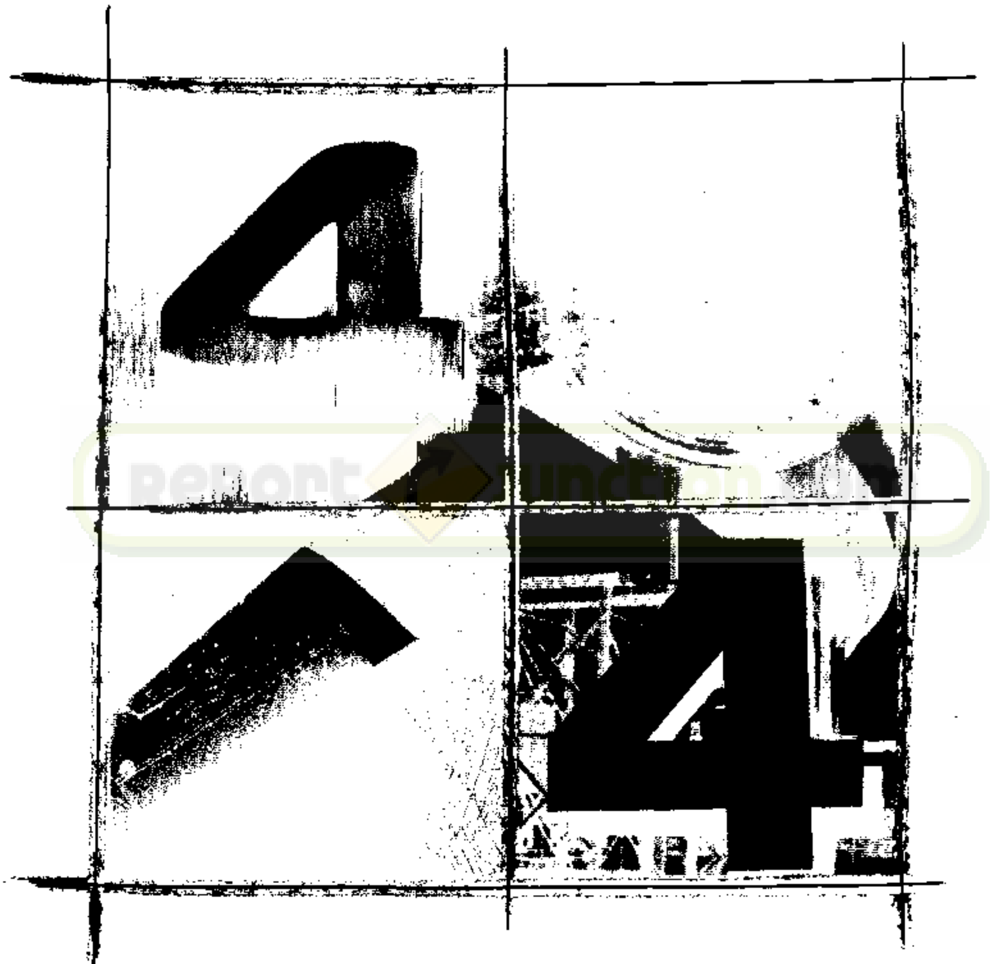
Eighth Annual Report 2004 - 2005



THE 4x4 STRATEGY

IDFC

Our Mission is to be the Financier and Advisor of Choice for Infrastructure in India

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Chairman's Statement

Fiscal 2005 has been a watershed year for IDFC. In this year: IDFC delivered record profits of Rs. 3,040 million representing a post tax RoA of 4.5%; annual approvals and disbursements reached new highