2 million, or 1.3%. The ratios of net premiums written to gross premiums written for the six months ended June 30, 2011 and 2010 were 83.4% and 88.6%, respectively. Details of net premiums written by line of business are provided below.

| | Six Months Ended June 30, 2011 | | Six Months Ended June 30, 2010 | | |
|---|---|---|---|---|---|
| **(Dollars in thousands)** | **Net Premiums Written** | **Net Premiums Written (%)** | **Net Premiums Written** | **Net Premiums Written (%)** | **% Change** |
| Property | $ 647,441 | 53.4% | $ 721,927 | 58.7% | (10.3)% |
| Marine | 353,391 | 29.1% | 326,456 | 26.6% | 8.3% |
| Specialty | 212,285 | 17.5% | 180,947 | 14.7% | 17.3% |
| **Total** | $ 1,213,117 | 100.0% | $ 1,229,330 | 100.0% | (1.3)% |

*Validus Re*. Validus Re net premiums written for the six months ended June 30, 2011 were $807.9 million compared to $870.3 million for the six months ended June 30, 2010, a decrease of $62.5 million or 7.2%. Details of Validus Re net premiums written by line of business are provided below.

| (Dollars in thousands) | Six Months Ended June 30, 2011 Net Premiums Written | Six Months Ended June 30, 2011 Net Premiums Written (%) | Six Months Ended June 30, 2010 Net Premiums Written | Six Months Ended June 30, 2010 Net Premiums Written (%) | % Change |
|---|---|---|---|---|---|
| Property | $ 556,307 | 68.8% | $ 630,701 | 72.5% | (11.8)% |
| Marine | 177,426 | 22.0% | 174,103 | 20.0% | 1.9% |
| Specialty | 74,133 | 9.2% | 65,534 | 7.5% | 13.1% |
| **Total** | $ 807,866 | 100.0% | $ 870,338 | 100.0% | (7.2)% |

The decrease in Validus Re net premiums written was driven by factors highlighted above in respect of gross premiums written and reinsurance premiums ceded. The ratios of net premiums written to gross premiums written were 84.8% and 94.1% for the six months ended June 30, 2011 and 2010, respectively. This reflects the increase in reinsurance premiums ceded as a result of the purchase of additional and replacement retrocessional coverage as described above.

*Talbot.* Talbot net premiums written for the six months ended June 30, 2011 were $405.3 million compared to $359.0 million for the six months ended June 30, 2010, an increase of $46.3 million or 12.9%. Details of Talbot net premiums written by line of business are provided below.

| (Dollars in thousands) | Six Months Ended June 30, 2011 Net Premiums Written | Six Months Ended June 30, 2011 Net Premiums Written (%) | Six Months Ended June 30, 2010 Net Premiums Written | Six Months Ended June 30, 2010 Net Premiums Written (%) | % Change |
|---|---|---|---|---|---|
| Property | $ 91,134 | 22.5% | $ 91,226 | 25.4% | (0.1)% |
| Marine | 175,965 | 43.4% | 152,353 | 42.4% | 15.5% |
| Specialty | 138,152 | 34.1% | 115,413 | 32.2% | 19.7% |
| **Total** | $ 405,251 | 100.0% | $ 358,992 | 100.0% | 12.9% |

The increase in Talbot net premiums written was driven by the factors highlighted above in respect of gross premiums written and reinsurance premiums ceded. The ratios of net premiums written to gross premiums written for the six months ended June 30, 2011 and 2010 were 75.1% and 68.5%, respectively, reflecting the lower reinsurance premiums ceded.

**Change in Unearned Premiums**

Change in unearned premiums for the six months ended June 30, 2011 was ($357.9) million compared to ($333.7) million for the six months ended June 30, 2010, a change of $24.3 million or 7.3%.

| (Dollars in thousands) | Six Months Ended June 30, 2011 Change in Unearned Premiums | Six Months Ended June 30, 2010 Change in Unearned Premiums | % Change |
|---|---|---|---|

| | | | | | |
|---|---|---|---|---|---|
| Change in gross unearned premium | $ | (464,256) | $ | (460,166) | 0.9% |
| Change in prepaid reinsurance premium | | 106,312 | | 126,474 | (15.9)% |
| **Net change in unearned premium** | $ | (357,944) | $ | (333,692) | 7.3% |

*Validus Re.* Validus Re s change in unearned premiums for the six months ended June 30, 2011 was ($322.9) million compared to ($324.4) million for the six months ended June 30, 2010, a change of $1.5 million, or 0.5%.

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| (Dollars in thousands) | Six Months Ended June 30, 2011 Change in Unearned Premiums | Six Months Ended June 30, 2010 Change in Unearned Premiums | % Change |
|---|---|---|---|
| Change in gross unearned premium | $ (403,255) | $ (407,280) | (1.0)% |
| Change in prepaid reinsurance premium | 80,376 | 82,904 | (3.0)% |
| **Net change in unearned premium** | $ (322,879) | $ (324,376) | (0.5)% |

The Validus Re net change in unearned premium for the six months ended June 30, 2011 has remained generally consistent with the six months ended June 30, 2010.

*Talbot.* The Talbot change in unearned premiums for the six months ended June 30, 2011 was ($35.1) million compared to ($9.3) million for the six months ended June 30, 2010, a change of $25.7 million, or 276.4%.

| (Dollars in thousands) | Six Months Ended June 30, 2011 Change in Unearned Premiums | Six Months Ended June 30, 2010 Change in Unearned Premiums | % Change |
|---|---|---|---|
| Change in gross unearned premium | $ (61,001) | $ (52,886) | 15.3% |
| Change in prepaid reinsurance premium | 25,936 | 43,570 | (40.5)% |
| **Net change in unearned premium** | $ (35,065) | $ (9,316) | 276.4% |

The Talbot net change in unearned premium has decreased for the six months ended June 30, 2011 due primarily to a significant decrease in reinsurance premiums ceded, partially offset by an increase in gross written premiums compared to the six months ended June 30, 2010.

**Net Premiums Earned**

Net premiums earned for the six months ended June 30, 2011 were $855.2 million compared to $895.6 million for the six months ended June 30, 2010, a decrease of $40.5 million or 4.5%. The decrease in net premiums earned was driven by decreased premiums earned in the Validus Re segment of $61.0 million and increased premiums earned in the Talbot segment of $20.5 million. Details of net premiums earned by line of business are provided below.

| | Six Months Ended June 30, 2011 | | Six Months Ended June 30, 2010 | | |
|---|---|---|---|---|---|
| (Dollars in thousands) | Net Premiums Earned | Net Premiums Earned (%) | Net Premiums Earned | Net Premiums Earned (%) | % Change |
| Property | $ 420,337 | 49.2% | $ 473,082 | 52.8% | (11.1)% |
| Marine | 243,793 | 28.5% | 215,818 | 24.1% | 13.0% |
| Specialty | 191,043 | 22.3% | 206,738 | 23.1% | (7.6)% |

| **Total** | $ 855,173 | 100.0% | $ 895,638 | 100.0% | (4.5)% |
|---|---|---|---|---|---|

*Validus Re*. Validus Re net premiums earned for the six months ended June 30, 2011 were $485.0 million compared to $546.0 million for the six months ended June 30, 2010, a decrease of $61.0 million or 11.2%. Details of Validus Re net premiums earned by line of business are provided below.

| | **Six Months Ended June 30, 2011** | | **Six Months Ended June 30, 2010** | | |
|---|---|---|---|---|---|
| **(Dollars in thousands)** | **Net Premiums Earned** | **Net Premiums Earned (%)** | **Net Premiums Earned** | **Net Premiums Earned (%)** | **% Change** |
| Property | $ 343,549 | 70.8% | $ 397,887 | 72.9% | (13.7)% |
| Marine | 100,407 | 20.7% | 89,183 | 16.3% | 12.6% |
| Specialty | 41,031 | 8.5% | 58,892 | 10.8% | (30.3)% |
| **Total** | $ 484,987 | 100.0% | $ 545,962 | 100.0% | (11.2)% |

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The decrease in Validus Re net premiums earned is generally consistent with the decrease in net premiums written for the six months ended June 30, 2011.

*Talbot*. Talbot net premiums earned for the six months ended June 30, 2011 were $370.2 million compared to $349.7 million for the six months ended June 30, 2010, an increase of $20.5 million or 5.9%. Details of Talbot net premiums earned by line of business are provided below.

| | Six Months Ended June 30, 2011 | | Six Months Ended June 30, 2010 | | |
|---|---|---|---|---|---|
| **(Dollars in thousands)** | **Net Premiums Earned** | **Net Premiums Earned (%)** | **Net Premiums Earned** | **Net Premiums Earned (%)** | **% Change** |
| Property | $ 76,788 | 20.8% | $ 75,195 | 21.5% | 2.1% |
| Marine | 143,386 | 38.7% | 126,635 | 36.2% | 13.2% |
| Specialty | 150,012 | 40.5% | 147,846 | 42.3% | 1.5% |
| **Total** | $ 370,186 | 100.0% | $ 349,676 | 100.0% | 5.9% |

The increase in Talbot net premiums earned is due primarily to the increased levels of net premiums written and the reduced levels of reinsurance premiums ceded during the six months ended June 30, 2011 as compared to the six months ended June 30, 2010.

**Losses and Loss Expenses**

Losses and loss expenses for the six months ended June 30, 2011 were $683.5 million compared to $673.4 million for the six months ended June 30, 2010, an increase of $10.1 million or 1.5%. The loss ratios, defined as losses and loss expenses divided by net premiums earned, for the six months ended June 30, 2011 and 2010 were 79.9% and 75.2%, respectively. Details of loss ratios by line of business are provided below.

| | **Six Months Ended June 30, 2011** | **Six Months Ended June 30, 2010** | **Percentage Point Change** |
|---|---|---|---|
| Property | 95.5% | 93.8% | 1.7 |
| Marine | 86.2% | 66.0% | 20.2 |
| Specialty | 37.7% | 42.2% | (4.5) |
| **All lines** | 79.9% | 75.2% | 4.7 |

| | **Six Months Ended June 30,** | | |
|---|---|---|---|
| | **2011** | **2010** | **Percentage Point Change** |
| Property current period excluding notable losses | 25.5% | 29.9% | (4.4) |
| Property current period notable losses | 74.1% | 71.5% | 2.6 |
| Property change in prior accident years | (4.1)% | (7.6)% | 3.5 |
| Property loss ratio | 95.5% | 93.8% | 1.7 |
| Marine current period excluding notable losses | 49.7% | 46.0% | 3.7 |
| Marine current period notable losses | 42.6% | 32.5% | 10.1 |
| Marine change in prior accident years | (6.1)% | (12.5)% | 6.4 |

| | | | |
|---|---|---|---|
| Marine loss ratio | 86.2% | 66.0% | 20.2 |
| | | | |
| Specialty current period excluding notable losses | 43.5% | 44.3% | (0.8) |
| Specialty current period notable losses | 4.7% | 4.3% | 0.4 |
| Specialty change in prior accident years | (10.5)% | (6.4)% | (4.1) |
| | | | |
| Specialty loss ratio | 37.7% | 42.2% | (4.5) |
| | | | |
| All lines current period excluding notable losses | 36.4% | 37.1% | (0.7) |
| All lines current period notable losses | 49.6% | 46.6% | 3.0 |
| All lines change in prior accident years | (6.1)% | (8.5)% | 2.4 |
| | | | |
| **All lines loss ratio** | 79.9% | 75.2% | 4.7 |

*Validus Re.* Validus Re losses and loss expenses for the six months ended June 30, 2011 were $404.6 million compared to $472.7 million for the six months ended June 30, 2010, a decrease of $68.1 million or 14.4%. The loss ratio, defined as losses and loss expenses divided by net premiums earned, was 83.4% and 86.6% for the six months ended June 30, 2011 and 2010, respectively. For the six months ended June 30, 2011, Validus Re incurred $316.2 million of notable losses, which represented 65.2 percentage points of the Validus Re segment loss ratio, excluding reserve for potential development on notable loss events. For the six months ended June 30, 2010, Validus Re incurred $356.3 million of notable losses, which represented 65.3 percentage points of the Validus Re segment loss ratio. Validus Re segment loss ratios, excluding prior year development and loss events identified above, for the six months ended June 30, 2011 and 2010 were 23.1% and 26.7%, respectively. Details of loss ratios by line of business and period of occurrence are provided below.

| | Six Months ended June 30, | | |
|---|---|---|---|
| | **2011** | **2010** | **Percentage Point Change** |
| Property current period excluding notable losses | 18.0% | 25.6% | (7.6) |
| Property current period notable losses | 71.0% | 74.3% | (3.3) |
| Property change in prior accident years | (3.6)% | (5.5)% | 1.9 |
| Property loss ratio | 85.4% | 94.4% | (9.0) |
| Marine current period excluding notable losses | 40.9% | 34.4% | 6.5 |
| Marine current period notable losses | 67.6% | 59.7% | 7.9 |
| Marine change in prior accident years | (4.4)% | (8.6)% | 4.2 |
| Marine loss ratio | 104.1% | 85.5% | 18.6 |
| Specialty current period excluding notable losses | 21.6% | 22.4% | (0.7) |
| Specialty current period notable losses | 11.0% | 12.7% | (1.8) |
| Specialty change in prior accident years | (16.3)% | 0.3% | (16.6) |
| Specialty loss ratio | 16.3% | 35.4% | (19.1) |
| All lines current period excluding notable losses | 23.1% | 26.7% | (3.6) |
| All lines current period notable losses | 65.2% | 65.3% | (0.1) |
| All lines change in prior accident years | (4.9)% | (5.4)% | 0.5 |
| **All lines loss ratio** | 83.4% | 86.6% | (3.2) |

For the six months ended June 30, 2011, the Validus Re property line incurred $305.9 million related to current year losses and $12.5 million of favorable development relating to prior accident years. This favorable development is attributable to lower than expected claims development. For the six months ended June 30, 2010, the Validus Re property lines included $397.5 million related to current year losses and $21.9 million of favorable development relating to prior accident years. This favorable development was attributable to reduced losses estimated for the Dublin and U.K. flood events and windstorm Kyrill, as well as lower than expected claim development elsewhere.

For the six months ended June 30, 2011, Validus Re s property line incurred $243.8 million of notable losses, which represented 71.0 percentage points of the Validus Re property loss ratio, excluding the reserve for potential development on notable loss events. For the six months ended June 30, 2010, Validus Re s property line incurred $295.6 million of notable losses, which represented 74.3 percentage points of the Validus Re property loss ratio. Validus Re property line loss ratios, excluding prior year development and loss events identified above, for the six months ended June 30, 2011 and 2010 were 18.0% and 25.6%, respectively.

For the six months ended June 30, 2011, the Validus Re marine line incurred $108.9 million related to current year losses and $4.4 million of favorable development relating to prior accident years. For the six months ended June 30, 2010, the Validus Re marine lines included $83.9 million related to current year losses and $7.6 million of favorable development relating to prior accident years. For the six months ended June 30, 2011, Validus Re marine line incurred $67.9 million of notable losses, which represented 67.6 percentage points of the Validus Re marine loss ratio, excluding reserve for potential development on notable loss events. For the six months ended June 30, 2010, Validus Re s marine line incurred $53.2 million of notable losses, which represented 59.7 percentage points of the Validus Re marine loss ratio. Validus Re marine line loss ratios, excluding prior year development and loss events identified above, for the six months ended June 30, 2011 and 2010 were 40.9% and 34.4%, respectively.

For the six months ended June 30, 2011, the Validus Re specialty line incurred $13.4 million related to current year losses and $6.7 million of favorable development relating to prior accident years. For the six months ended June 30, 2010, the Validus Re specialty lines included $20.7 million related to current year losses and $0.2 million of adverse development relating to prior accident years. For the six months ended June 30, 2011, Validus Re specialty line incurred $4.5 million of notable losses, which represented 11.0 percentage points of the Validus Re specialty loss ratio, excluding the reserve for potential development on notable loss events. For the six months ended June 30, 2010, the Validus Re specialty line incurred $7.5 million of notable losses, which represented 12.7 percentage points of the Validus Re specialty loss ratio. Validus Re specialty line loss ratios, excluding prior year development and loss events identified above, for the six months ended June 30, 2011 and 2010 were 21.6% and 22.4%, respectively.

*Talbot.* Talbot losses and loss expenses for the six months ended June 30, 2011 were $278.9 million compared to $200.7 million for the six months ended June 30, 2010, an increase of $78.2 million, or 39.0%. The loss ratio, defined as losses and loss expenses divided by net premiums earned, was 75.3% and 57.4% for the six months ended June 30, 2011 and 2010, respectively. For the six months ended June 30, 2011, Talbot incurred $307.5 million related to current year losses and $28.6 million of favorable loss development relating to prior accident years. Favorable loss reserve development benefited the Talbot segment loss ratio by 7.7 percentage points for the six months ended June 30, 2011. For the six months ended June 30, 2010, Talbot incurred $247.6 million related to current year losses and $46.9 million of favorable loss development relating to prior accident years. Favorable loss reserve development benefitted the segment loss ratio by 13.4 percentage points for the six months ended June 30, 2010. For the six months ended June 30, 2011, Talbot incurred $108.2 million of notable losses, which represented 29.2 percentage points of the Talbot segment loss ratio. For the six months ended June 30, 2010, Talbot incurred $60.8 million of notable losses, which represented 17.4 percentage points of the Talbot segment loss ratio. Talbot loss ratios, excluding prior year development and loss events identified above, for the six months ended June 30, 2011 and 2010 were 53.8% and 53.4%, respectively. Details of loss ratios by line of business and period of occurence are provided below.

| | Six Months Ended June 30, | | |
|---|---|---|---|
| | **2011** | **2010** | **Percentage Point Change** |
| Property current period excluding notable losses | 58.4% | 52.9% | 5.5 |
| Property current period notable losses | 88.3% | 56.5% | 31.8 |
| Property change in prior accident years | (6.2)% | (18.7)% | 12.5 |
| Property loss ratio | 140.5% | 90.7% | 49.8 |

| | | | |
|---|---|---|---|
| Marine current period excluding notable losses | 55.9% | 54.2% | 1.7 |
| Marine current period notable losses | 25.1% | 13.4% | 11.7 |
| Marine change in prior accident years | (7.3)% | (15.3)% | 8.0 |
| Marine loss ratio | 73.7% | 52.3% | 21.4 |

| | Six Months Ended June 30, | | |
|---|---|---|---|
| | 2011 | 2010 | Percentage Point Change |
| Specialty current period excluding notable losses | 49.6% | 53.1% | (3.5) |
| Specialty current period notable losses | 2.9% | 0.9% | 2.0 |
| Specialty change in prior accident years | (8.9)% | (9.2)% | 0.3 |
| Specialty loss ratio | 43.6% | 44.8% | (1.2) |
| All lines current period excluding notable losses | 53.8% | 53.4% | 0.4 |
| All lines current period notable losses | 29.2% | 17.4% | 11.8 |
| All lines change in prior accident years | (7.7)% | (13.4)% | 5.7 |
| **All lines loss ratio** | 75.3% | 57.4% | 17.9 |

For the six months ended June 30, 2011, the Talbot property line incurred $112.6 million related to current year losses and $4.7 million of favorable loss development relating to prior accident years. This favorable development is attributable to lower than expected claims development. For the six months ended June 30, 2010, the Talbot property line included $82.3 million related to current year losses and $14.1 million of favorable loss development relating to prior accident years. The prior year favorable development was primarily due to lower than expected claim development on the property facultative and binder accounts, together with favorable development on hurricanes Katrina and Ike. For the six months ended June 30, 2011, the Talbot property line incurred $67.8 million of notable losses, which represented 88.3 percentage points of the Talbot property line loss ratio. For the six months ended June 30, 2010, the Talbot property line incurred $42.5 million of notable losses, which represented 56.5 percentage points of the Talbot property line loss ratio. Talbot property line loss ratio, excluding prior year development and the loss events identified above, for the six months ended June 30, 2011 and 2010 were 58.4% and 52.9%, respectively.

For the six months ended June 30, 2011, the Talbot marine line incurred $116.1 million related to current year losses and $10.5 million of favorable development relating to prior accident years. This favorable development is attributable to lower than expected claims development. For the six months ended June 30, 2010, the Talbot marine line included $85.6 million related to current year losses and $19.4 million of favorable development relating to prior accident years. The prior year favorable development was due to lower than expected attritional loss development mainly on the Hull lines. For the six months ended June 30, 2011, the Talbot marine line incurred $36.0 million of notable losses, which represented 25.1 percentage points of the Talbot marine line loss ratio. For the six months ended June 30, 2010, the Talbot marine line incurred $17.0 million of notable loss events, which represented 13.4 percentage points of the Talbot marine loss ratio. Talbot marine line loss ratios, excluding prior year development and the loss events identified above, for the six months ended June 30, 2011 and 2010 were 55.9% and 54.2%, respectively.

For the six months ended June 30, 2011, the Talbot specialty line incurred $78.8 million relating to current year losses and $13.4 million due to favorable development on prior accident years. This favorable development is attributable to lower than expected claims development. For the six months ended June 30, 2010, the Talbot specialty line included $79.8 million relating to current year losses and $13.5 million due to favorable development on prior accident years. The prior year favorable development was primarily due to lower than expected claims across most of the specialty sub-classes. For the six months ended June 30, 2011, Talbot incurred $4.4 million of notable losses, which represented 2.9 percentage points of the Talbot specialty line loss ratio. For the six months ended June 30, 2010, the Talbot specialty line incurred $1.3 million of notable losses, which represented 0.9 percentage points of the Talbot loss ratio. Talbot specialty line loss ratios, excluding prior year development and the loss events identified above, for the six months ended June 30, 2011 and 2010 were 49.6% and 53.1%, respectively.

At June 30, 2011 and 2010, gross and net reserves for losses and loss expenses were estimated using the methodology as outlined in the critical accounting policies and estimates as discussed in Item 7, *Management s*

*Discussion and Analysis of Results of Operations and Financial Condition* in the Company s Annual Report on Form 10-K for the year ended December 31, 2010. The Company did not make any significant changes in the assumptions or methodology used in its reserving process for the six months ended June 30, 2011.

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| | As at June 30, 2011 | | |
|---|---|---|---|
| (Dollars in thousands) | Gross Case Reserves | Gross IBNR | Total Gross Reserve for Losses and Loss Expenses |
| Property | $ 757,858 | $ 556,685 | $ 1,314,543 |
| Marine | 404,886 | 372,778 | 777,664 |
| Specialty | 236,659 | 291,494 | 528,153 |
| **Total** | $ 1,399,403 | $ 1,220,957 | $ 2,620,360 |

| | As at June 30, 2011 | | |
|---|---|---|---|
| (Dollars in thousands) | Net Case Reserves | Net IBNR | Total Net Reserve for Losses and Loss Expenses |
| Property | $ 544,165 | $ 522,391 | $ 1,066,556 |
| Marine | 328,987 | 356,046 | 685,033 |
| Specialty | 184,767 | 244,199 | 428,966 |
| **Total** | $ 1,057,919 | $ 1,122,636 | $ 2,180,555 |

The following table sets forth a reconciliation of gross and net reserves for losses and loss expenses by segment for the six months ended June 30, 2011.

| | Six Months Ended June 30, 2011 | | | |
|---|---|---|---|---|
| (Dollars in thousands) | Validus Re | Talbot | Eliminations | Total |
| Gross reserves at period beginning | $ 998,165 | $ 1,191,548 | $ (153,740) | $ 2,035,973 |
| Losses recoverable | (80,219) | (356,655) | 153,740 | (283,134) |
| Net reserves at period beginning | 917,946 | 834,893 | | 1,752,839 |
| Incurred losses- current year | 428,169 | 307,557 | | 735,726 |
| Change in prior accident years | (23,590) | (28,631) | | (52,221) |
| Incurred losses | 404,579 | 278,926 | | 683,505 |
| Foreign exchange | 21,624 | 6,890 | | 28,514 |
| Paid losses | (150,016) | (134,287) | | (284,303) |
| Net reserves at period end | 1,194,133 | 986,422 | | 2,180,555 |
| Losses recoverable | 182,306 | 384,268 | (126,769) | 439,805 |

| | | | | |
|---|---|---|---|---|
| Gross reserves at period end | $ 1,376,439 | $ 1,370,690 | $ (126,769) | $ 2,620,360 |

The amount of recorded reserves represents management s best estimate of expected losses and loss expenses on premiums earned. For the six months ended June 30, 2011, favorable loss reserve development on prior years totaled $52.2 million. $23.6 million of the favorable loss reserve development related to the Validus Re segment and $28.6 million related to the Talbot segment. Favorable loss reserve development benefited the Company s loss ratio by 6.1 percentage points for the six months ended June 30, 2011. For the six months ended June 30, 2010, favorable loss reserve development on prior years totaled $76.3 million. $29.4 million of the favorable development related to the Validus Re segment and $46.9 million related to the Talbot segment. This favorable loss reserve development benefitted the Company s loss ratio by 8.5 percentage points

During the three months ended June 30, 2011, the Company recorded losses of $43,806 for the Cat 46 tornado, $31,481 for the Cat 48 tornado and $15,008 for the Jupiter 1 platform failure. During the six months ended June 30, 2011, in addition to the loss events for the three months ended June 30, 2011, the Company recorded losses of $169,037 for the Tohoku earthquake, $52,435 for the Gryphon Alpha mooring failure, $62,093 for the Christchurch earthquake, $31,002 for the Brisbane floods and $19,500 for the CNRL Horizon explosion. For the six months ended June 30, 2011, the Company incurred $424.4 million of notable losses, which represented 49.6 percentage points of the loss ratio, excluding reserve for potential development on notable loss events, as described below. Net of $31.7 million in reinstatement premiums, the effect of these events on net income was $392.7 million.

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During the three months ended June 30, 2010, the Company recorded losses of $44,101 for the Deepwater Horizon oil spill, $10,500 for the sinking of the Aban Pearl oil rig, $7,500 for the Bangkok riots and $8,390 for the Perth hailstorm. During the six months ended June 30, 2010, in addition to the loss events for the three months ended June 30, 2010, the Company recorded losses of $317,435 for the Chilean earthquake, $9,758 for the Xynthia windstorm and $19,383 for the Melbourne hailstorm. For the six months ended June 30, 2010, the Company incurred $417.1 million of notable losses which represented 46.6 percentage points of the loss ratio. The Company s loss ratio, excluding prior year development and notable loss events for the six months ended June 30, 2011 and 2010 were 36.4% and 37.1%, respectively.

Management of insurance and reinsurance companies use significant judgment in the estimation of reserves for losses and loss expenses. Given the magnitude of recent loss events and other uncertainties inherent in loss estimation, meaningful uncertainty remains regarding the estimation of recent notable loss events. The Company s actual ultimate net loss may vary materially from estimates. Validus Re ultimate losses for notable loss events are estimated through detailed review of contracts which are identified by the Company as potentially exposed to the specific notable loss event. However, there can be no assurance that the ultimate loss amount estimated for a specific contract will be accurate, or that all contracts with exposure to a specific notable loss event will be identified in a timely manner. Potential losses in excess of the estimated ultimate loss assigned to a contract on the basis of a specific review, or loss amounts from contracts not specifically included in the detailed review are reserved for in the reserve for potential development on notable loss events.

As at December 31, 2010 the reserve for potential development on 2010 events was $33.4 million. During the six months ended June 30, 2011, $8.9 million was allocated to the Deepwater Horizon loss. During the first quarter of 2011, the Company incurred $50.0 million for a reserve for potential development on 2011 notable loss events as compared to a $19.2 million reserve for potential development on 2010 notable loss events for the three months ended March 31, 2010. During the second quarter of 2011, $20.1 million and $20.2 million were allocated to the Tohoku earthquake and Christchurch earthquake, respectively. Therefore the reserve for development on notable loss events as at June 30, 2011 is $34.2 million.

**Policy Acquisition Costs**

Policy acquisition costs for the six months ended June 30, 2011 were $155.5 million compared to $150.3 million for the six months ended June 30, 2010, an increase of $5.2 million or 3.5%. Policy acquisition costs as a percent of net premiums earned for the six months ended June 30, 2011 and 2010 were 18.2% and 16.8%, respectively. Details of policy acquisition costs by line of business are provided below.

| | Six Months Ended June 30, 2011 | | | Six Months Ended June 30, 2010 | | | |
|---|---|---|---|---|---|---|---|
| **(Dollars in thousands)** | **Policy Acquisition Costs** | **Policy Acquisition Costs (%)** | **Acquisition Cost Ratio** | **Policy Acquisition Costs** | **Policy Acquisition Costs (%)** | **Acquisition Cost Ratio** | **% Change** |
| Property | $ 59,216 | 38.0% | 14.1% | $ 67,716 | 45.0% | 14.3% | (12.6)% |
| Marine | 54,060 | 34.8% | 22.2% | 41,145 | 27.4% | 19.1% | 31.4% |
| Specialty | 42,250 | 27.2% | 22.1% | 41,441 | 27.6% | 20.0% | 2.0% |
| **Total** | $ 155,526 | 100.0% | 18.2% | $ 150,302 | 100.0% | 16.8% | 3.5% |

*Validus Re.* Validus Re policy acquisition costs for the six months ended June 30, 2011 were $75.8 million compared to $81.5 million for the six months ended June 30, 2010, a decrease of $5.6 million or 6.9%. Details of Validus Re policy acquisition costs by line of business are provided below.

| Six Months Ended | Six Months Ended |
|---|---|

| | June 30, 2011 | | | June 30, 2010 | | | |
|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Policy Acquisition Costs | Policy Acquisition Costs (%) | Acquisition Cost Ratio | Policy Acquisition Costs | Policy Acquisition Costs (%) | Acquisition Cost Ratio | % Change |
| Property | $ 48,421 | 63.9% | 14.1% | $ 59,440 | 73.0% | 14.9% | (18.5)% |
| Marine | 20,657 | 27.2% | 20.6% | 14,516 | 17.8% | 16.3% | 42.3% |
| Specialty | 6,757 | 8.9% | 16.5% | 7,526 | 9.2% | 12.8% | (10.2)% |
| **Total** | $ 75,835 | 100.0% | 15.6% | $ 81,482 | 100.0% | 14.9% | (6.9)% |

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Policy acquisition costs include brokerage, commission and excise tax, are generally driven by contract terms and are normally a set percentage of premiums and are also net of ceding commission income on retrocessions. Items such as ceded premium, earned premium adjustments and reinstatement premiums that are recognized in the period have an effect on policy acquisition costs. Validus Re policy acquisition costs as a percent of net premiums earned for the six months ended June 30, 2011 and 2010 were 15.6% and 14.9%, respectively. The policy acquisition cost ratio in the marine lines increased by 4.3 percentage points due primarily to the largest single contract, by gross written premium, having an acquisition cost ratio of 36% and specialty lines increased by 3.7 percentage points.

*Talbot.* Talbot policy acquisition costs for the six months ended June 30, 2011 were $79.5 million compared to $73.6 million for the six months ended June 30, 2010, an increase of $5.9 million or 8.1%. Details of Talbot policy acquisition costs by line of business are provided below.

| | Six Months Ended June 30, 2011 | | | Six Months Ended June 30, 2010 | | | |
|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Policy Acquisition Costs | Policy Acquisition Costs (%) | Acquisition Cost Ratio | Policy Acquisition Costs | Policy Acquisition Costs (%) | Acquisition Cost Ratio | % Change |
| Property | $ 10,583 | 13.3% | 13.8% | $ 12,880 | 17.5% | 17.1% | (17.8)% |
| Marine | 33,427 | 42.0% | 23.3% | 26,709 | 36.3% | 21.1% | 25.2% |
| Specialty | 35,513 | 44.7% | 23.7% | 34,003 | 46.2% | 23.0% | 4.4% |
| **Total** | $ 79,523 | 100.0% | 21.5% | $ 73,592 | 100.0% | 21.0% | 8.1% |

The policy acquisition cost ratio in the property lines decreased due primarily to increases in ceded intercompany policy acquisition costs on the property treaty lines. The policy acquisition cost ratio on the marine lines increased due primarily to acquisition cost rate increases in the Hull, Cargo and other treaty lines. Talbot policy acquisition costs as a percent of net premiums earned were 21.5% and 21.0%, respectively, for the six months ended June 30, 2011 and 2010.

**General and Administrative Expenses**

General and administrative expenses for the six months ended June 30, 2011 were $109.3 million compared to $105.9 million for the six months ended June 30, 2010, an increase of $3.4 million or 3.2%. The increase was a result of increased expenses in the Talbot segment, offset by decreases in the Validus Re and Corporate segments.

| | Six Months Ended June 30, 2011 | | Six Months Ended June 30, 2010 | | |
|---|---|---|---|---|---|
| (Dollars in thousands) | General and Administrative Expenses | General and Administrative Expenses (%) | General and Administrative Expenses | General and Administrative Expenses (%) | % Change |
| Validus Re | $ 26,115 | 23.9% | $ 27,295 | 25.7% | (4.3)% |
| Talbot | 63,440 | 58.0% | 50,508 | 47.7% | 25.6% |
| Corporate & Eliminations | 19,763 | 18.1% | 28,145 | 26.6% | (29.8)% |
| **Total** | $ 109,318 | 100.0% | $ 105,948 | 100.0% | 3.2% |

General and administrative expenses of $109.3 million in the six months ended June 30, 2011 represents 12.8 percentage points of the expense ratio. General and administrative expenses include salaries and benefits,

professional fees, rent and office expenses. Share compensation expenses are discussed in the following section.

*Validus Re.* Validus Re general and administrative expenses for the six months ended June 30, 2011 were $26.1 million compared to $27.3 million for the six months ended June 30, 2010, a decrease of $1.2 million or 4.3%. General and administrative expenses have remained generally consistent with the six months ended June 30, 2010.

Validus Re s general and administrative expenses as a percent of net premiums earned for the six months ended June 30, 2011 and 2010 were 5.4% and 5.0%, respectively.

*Talbot.* Talbot general and administrative expenses for the six months ended June 30, 2011 were $63.4 million compared to $50.5 million for the six months ended June 30, 2010, an increase of $12.9 million or 25.6%. To better align the Company s operating and reporting structure with its current strategy, there was an internal reallocation of expenses relating to the New York operations from the Corporate segment to the Talbot segment. For the six months ended June 30, 2011, these expenses amounted to $3.8 million. Other factors contributing to the increase in general and administrative expenses are a $5.0 million increase in staff costs as a result of an increase in staff from 241 at June 30, 2010 to 285 at June 30, 2011 and an increase of $3.2 million in Talbot s syndicate costs. Talbot s general and administrative expenses as a percent of net premiums earned for the six months ended June 30, 2011 and 2010 were 17.1% and 14.4%, respectively.

*Corporate & Eliminations.* Corporate general and administrative expenses for the six months ended June 30, 2011 were $19.8 million compared to $28.1 million for the six months ended June 30, 2010, a decrease of $8.4 million or 29.8%. To better align the Company s operating and reporting structure with its current strategy, there was an internal reallocation of expenses relating to the New York operations from the Corporate segment to the Talbot segment. For the six months ended June 30, 2011, these expenses amounted to $3.8 million. There was also an allocation of corporate expenses of $2.2 million to the operating segments relating to group-wide costs. Corporate general and administrative expenses are comprised of executive and board expenses, internal and external audit expenses and other costs relating to the Company as a whole.

**Share Compensation Expenses**

Share compensation expenses for the six months ended June 30, 2011 were $19.7 million compared to $13.4 million for the six months ended June 30, 2010, an increase of $6.3 million or 46.6%. This expense is non-cash and has no net effect on total shareholders equity, as it is balanced by an increase in additional paid-in capital.

| | **Six Months Ended June 30, 2011** | | **Six Months Ended June 30, 2010** | | |
|---|---|---|---|---|---|
| **(Dollars in thousands)** | **Share Compensation Expenses** | **Share Compensation Expenses (%)** | **Share Compensation Expenses** | **Share Compensation Expenses (%)** | **% Change** |
| Validus Re | $ 4,928 | 25.1% | $ 3,378 | 25.1% | 45.9% |
| Talbot | 4,745 | 24.1% | 3,027 | 22.6% | 56.8% |
| Corporate & Eliminations | 10,004 | 50.8% | 7,017 | 52.3% | 42.6% |
| **Total** | $ 19,677 | 100.0% | $ 13,422 | 100.0% | 46.6% |

Share compensation expenses of $19.7 million in the six months ended June 30, 2011 represents 2.3 percentage points of the general and administrative expense ratio.

*Validus Re.* Validus Re share compensation expenses for the six months ended June 30, 2011 was $4.9 million compared to $3.4 million for the six months ended June 30, 2010, an increase of $1.6 million or 45.9%. This increase was due primarily to a change in forfeiture rates during the three months ended March 31, 2011, resulting in an increase of $1.2 million in share compensation expenses in the segment primarily relating to restricted share awards. Share compensation expenses as a percent of net premiums earned for the six months ended June 30, 2011 and 2010 were 1.0% and 0.6%, respectively.

*Talbot*. Talbot share compensation expenses for the six months ended June 30, 2011 was $4.7 million compared to $3.0 million for the six months ended June 30, 2010, an increase of $1.7 million or 56.8%. This increase was due primarily to a change in forfeiture rates during the three months ended March 31, 2011, resulting in an increase of $0.5 million in share compensation expenses in the segment primarily relating to restricted share awards. Share compensation expenses as a percent of net premiums earned for the six months ended June 30, 2011 and 2010 were

1.3% and 0.9%, respectively.

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*Corporate & Eliminations.* Corporate share compensation expenses for the six months ended June 30, 2011 was $10.0 million compared to $7.0 million for the six months ended June 30, 2010, an increase of $3.0 million or 42.6%, due primarily to a change in forfeiture rates during the three months ended March 31, 2011, resulting in an increase of $2.3 million in share compensation expenses in the segment primarily relating to restricted share awards.

**Selected Ratios**

The underwriting results of an insurance or reinsurance company are often measured by reference to its combined ratio, which is the sum of the loss ratio and the expense ratio. The net loss ratio is calculated by dividing losses and loss expenses incurred (including estimates for incurred but not reported losses) by net premiums earned. The expense ratio is calculated by dividing acquisition costs combined with general and administrative expenses by net premiums earned. The following table presents the losses and loss expenses ratio, policy acquisition cost ratio, general and administrative expense ratio, expense ratio and combined ratio for the six months ended June 30, 2011 and 2010.

| | **Six Months Ended June 30, 2011** | **Six Months Ended June 30, 2010** | **Percentage point change** |
|---|---|---|---|
| Losses and loss expenses ratio | 79.9% | 75.2% | 4.7 |
| Policy acquisition costs ratio | 18.2% | 16.8% | 1.4 |
| General and administrative expenses ratio (a) | 15.1% | 13.3% | 1.8 |
| **Expense ratio** | 33.3% | 30.1% | 3.2 |
| **Combined ratio** | 113.2% | 105.3% | 7.9 |

| *Validus Re* | **Six Months Ended June 30, 2011** | **Six Months Ended June 30, 2010** | **Percentage point change** |
|---|---|---|---|
| Losses and loss expenses ratio | 83.4% | 86.6% | (3.2) |
| Policy acquisition costs ratio | 15.6% | 14.9% | 0.7 |
| General and administrative expenses ratio (a) | 6.4% | 5.6% | 0.8 |
| **Expense ratio** | 22.0% | 20.5% | 1.5 |
| **Combined ratio** | 105.4% | 107.1% | (1.7) |

| *Talbot* | **Six Months Ended June 30, 2011** | **Six Months Ended June 30, 2010** | **Percentage point change** |
|---|---|---|---|
| Losses and loss expenses ratio | 75.3% | 57.4% | 17.9 |
| Policy acquisition costs ratio | 21.5% | 21.0% | 0.5 |
| General and administrative expenses ratio (a) | 18.4% | 15.3% | 3.1 |
| **Expense ratio** | 39.9% | 36.3% | 3.6 |
| **Combined ratio** | 115.2% | 93.7% | 21.5 |

(a) Includes general and administrative expenses and share compensation expenses.

General and administrative expense ratios for the six months ended June 30, 2011 and 2010 were 15.1% and 13.3%, respectively. General and administrative expense ratio is the sum of general and administrative expenses and share compensation expense divided by net premiums earned.

| | Six Months Ended June 30, 2011 | | Six Months Ended June 30, 2010 | |
|---|---|---|---|---|
| **(Dollars in thousands)** | **Expenses** | **Expenses as % of Net Earned Premiums** | **Expenses** | **Expenses as % of Net Earned Premiums** |
| General and administrative expenses | $ 109,318 | 12.8% | $ 105,948 | 11.8% |
| Share compensation expenses | 19,677 | 2.3% | 13,422 | 1.5% |
| **Total** | $ 128,995 | 15.1% | $ 119,370 | 13.3% |

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**Underwriting (Loss)**

Underwriting (loss) for the six months ended June 30, 2011 was ($112.9) million compared to ($47.5) million for the six months ended June 30, 2010, an increase of $65.4 million or 137.8%.

| (Dollars in thousands) | Six Months Ended June 30, 2011 | % of Sub-total | Six Months Ended June 30, 2010 | % of Sub-total | % Change |
|---|---|---|---|---|---|
| Validus Re | $ (26,470) | 31.9% | $ (38,906) | 227.9% | 32.0% |
| Talbot | (56,448) | 68.1% | 21,837 | (127.9)% | (358.5)% |
| Sub total | (82,918) | 100.0% | (17,069) | 100.0% | (385.8)% |
| Corporate & Eliminations | (29,935) | | (30,390) | | 1.5% |
| **Total** | $ (112,853) | | $ (47,459) | | (137.8)% |

The underwriting results of an insurance or reinsurance company are also often measured by reference to its underwriting income, which is a non-GAAP measure as previously defined. Underwriting income, as set in the table below, is reconciled to net income (the most directly comparable GAAP financial measure) by the addition or subtraction of certain Consolidated Statement of Operations and Comprehensive Income line items, as illustrated below.

| (Dollars in thousands) | Six Months Ended June 30, 2011 | Six Months Ended June 30, 2010 |
|---|---|---|
| **Underwriting (loss)** | $ (112,853) | $ (47,459) |
| Net investment income | 56,469 | 69,108 |
| Other income | 2,201 | 3,585 |
| Finance expenses | (30,362) | (28,369) |
| Net realized gains on investments | 17,931 | 23,839 |
| Net unrealized gains on investments | 5,698 | 57,053 |
| Foreign exchange (losses) | (2,458) | (12,863) |
| **Net (loss) income before taxes** | $ (63,374) | $ 64,894 |

Underwriting income indicates the performance of the Company s core underwriting function, excluding revenues and expenses such as the reconciling items in the table above. The Company believes the reporting of underwriting income enhances the understanding of our results by highlighting the underlying profitability of the Company s core insurance and reinsurance business. Underwriting profitability is influenced significantly by earned premium growth, adequacy of the Company s pricing and loss frequency and severity. Underwriting profitability over time is also influenced by the Company s underwriting discipline, which seeks to manage exposure to loss through favorable risk selection and diversification, its management of claims, its use of reinsurance and its ability to manage its expense ratio, which it accomplishes through its management of acquisition costs and other underwriting expenses. The Company believes that underwriting income provides investors with a valuable measure of profitability derived from underwriting activities.

The Company excludes the U.S. GAAP measures noted above, in particular net realized and unrealized gains and losses on investments, from its calculation of underwriting income because the amount of these gains and losses is heavily influenced by, and fluctuates in part, according to availability of investment market opportunities. The

Company believes these amounts are largely independent of its underwriting business and including them distorts the analysis of trends in its operations.



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In addition to presenting net income determined in accordance with U.S. GAAP, the Company believes that showing underwriting income enables investors, analysts, rating agencies and other users of its financial information to more easily analyze the Company s results of operations in a manner similar to how management analyzes the Company s underlying business performance. The Company uses underwriting income as a primary measure of underwriting results in its analysis of historical financial information and when performing its budgeting and forecasting processes. Analysts, investors and rating agencies who follow the Company request this non-GAAP financial information on a regular basis. In addition, underwriting income is one of the factors considered by the compensation committee of our Board of Directors in determining the bonus component of the total annual incentive compensation.

Underwriting income should not be viewed as a substitute for U.S. GAAP net income as there are inherent material limitations associated with the use of underwriting income as compared to using net income, which is the most directly comparable U.S. GAAP financial measure. The most significant limitation is the ability of users of the financial information to make comparable assessments of underwriting income with other companies, particularly as underwriting income may be defined or calculated differently by other companies. Therefore, the Company provides more prominence in this filing to the use of the most comparable U.S. GAAP financial measure, net income, which includes the reconciling items in the table above. The Company compensates for these limitations by providing both clear and transparent disclosure of net income and reconciliation of underwriting income to net income.

**Net Investment Income**

Net investment income for the six months ended June 30, 2011 was $56.5 million compared to $69.1 million for the six months ended June 30, 2010, a decrease of $12.6 million or 18.3%. Net investment income decreased due to falling yields on fixed maturity investments. Net investment income includes accretion of premium or discount on fixed maturities, interest on coupon-paying bonds, short-term investments and cash and cash equivalents, partially offset by investment management fees. The components of net investment income for the six months ended June 30, 2011 and 2010 are provided below.

| **(Dollars in thousands)** | **Six Months Ended June 30, 2011** | **Six Months Ended June 30, 2010** | **% Change** |
|---|---|---|---|
| Fixed maturities and short-term investments | $ 56,470 | $ 72,101 | (21.7)% |
| Fixed maturities and short-term investments | 3,268 | 897 | 264.3% |
| Cash and cash equivalents | 24 | 119 | (79.8)% |
| Total investment income | 59,762 | 73,117 | (18.3)% |
| Investment expenses | (3,293) | (4,009) | (17.9)% |
| **Net investment income** | $ 56,469 | $ 69,108 | (18.3)% |

Annualized effective investment yield is based on the weighted average investments held calculated on a simple period average and excludes net unrealized gains (losses), realized gains (losses) on investments, foreign exchange gains (losses) on investments and the foreign exchange effect of insurance balances. The Company s annualized effective investment yield was 1.90% and 2.36% for the six months ended June 30, 2011 and 2010, respectively and the average duration at June 30, 2011 was 1.57 years (December 31, 2010: 2.27 years).

**Other Income**

Other income for the six months ended June 30, 2011 was $2.2 million compared to $3.6 million for the six months ended June 30, 2010, a decrease of $1.4 million or 38.6%.

**Finance Expenses**

Finance expenses for the six months ended June 30, 2011 were $30.4 million compared to $28.4 million for the six months ended June 30, 2010, an increase of $2.0 million or 7.0%. Finance expenses also include the amortization of debt offering costs and discounts, and fees related to our credit facilities.

| (Dollars in thousands) | Six Months Ended June 30, 2011 2011 | 2010 | % Change |
|---|---|---|---|
| 9.069% Junior Subordinated Deferrable Debentures | $ 6,816 | $ 7,177 | (5.0)% |
| 8.480% Junior Subordinated Deferrable Debentures | 6,057 | 6,057 | 0.0% |
| 2010 Senior Notes due 2040 | 11,194 | 9,575 | 16.9% |
| Credit facilities | 3,313 | 2,420 | 36.9% |
| AlphaCat Re 2011 fees (a) | 2,919 | | NM |
| Talbot FAL Facility | 63 | 333 | (81.1)% |
| Talbot other interest | | 59 | NM |
| Talbot third party FAL facility | | 2,748 | NM |
| **Finance expenses** | $ 30,362 | $ 28,369 | 7.0% |

(a) Includes finance expenses attributable to noncontrolling interest.

NM: Not Meaningful

Capital in Lloyd s entities, whether personal or corporate, is required to be set annually for the prospective year and held by Lloyd s in trust ( Funds at Lloyd s or FAL ). For underwriting years up to and including 2007, Talbot s FAL has been provided both by Talbot and by third parties, thereafter Talbot s FAL has been provided exclusively by the Company. As all of the underwriting years up to and including 2007 are closed with effect from December 31, 2009, the FAL relating to these years has been returned to the third party providers. There were some costs paid in 2010, which are the final amounts payable under the Talbot third party FAL facility.

**Tax Benefit (Expense)**

Tax benefit for the six months ended June 30, 2011 was $1.5 million compared to an expense of ($3.5) million for the six months ended June 30, 2010, a change of $5.0 million or 142.6%. For the six months ended June 30, 2011, the Talbot tax benefit arose primarily due to a reduction in the U.K. taxable profits and adjustments to deferred tax balances following a reduction in the effective U.K tax rate from 28% to 26.5%.

**Net Realized Gains on Investments**

Net realized gains on investments for the six months ended June 30, 2011 were $17.9 million compared to $23.8 million for the six months ended June 30, 2010, a decrease of $5.9 million or 24.8%.

**Net Unrealized Gains on Investments**

Net unrealized gains on investments for the six months ended June 30, 2011 were $5.7 million compared to $57.1 million for the six months ended June 30, 2010, a decrease of $51.4 million or 90.0%. The net unrealized gains in the six months ended June 30, 2011 were partially as a result of downward shift in rates as the two-year Treasury rate fell from 0.59% to 0.46% (13 bps) and the five-year rate decreased from 2.01% to 1.76% (25 bps) in the period.

Net unrealized gains on investments are recorded as a component of net income. The Company has adopted all authoritative guidance on U.S. GAAP fair value measurements in effect as of the balance sheet date. Consistent with these standards, certain market conditions allow for fair value measurements that incorporate unobservable inputs where active market transaction based measurements are unavailable. Certain non-Agency RMBS securities were previously identified as trading in inactive markets.

**Foreign Exchange (Losses)**

Foreign exchange losses for the six months ended June 30, 2011 were ($2.5) million compared to ($12.9) million for the six months ended June 30, 2010, a favorable movement of $10.4 million or 80.9%. The favorable movement in foreign exchange resulted primarily from the effect of the appreciation of the Euro and British pound sterling against the U.S. dollar on assets held in these foreign currencies.

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The Euro to U.S. dollar exchange rates were 1.33 and 1.44 at December 31, 2010 and June 30, 2011, respectively. The British pound sterling to U.S. dollar exchange rates were 1.55 and 1.60 at December 31, 2010 and June 30, 2011, respectively. During the six months ended June 30, 2011, the Euro appreciated by 8.3% and the British pound sterling appreciated by 3.2%. For the six months ended June 30, 2011, Validus Re recognized foreign exchange losses of ($9.7) million and Talbot recognized foreign exchange gains of $7.3 million.

For the six months ended June 30, 2011, the Validus Re segment foreign exchange losses were ($9.7) million compared to losses of ($6.0) million for the six months ended June 30, 2010, an unfavorable movement of $3.7 million or 62.1%. The unfavorable movement in Validus Re foreign exchange losses was due primarily to a ($5.3) million loss incurred as a result of the Company having liabilities in both New Zealand dollars and Japanese Yen during a period when both of these currencies strengthened against the U.S. dollar.

For the six months ended June 30, 2011, the Talbot segment foreign exchange gains were $7.3 million compared to losses of ($6.8) million for the six months ended June 30, 2010, a favorable movement of $14.2 million or 206.9%. This increase was due primarily to gains of $4.2 million on revaluation of funds held in Euros due to the strengthening of the Euro, compared to losses on revaluation of ($3.7) million in the six months ended June 30, 2010. Certain premiums receivable and liabilities for losses incurred in currencies other than the U.S. dollar are exposed to the risk of changes in value resulting from fluctuations in foreign exchange rates and may affect financial results in the future.

At June 30, 2011, Talbot s balance sheet includes net unearned premiums and deferred acquisition costs denominated in foreign currencies of approximately $103.7 million and $21.6 million, respectively. These balances consisted of British pounds sterling and Canadian dollars of $73.0 million and $9.1 million, respectively. Net unearned premiums and deferred acquisition costs are classified as non-monetary items and are translated at historic exchange rates. All of Talbot s other balance sheet items are classified as monetary items and are translated at period end exchange rates. Additional foreign exchange (losses) gains may be incurred on the translation of net unearned premiums and deferred acquisition costs arising from insurance and reinsurance premiums written in future periods.

**Net Income Attributable to Noncontrolling Interest**

On May 25, 2011, the Company joined with other investors in capitalizing AlphaCat Re 2011, a new special purpose sidecar reinsurer formed for the purpose of writing collateralized reinsurance and retrocessional reinsurance. Validus Re has an equity interest in AlphaCat Re 2011 and as Validus Re holds a majority of AlphaCat Re 2011 s outstanding voting rights, the financial statements of AlphaCat Re 2011 are included in the consolidated financial statements of the Company. The portion of AlphaCat Re 2011 s earnings attributable to third party investors for the three months ended June 30, 2011 is recorded in the consolidated statement of operations and comprehensive income as net income attributable to noncontrolling interest.

**Other Non-GAAP Financial Measures**

In presenting the Company s results, management has included and discussed certain schedules containing net operating income, underwriting income (loss), annualized return on average equity and diluted book value per common share that are not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other companies. These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. The calculation of annualized return on average equity is discussed in the section above entitled Financial Measures. A reconciliation of underwriting income to net income, the most comparable U.S. GAAP financial measure, is presented above in the section entitled Underwriting Income. A reconciliation of diluted book value per share to book value per share, the most comparable U.S. GAAP financial measure, is presented below. Operating income is calculated based on net income (loss) excluding net realized gains (losses), net unrealized gains (losses) on investments, gains (losses) arising from translation of non-US$ denominated balances and non-recurring items. A reconciliation of operating income to net income, the most comparable U.S. GAAP financial measure, is embedded in the table presenting results of operations for the six months ended June 30, 2011 and 2010 in the section above entitled Results of Operations.

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Realized gains (losses) from the sale of investments are driven by the timing of the disposition of investments, not by our operating performance. Gains (losses) arising from translation of non-US dollar denominated balances are unrelated to our underlying business.

The following tables present reconciliations of diluted book value per share to book value per share, the most comparable U.S. GAAP financial measure, at June 30, 2011 and December 31, 2010.

| | As at June 30, 2011 (unaudited) | | | |
|---|---|---|---|---|
| | Equity Amount | Shares | Exercise Price | Book Value Per Share |
| **Book value per common share** | | | | |
| Total shareholders equity available to Validus | $ 3,408,317 | 98,763,928 | | $ 34.51 |
| **Diluted book value per common share** | | | | |
| Total shareholders equity available to Validus | 3,408,317 | 98,763,928 | | |
| Assumed exercise of outstanding warrants | 137,992 | 7,862,262 | $ 17.55 | |
| Assumed exercise of outstanding stock options | 45,604 | 2,266,801 | $ 20.12 | |
| Unvested restricted shares | | 3,670,942 | | |
| **Diluted book value per common share** | $ 3,591,913 | 112,563,933 | | $ 31.91 |

| | As at December 31, 2010 | | | |
|---|---|---|---|---|
| | Equity Amount | Shares | Exercise Price | Book Value Per Share |
| **Book value per common share** | | | | |
| Total shareholders equity available to Validus | $ 3,504,831 | 98,001,226 | | $ 35.76 |
| **Diluted book value per common share** | | | | |
| Total shareholders equity available to Validus | 3,504,831 | 98,001,226 | | |
| Assumed exercise of outstanding warrants | 139,272 | 7,934,860 | $ 17.55 | |
| Assumed exercise of outstanding stock options | 54,997 | 2,723,684 | $ 20.19 | |
| Unvested restricted shares | | 3,496,096 | | |
| **Diluted book value per common share** | $ 3,699,100 | 112,155,866 | | $ 32.98 |

**Financial Condition and Liquidity**

Validus Holdings, Ltd. is a holding company and conducts no operations of its own. The Company relies primarily on cash dividends and other permitted payments from Validus Re and Talbot to pay finance expenses and other holding company expenses. There are restrictions on the payment of dividends from Validus Re and Talbot to the

Company. Please refer to Part II, Item 5, Market for Registrants, Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities in the Company s Annual Report on Form 10-K for the year ended December 31, 2010 for further discussion of the Company s dividend policy.

Three main sources provide cash flows for the Company: operating activities, investing activities and financing activities. Cash flow from operating activities is derived primarily from the net receipt of premiums less claims and expenses related to underwriting activities. Cash flow from investing activities is derived primarily from the receipt of net proceeds on the Company s total investment portfolio. Cash flow from financing activities is derived primarily from the issuance of common shares and debentures payable. The movement in net cash provided by operating activities, net cash (used in) provided by investing activities, net cash provided by (used in) financing activities and the effect of foreign currency rate changes on cash and cash equivalents for the six months ended June 30, 2011 and 2010 is provided in the following table.

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| (Dollars in thousands) | Six Months Ended June 30, 2011 | 2010 | % Change |
|---|---|---|---|
| Net cash provided by operating activities | $ 309,614 | $ 263,582 | 17.5% |
| Net cash (used in) provided by investing activities | (211,059) | 101,434 | (308.1)% |
| Net cash provided by (used in) financing activities | 79,584 | (243,398) | 132.7% |
| Effect of foreign currency rate changes on cash and cash equivalents | 17,042 | (16,714) | 202.0% |
| **Net increase in cash** | $ 195,181 | $ 104,904 | 86.1% |

During the six months ended June 30, 2011, net cash provided by operating activities of $309.6 million was driven primarily by a significant portion of the 2011 incurred losses which have yet to be paid. Net cash used in investing activities of $211.1 million was driven primarily by a net purchase of investments of $212.0 million. Net cash provided by financing activities of $79.6 million was driven primarily by $134.3 million of third party investment in AlphaCat Re 2011, partially offset by the payment of $54.0 million of quarterly dividends.

During the six months ended June 30, 2010, net cash provided by operating activities of $263.6 million was driven primarily by a $452.5 million change in unearned premiums relating to increased premiums written following the IPC acquisition. In addition, there was an increase of $367.8 million in reserve for losses and loss expenses primarily due to the increase in notable loss events in the six months ended June 30, 2010 and a $61.4 million contribution from net income in the six months ended June 30, 2010. These amounts were partially offset by an increase of $383.7 million in premiums receivable and a combined $166.2 million decrease in deferred acquisition costs and prepaid reinsurance premiums. Net cash provided by investing activities of $101.4 million was driven primarily by the net sales of short term investments. Net cash used in financing activities of $243.4 million was driven primarily by the purchase of $444.0 million of common shares under the share repurchase program and the payment of $56.0 million in quarterly dividend, partially offset by the issuance of $246.8 million of 8.875% Senior Notes due 2040.

As at June 30, 2011, the Company s portfolio was composed of fixed income investments including; short-term investments, agency securities and sovereign securities amounting to $5,347.5 million or 86.8% of total cash and investments. Details of the Company s debt and financing arrangements at June 30, 2011 are provided below.

| (Dollars in thousands) | Maturity Date / Term | In Use/ Outstanding |
|---|---|---|
| 2006 Junior Subordinated Deferrable Debentures | June 15, 2036 | $ 150,000 |
| 2007 Junior Subordinated Deferrable Debentures | June 15, 2037 | 139,800 |
| 2010 Senior Notes due 2040 | January 26, 2040 | 250,000 |
| $340,000 syndicated unsecured letter of credit facility | March 12, 2013 | |
| $60,000 bilateral unsecured letter of credit facility | March 12, 2013 | |
| $500,000 secured letter of credit facility | March 12, 2012 | 277,679 |
| Talbot FAL facility | April 13, 2011 | 25,000 |
| IPC Bi-Lateral Facility | December 31, 2010 | 63,284 |
| **Total** | | $ 905,763 |

**Capital Resources**

Shareholders equity at June 30, 2011 was $3,408.3 million.

On February 9, 2011, the Company announced that its Board of Directors (the Board ) had increased the Company s annual dividend by 13.6% from $0.88 to $1.00 per common share and common share equivalent for which each

outstanding warrant is exercisable.

On May 4, 2011, the Company announced a quarterly cash dividend of $0.25 per common share and $0.25 per common share equivalent for which each outstanding warrant is exercisable, payable on June 30, 2011 to holders of record on June 5, 2011.

On August 3, 2011 the Company announced a quarterly cash dividend of $0.25 per common share and $0.25 per common share equivalent for which each outstanding warrant is exercisable, payable on September 30, 2011 to holders of record on September 15, 2011.

The timing and amount of any future cash dividends, however, will be at the discretion of the Board and will depend upon our results of operations and cash flows, our financial position and capital requirements, general business conditions, legal, tax, regulatory, rating agency and contractual constraints or restrictions and any other factors that the Board deems relevant.

The Company may from time to time repurchase its securities, including common shares, Junior Subordinated Deferrable Debentures and Senior Notes. In November 2009, the Board of Directors of the Company authorized an initial $400.0 million share repurchase program. On February 17, 2010, the Board of Directors of the Company authorized the Company to return up to $750.0 million to shareholders. This amount was in addition to, and in excess of, the $135.5 million of common shares purchased by the Company through February 17, 2010 under its previously authorized $400.0 million share repurchase program. On May 6, 2010, the Board of Directors authorized a self tender offer pursuant to which the Company has repurchased $300.0 million in common shares. On November 4, 2010, the Board of Directors authorized a self tender offer pursuant to which the Company has repurchased $238.4 million in common shares. In addition, the Board of Directors authorized separate repurchase agreements with funds affiliated with or managed by each of Aquiline Capital Partners LLC, New Mountain Capital LLC, and Vestar Capital Partners pursuant to which the Company has repurchased $61.6 million in common shares. On December 20, 2010, the Board of Directors authorized the Company to return up to $400.0 million to shareholders. This amount is in addition to the $929.2 million of common shares purchased by the Company through December 23, 2010 under its previously authorized share repurchase program.

The Company expects the purchases under its share repurchase program to be made from time to time in the open market or in privately negotiated transactions. The timing, form and amount of the share repurchases under the program will depend on a variety of factors, including market conditions, the Company s capital position relative to internal and rating agency targets, legal requirements and other factors. The repurchase program may be modified, extended or terminated by the Board of Directors at any time.

The Company repurchased 35.0 million shares at a cost of $947.2 million under the share repurchase programs for the period November 4, 2009 through August 4, 2011.

On August 7, 2008, the Company filed a shelf registration statement on Form S-3 (No. 333-152856) with the U.S Securities Exchange Committee in which we may offer from time to time common shares, preference shares, depository shares representing common shares or preference shares, senior or subordinated debt securities, warrants to purchase common shares, preference shares and debt securities, share purchase contracts, share purchase units and units which may consist of any combination of the securities listed above. In addition, the shelf registration statement will provide for secondary sales of common shares sold by the Company s shareholders. The registration statement is intended to provide the Company with additional flexibility to access capital markets for general corporate purposes, subject to market conditions and the Company s capital needs.

On May 25, 2011, the Company joined with other investors in capitalizing AlphaCat Re 2011, a new special purpose sidecar reinsurer formed for the purpose of writing collateralized reinsurance and retrocessional reinsurance. Validus Re has an equity interest in AlphaCat Re 2011 and as Validus Re holds a majority of AlphaCat Re 2011 s outstanding voting rights, the financial statements of AlphaCat Re 2011 are included in the consolidated financial statements of the Company. The portion of AlphaCat Re 2011 s earnings attributable to third party investors for the three months ended June 30, 2011 is recorded in the consolidated statement of operations and comprehensive income as net income attributable to noncontrolling interest.

The following table details the capital resources of the Company s more significant subsidiaries on an unconsolidated basis.

| (Dollars in thousands) | Capital at June 30, 2011 |
|---|---|
| Validus Reinsurance, Ltd. (consolidated), excluding IPCRe, Ltd. | $ 3,004,720 |
| IPCRe, Ltd. | 314,310 |
| **Total Validus Reinsurance, Ltd. (consolidated)** | 3,319,030 |
| Noncontrolling interest in AlphaCat Re 2011, Ltd. | 134,895 |
| Talbot Holdings, Ltd. | 627,554 |
| Other subsidiaries | 3,933 |
| Other, net | (5,472) |
| **Total consolidated capitalization** | 4,079,940 |
| Senior notes payable | (246,928) |
| Debentures payable | (289,800) |
| **Total shareholders equity** | $ 3,543,212 |

*Ratings*

The following table summarizes the financial strength ratings of the Company and its principal reinsurance and insurance subsidiaries from internationally recognized rating agencies as of August 5, 2011:

| | A.M. Best | S&P | Moody s | Fitch |
|---|---|---|---|---|
| ***Validus Holdings, Ltd.*** | | | | |
| Issuer credit rating | bbb- | BBB | Baa2 | BBB+ |
| Senior debt | bbb- | BBB | Baa2 | BBB |
| Subordinated debt | bb+ | BBB- | Baa3 | BB+ |
| Preferred stock | bb | BB+ | Ba1 | |
| Outlook on ratings | Positive | Stable | Stable | Stable |
| ***Validus Reinsurance, Ltd.*** | | | | |
| Financial strength rating | A- | A- | A3 | A- |
| Issuer credit rating | a- | | | |
| Outlook on ratings | Positive | Stable | Stable | Stable |
| ***IPCRe Ltd.*** | | | | |
| Financial strength rating | A- | | | |
| Issuer credit rating | a- | | | |
| Outlook on rating | Stable | | | |
| ***Validus Re Europe Ltd.*** | | | | |
| Financial strength rating | A- | | | |
| Issuer credit rating | a- | | | |
| Outlook on rating | Stable | | | |
| ***Talbot*** | | | | |
| Financial strength rating applicable to all Lloyds syndicates | A | A+ | | A+ |

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**Recent accounting pronouncements**

Please refer to Note 2 to the Consolidated Financial Statements (Part I, Item I) for further discussion of relevant recent accounting pronouncements.

**Debt and Financing Arrangements**

The following table details the Company s borrowings and credit facilities as at June 30, 2011.

| (Dollars in thousands) | Commitments (a) | Outstanding |
|---|---|---|
| 2006 Junior Subordinated Deferrable Debentures | $ 150,000 | $ 150,000 |
| 2007 Junior Subordinated Deferrable Debentures | 200,000 | 139,800 |
| 2010 Senior Notes due 2040 | 250,000 | 250,000 |
| $340,000 syndicated unsecured letter of credit facility | 340,000 | |
| $60,000 bilateral unsecured letter of credit facility | 60,000 | |
| $500,000 secured letter of credit facility | 500,000 | 277,679 |
| Talbot FAL facility (b) | 25,000 | 25,000 |
| IPC Bi-Lateral Facility | 80,000 | 63,284 |
| **Total** | $ 1,605,000 | $ 905,763 |

(a) Indicates utilization of commitment amount, not drawn borrowings.

(b) Talbot operates in Lloyd s through a corporate member, Talbot 2002 Underwriting Capital Ltd ( T02 ), which is the sole participant in Syndicate 1183. Lloyd s sets T02 s required capital annually based on syndicate 1183 s business plan, rating environment, reserving environment together with input arising from Lloyd s discussions with, inter alia, regulatory and rating agencies. Such capital, called Funds at Lloyd s ( FAL ), comprises: cash, investments and a letter of credit facility of up to $25 million.

Please refer to Note 10 the Consolidated Financial Statements (Part I, Item I) for further discussion of the Company s debt and financing arrangements.

**Investments**

A significant portion of contracts written provide short-tail reinsurance coverage for losses resulting mainly from natural and man-made catastrophes, which could result in a significant amount of losses on short notice. Accordingly, the Company s investment portfolio is structured to provide significant liquidity and preserve capital, which means the investment portfolio contains a significant amount of relatively short-term fixed maturity investments, such as U.S. government securities, U.S. government-sponsored enterprises securities, corporate debt securities and mortgage-backed and asset-backed securities.

Substantially all of the fixed maturity investments held at June 30, 2011 were publicly traded. At June 30, 2011, the average duration of the Company s fixed maturity portfolio was 1.57 years (December 31, 2010: 2.27 years) and the average rating of the portfolio was AA- (December 31, 2010: AA+). At June 30, 2011, the total fixed maturity portfolio was $4,603.5 million (December 31, 2010: $4,823.9 million), of which $2,237.0 million (December 31, 2010: $2,946.5 million) were rated AAA.

With the exception of the bank loan portfolio, the Company s investment guidelines require that investments be rated BBB- or higher at the time of purchase. The Company reports the ratings of its investment portfolio securities at the lower of Moody s or Standard & Poor s rating for each investment security and, as a result, the Company s investment portfolio now has $34.2 million of non-agency mortgage backed securities rated less than investment grade.

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The other components of less than investment grade securities held by the Company at June 30, 2011 were $29.9 million of catastrophe bonds, $375.3 million of bank loans and $2.3 million of corporate bonds.

Cash and cash equivalents and investments in Talbot of $1,545.5 million at June 30, 2011 were held in trust for the benefit of cedants and policyholders and to facilitate the accreditation as an alien insurer/reinsurer by certain regulators (December 31, 2010: $1,489.2 million). Total cash and cash equivalents and investments in Talbot were $1,649.2 million at June 30, 2011 (December 31, 2010: $1,592.1 million).

As of June 30, 2011, the Company had approximately $1.2 million of asset-backed securities with sub-prime collateral (December 31, 2010: $1.6 million) and $8.5 million of Alt-A RMBS (December 31, 2010: $9.9 million).

**Cash Flows**

During the six months ended June 30, 2011 and 2010, the Company generated net cash from operating activities of $309.6 million and $263.6 million, respectively. Cash flows from operations generally represent premiums collected, less losses and loss expenses paid and underwriting and other expenses paid. Cash flows from operations may differ substantially from net income.

As of June 30, 2011 and December 31, 2010, the Company had cash and cash equivalents of $815.9 million and $620.7 million, respectively.

The Company has written certain business that has loss experience generally characterized as having low frequency and high severity. This results in volatility in both results and operational cash flows. The potential for large claims or a series of claims under one or more reinsurance contracts means that substantial and unpredictable payments may be required within relatively short periods of time. As a result, cash flows from operating activities may fluctuate, perhaps significantly, between individual quarters and years. Management believes the Company s unused credit facility amounts and highly liquid investment portfolio are sufficient to support any potential operating cash flow deficiencies. Please refer to the table detailing the Company s borrowings and credit facilities as at June 30, 2011, presented above.

In addition to relying on premiums received and investment income from the investment portfolio, the Company intends to meet these cash flow demands by carrying a substantial amount of short and medium term investments that would mature, or possibly be sold, prior to the settlement of expected liabilities. The Company cannot provide assurance, however, that it will successfully match the structure of its investments with its liabilities due to uncertainty related to the timing and severity of loss events.

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## CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

The Private Securities Litigation Reform Act of 1995 ( PSLRA ) provides a safe harbor for forward-looking statements. Any prospectus, prospectus supplement, the Company s Annual Report to shareholders, any proxy statement, any other Form 10-K, Form 10-Q or Form 8-K of the Company or any other written or oral statements made by or on behalf of the Company may include forward-looking statements that reflect the Company s current views with respect to future events and financial performance. Such statements include forward-looking statements both with respect to the Company in general, and to the insurance and reinsurance sectors in particular. Statements that include the words expect , intend , plan , believe , project , anticipate , will , may , and similar statement forward-looking nature identify forward-looking statements for purposes of the PSLRA or otherwise. All forward-looking statements address matters that involve risks and uncertainties. Accordingly, there are or will be important factors that could cause actual results to differ materially from those indicated in such statements and, therefore, you should not place undue reliance on any such statement.

We believe that these factors include, but are not limited to, the following:

- unpredictability and severity of catastrophic events;
- our ability to obtain and maintain ratings, which may affect by our ability to raise additional equity or debt financings, as well as other factors described herein;
- adequacy of the Company s risk management and loss limitation methods;
- cyclicality of demand and pricing in the insurance and reinsurance markets;
- the Company s ability to implement its business strategy during soft as well as hard markets;
- adequacy of the Company s loss reserves;
- continued availability of capital and financing;
- the Company s ability to identify, hire and retain, on a timely and unimpeded basis and on anticipated economic and other terms, experienced and capable senior management, as well as underwriters, claims professionals and support staff;
- acceptance of our business strategy, security and financial condition by rating agencies and regulators, as well as by brokers and (re)insureds;
- competition, including increased competition, on the basis of pricing, capacity, coverage terms or other factors;
- potential loss of business from one or more major insurance or reinsurance brokers;
- the Company s ability to implement, successfully and on a timely basis, complex infrastructure, distribution capabilities, systems, procedures and internal controls, and to develop accurate actuarial data to support the business and regulatory and reporting requirements;
- general economic and market conditions (including inflation, volatility in the credit and capital markets, interest rates and foreign currency exchange rates) and conditions specific to the insurance and reinsurance markets in which we operate;
- the integration of businesses we may acquire or new business ventures, including overseas offices, we may start;

accuracy of those estimates and judgments used in the preparation of our financial statements, including those related to revenue recognition, insurance and other reserves, reinsurance recoverables, investment valuations, intangible assets, bad debts, taxes, contingencies, litigation and any determination to use the deposit method of accounting, which, for a relatively new insurance and reinsurance company like our

company, are even more difficult to make than those made in a mature company because of limited historical information;

the effect on the Company s investment portfolio of changing financial market conditions including inflation, interest rates, liquidity and the possible downgrade of U.S. securities by credit rating agencies and the resulting effect on the value of securities in the Company s investment portfolio, as well as other factors;

acts of terrorism, political unrest, outbreak of war and other hostilities or other non-forecasted and unpredictable events;

availability and cost of reinsurance and retrocession coverage;

the failure of reinsurers, retrocessionaires, producers or others to meet their obligations to us;

the timing of loss payments being faster or the receipt of reinsurance recoverables being slower than anticipated by us;

changes in domestic or foreign laws or regulations, or their interpretations;

changes in accounting principles or the application of such principles by regulators;

statutory or regulatory or rating agency developments, including as to tax policy and reinsurance and other regulatory matters such as the adoption of proposed legislation that would affect Bermuda-headquartered companies and/or Bermuda-based insurers or reinsurers; and

the other factors set forth herein under Part I Item 1A Risk Factors and under Part II Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations and the other sections of the Company s Annual Report on Form 10-K for the year ended December 31, 2010, as well as the risk and other factors set forth in the Company s other filings with the SEC, as well as management s response to any of the aforementioned factors.

In addition, other general factors could affect our results, including: (a) developments in the world s financial and capital markets and our access to such markets; (b) changes in regulations or tax laws applicable to us, including, without limitation, any such changes resulting from the recent investigations relating to the insurance industry and any attendant litigation; and (c) the effects of business disruption or economic contraction due to terrorism or other hostilities.

The foregoing review of important factors should not be construed as exhaustive and should be read in conjunction with the other cautionary statements that are included herein or elsewhere. Any forward-looking statements made in this report are qualified by these cautionary statements, and there can be no assurance that the actual results or developments anticipated by us will be realized or, even if substantially realized, that they will have the expected consequences to, or effects on, us or our business or operations. We undertake no obligation to update publicly or revise any forward-looking statement, whether as a result of new information, future developments or otherwise.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We believe we are principally exposed to five types of market risk:

interest rate risk;

foreign currency risk;

credit risk;

liquidity risk; and

effects of inflation.

*Interest Rate Risk:* The Company s primary market risk exposure is to changes in interest rates. The Company s fixed maturity portfolio is exposed to interest rate risk. Fluctuations in interest rates have a direct impact on the market valuation of these investments. As interest rates rise, the market value of the Company s fixed maturity portfolio falls and the Company has the risk that cash outflows will have to be funded by selling assets, which will be trading at depreciated values. As interest rates decline, the market value of the Company s fixed income portfolio increases and the Company has reinvestment risk, as funds reinvested will earn less than is necessary to match anticipated liabilities. We manage interest rate risk by selecting investments with characteristics such as duration, yield, currency and liquidity tailored to the anticipated cash outflow characteristics of the insurance and reinsurance liabilities the Company assumes.

As at June 30, 2011, the impact on the Company s fixed maturity and short-term investments from an immediate 100 basis point increase in market interest rates (based on U.S. treasury yield) would have resulted in an estimated decrease in market value of 1.6%, or approximately $82.2 million. As at June 30, 2011, the impact on the Company s fixed maturity portfolio from an immediate 100 basis point decrease in market interest rates would have resulted in an estimated increase in market value of 1.1% or approximately $57.2 million.

As at June 30, 2010, the impact on the Company s fixed maturity and short-term investments from an immediate 100 basis point increase in market interest rates (based on U.S. treasury yield) would have resulted in an estimated decrease in market value of 2.3%, or approximately $122.0 million. As at June 30, 2010, the impact on the Company s fixed maturity portfolio from an immediate 100 basis point decrease in market interest rates would have resulted in an estimated increase in market value of 1.9% or approximately $102.9 million.

As at June 30, 2011, the Company held $806.7 million (December 31, 2010: $644.4 million), or 17.5% (December 31, 2010: 13.4%), of the Company s fixed maturity portfolio in asset-backed and mortgage-backed securities. These assets are exposed to prepayment risk, which occurs when holders of underlying loans increase the frequency with which they prepay the outstanding principal before the maturity date and refinance at a lower interest rate cost. The adverse impact of prepayment is more evident in a declining interest rate environment. As a result, the Company will be exposed to reinvestment risk, as cash flows received by the Company will be accelerated and will be reinvested at the prevailing interest rates.

*Foreign Currency Risk:* Certain of the Company s reinsurance contracts provide that ultimate losses may be payable in foreign currencies depending on the country of original loss. Foreign currency exchange rate risk exists to the extent that there is an increase in the exchange rate of the foreign currency in which losses are ultimately owed. Therefore, we attempt to manage our foreign currency risk by seeking to match our liabilities under insurance and reinsurance policies that are payable in foreign currencies with cash and investments that are denominated in such currencies. As of June 30, 2011, $727.1 million, or 8.8% of our total assets and $910.1 million, or 19.3% of our total liabilities were held in foreign currencies. As of June 30, 2011, $108.8 million, or 2.3% of our total liabilities held in foreign currencies was non-monetary items which do not require revaluation at each reporting date. As of June 30, 2010, $526.3 million, or 6.9% of our total assets and $494.3 million, or 12.3% of our total liabilities were held in foreign currencies. As of June 30, 2010, $95.9 million, or 2.4% of our total liabilities held in foreign currencies were non-monetary items which do not require revaluation at each reporting date.

*Credit Risk:* We are exposed to credit risk primarily from the possibility that counterparties may default on their obligations to us. We attempt to limit our credit exposure by purchasing high quality fixed income investments to maintain an average portfolio credit quality of AA- or higher with mortgage and commercial mortgage-backed issues having an aggregate weighted average credit quality of AAA. In addition, we have limited our exposure to any single issuer to 3.0% or less of total investments, excluding treasury and agency securities. With the exception of the bank loan portfolio, the minimum credit rating of any security purchased is BBB-/Baa3 and where investments are downgraded below BBB-/Baa3, we permit our investment managers to hold up to 2.0% in aggregate market value, or up to 10.0% with written authorization of the Company. At June 30, 2011, 1.0% of the portfolio, excluding bank loans was below BBB-/Baa3 and we did not have an aggregate exposure to any single issuer of more than 1.1% of total investments, other than with respect to government securities.

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The amount of the maximum exposure to credit risk is indicated by the carrying value of the Company s financial assets. The Company s primary credit risks reside in investment in U.S. corporate bonds and recoverables from reinsurers. The Company evaluates the financial condition of its reinsurers and monitors concentration of credit risk arising from its exposure to individual reinsurers. The reinsurance program is generally placed with reinsurers whose rating, at the time of placement, was A- or better rated by S & P or the equivalent with other rating agencies. Exposure to a single reinsurer is also controlled with restrictions dependent on rating. At June 30, 2011, 99.1% of reinsurance recoverables (which includes loss reserves recoverable and recoverables on paid losses) were from reinsurers rated A- or above, or from reinsurers posting full collateral (December 31, 2010: 97.4%, rated A-).

*Liquidity risk:* Certain of the Company s investments may become illiquid. Disruption in the credit markets may materially affect the liquidity of the Company s investments, including residential mortgage-backed securities which represent 8.5% (December 31, 2010: 8.8%) of total cash and investments. If the Company requires significant amounts of cash on short notice in excess of normal cash requirements (which could include claims on a major catastrophic event) in a period of market illiquidity, the investments may be difficult to sell in a timely manner and may have to be disposed of for less than what may otherwise have been possible under other conditions. At June 30, 2011, the Company had $1,685.6 million of unrestricted, liquid assets, defined as unpledged cash and cash equivalents, short term investments, government and government agency securities. Details of the Company s debt and financing arrangements at June 30, 2011 are provided below.

| (Dollars in thousands) | Maturity Date / Term | In Use/ Outstanding |
|---|---|---|
| 2006 Junior Subordinated Deferrable Debentures | June 15, 2036 | $ 150,000 |
| 2007 Junior Subordinated Deferrable Debentures | June 15, 2037 | 139,800 |
| 2010 Senior Notes due 2040 | January 26, 2040 | 250,000 |
| $340,000 syndicated unsecured letter of credit facility | March 12, 2013 | |
| $60,000 bilateral unsecured letter of credit facility | March 12, 2013 | |
| $500,000 secured letter of credit facility | March 12, 2012 | 277,679 |
| Talbot FAL facility | April 13, 2011 | 25,000 |
| IPC Bi-Lateral Facility | December 31, 2010 | 63,284 |
| **Total** | | $ 905,763 |

*Effects of Inflation:* We do not believe that inflation has had or will have a material effect on our combined results of operations, except insofar as (a) inflation may affect interest rates, and (b) losses and loss expenses may be affected by inflation.

**ITEM 4. CONTROLS AND PROCEDURES**

**Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures**

The Company carried out an evaluation, under the supervision and with the participation of the Company s management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of disclosure controls and procedures pursuant to Rules 13a-15 and 15d-15 promulgated under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this report.

Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective to provide reasonable assurance that all material information relating to the Company required to be filed in this report has been recorded, processed, summarized and reported when required and the information is accumulated and communicated, as appropriate, to allow timely decisions regarding required disclosures.

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**Changes in Internal Control Over Financial Reporting**

There have been no changes in internal control over financial reporting identified in connection with the Company s evaluation required pursuant to Rules 13a-15 and 15d-15 promulgated under the Securities Exchange Act of 1934, as amended, that occurred during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

## PART II OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

On June 12, 2011, Transatlantic Holdings, Inc. ( Transatlantic ), Allied World Assurance Company Holdings, AG ( Allied World ) and Go Sub, LLC entered into an Agreement and Plan of Merger (the Transatlantic-Allied World Merger Agreement ). Pursuant to the Transatlantic-Allied World Merger Agreement, Transatlantic s stockholders (including the stockholders that do not vote in favor of the Transatlantic-Allied World Merger Agreement) will, after the effective time, have the right to receive 0.88 validly issued, fully paid and non-assessable registered ordinary shares, par value CHF 15.00 per share (as may be adjusted in connection with the payment of dividends by virtue of a par value reduction, as approved by Allied World s shareholders at its 2011 Annual General Meeting) of Allied World, together with any cash paid in lieu of fractional shares, in exchange for each Transatlantic Common Share they hold.

On July 12, 2011, the Company announced that it had delivered to the Board of Directors of Transatlantic a proposal to merge the businesses of the Company and Transatlantic. Pursuant to the proposal, Transatlantic stockholders would receive 1.5564 Validus voting common shares in the merger and $8.00 in cash per share pursuant to a one-time special dividend from Transatlantic immediately prior to closing of the merger for each share of Transatlantic common stock they own.

On July 20, 2011, the Company filed a preliminary proxy statement with the SEC in connection with the special meeting of stockholders of Transatlantic, urging the Transatlantic shareholders to vote against the Transatlantic-Allied World Merger Agreement.

On July 25, 2011, the Company commenced an exchange offer for all of the outstanding shares of common stock of Transatlantic. Under the terms of the exchange offer, Transatlantic stockholders would receive 1.5564 Validus voting common shares and $8.00 in cash for each share of Transatlantic common stock they own. The terms and conditions of the exchange offer are set forth in the offering documents that the Company has filed with the SEC.

On July 28, 2011, Transatlantic filed a lawsuit against the Company in the United States District Court for the District of Delaware, alleging that the Company violated the U.S. securities laws by making false and misleading statements to Transatlantic s stockholders in the Company s proxy and exchange offer materials. The lawsuit seeks to compel the Company to correct alleged misstatements and omissions made in its proxy and exchange offer materials. The Company intends to vigorously defend this action. The Company believes that the ultimate outcome of this litigation will not have a material adverse effect on its consolidated financial condition, operating results and/or liquidity.

The Company anticipates that, similar to the rest of the insurance and reinsurance industry, it will be subject to litigation and arbitration in the ordinary course of business.

### ITEM 1A. RISK FACTORS

Please refer to the discussion of Risk Factors in Item 1A of the Company s Annual Report on Form 10-K for the year ended December 31, 2010.

### ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

In November 2009, the Board of Directors of the Company authorized an initial $400.0 million share repurchase program. On February 17, 2010, the Board of Directors of the Company authorized the Company to return up to $750.0 million to shareholders. This amount was in addition to, and in excess of, the $135.5 million of common shares purchased by the Company through February 17, 2010 under its previously authorized $400.0 million share repurchase program. On May 6, 2010, the Board of Directors authorized a self tender offer pursuant to which the Company has repurchased $300.0 million in common shares.

On November 4, 2010, the Company announced that its Board of Directors had approved share repurchase transactions aggregating $300.0 million. These repurchases were effected by a tender offer which the Company commenced on Monday November 8, 2010, for up to 7,945,400 of its common shares at a price of $30.00 per share.

In addition, the Board of Directors authorized separate repurchase agreements with funds affiliated with or managed by each of Aquiline Capital Partners LLC, New Mountain Capital, LLC and Vestar Capital Partners pursuant to which the Company has repurchased $61.6 million in common shares. On December 20, 2010, the Board of Directors authorized the Company to return up to $400.0 million to shareholders. This amount was in addition to the $929.2 million of common shares purchased by the Company through December 23, 2010 under its previously authorized share repurchase program.

The Company expects the purchases under its share repurchase program to be made from time to time in the open market or in privately negotiated transactions. The timing, form and amount of the share repurchases under the program will depend on a variety of factors, including market conditions, the Company s capital position relative to internal and rating agency targets, legal requirements and other factors. The repurchase program may be modified, extended or terminated by the Board of Directors at any time.

The Company has repurchased approximately 35.0 million common shares for an aggregate purchase price of $947.2 million from the inception of the share repurchase program to August 4, 2011.

Share repurchases include repurchases by the Company of shares, from time to time, from employees in order to facilitate the payment of withholding taxes on restricted shares granted and the exercise of stock appreciation rights. We purchased these shares at their fair market value, as determined by reference to the closing price of our common shares on the day the restricted shares vested or the stock appreciation rights were exercised.

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| | Share Repurchase Activity (Expressed in thousands of U.S. dollars except for share and per share information) | | | | |
|---|---|---|---|---|---|
| **Effect of share repurchases:** | **As at March 31, 2011 (cumulative)** | **April** | **May** | **June** | **Quarter ended June 30, 2011** |
| Aggregate purchase price (a) | $ 947,170 | $ | $ | $ | $ |
| Shares repurchased | 35,031,985 | | | | |
| Average price (a) | $ 27.04 | $ | $ | $ | $ |
| Estimated net accretive (dilutive) impact on: | | | | | |
| Diluted BV per common share (b) | | | | | $ 1.16 |
| Diluted EPS Quarter (c) | | | | | $ 0.26 |

| | Share Repurchase Activity (Expressed in thousands of U.S. dollars except for share and per share information) | | | | |
|---|---|---|---|---|---|
| **Effect of share repurchases:** | **As at June 30, 2011 (cumulative)** | **July** | **August** | **As at August 4, 2011** | **Cumulative to Date Effect** |
| Aggregate purchase price (a) | $ 947,170 | $ | $ | $ | $ 947,170 |
| Shares repurchased | 35,031,985 | | | | 35,031,985 |
| Average price (a) | $ 27.04 | $ | $ | $ | $ 27.04 |

(a) Share transactions are on a trade date basis through August 4, 2011 and are inclusive of commissions. Average share price is rounded to two decimal places.

(b) As the average price per share repurchased during the periods 2009, 2010 and 2011 was lower than the book value per common share, the repurchase of shares increased the Company s period ending book value per share.

(c) The estimated impact on diluted earnings per share was calculated by comparing reported results versus i) net income per share plus an estimate of lost net investment income on the cumulative share repurchases divided by ii) weighted average diluted shares outstanding excluding the weighted average impact of cumulative share repurchases. The impact of cumulative share repurchases was accretive to diluted earnings per share.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. (Removed and Reserved)**

**ITEM 5. OTHER INFORMATION**

None.

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## ITEM 6. EXHIBITS

| Exhibit | Description |
|---|---|
| Exhibit 31.1* | Certification of Chief Executive Officer pursuant to Section 302 of The Sarbanes-Oxley Act of 2002. |
| Exhibit 31.2* | Certification of Chief Financial Officer pursuant to Section 302 of The Sarbanes-Oxley Act of 2002. |
| Exhibit 32* | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of The Sarbanes-Oxley Act of 2002. |
| Exhibit 101.1 INS* | XBRL Instance Document |
| Exhibit 101.SCH* | XBRL Taxonomy Extension Schema Document |
| Exhibit 101.CAL* | XBRL Taxonomy Extension Calculation Linkbase Document |
| Exhibit 101.LAB* | XBRL Taxonomy Extension Label Linkbase Document |
| Exhibit 101.PRE* | XBRL Taxonomy Extension Presentation Linkbase Document |
| Exhibit 101.DEF* | XBRL Taxonomy Extension Definition Linkbase Document |

* Filed herewith

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## SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**VALIDUS HOLDINGS, LTD.**
(Registrant)

Date: August 5, 2011

/s/ Edward J. Noonan
Edward J. Noonan
Chief Executive Officer

Date: August 5, 2011

/s/ Joseph E. (Jeff) Consolino
Joseph E. (Jeff) Consolino
President and Chief Financial Officer

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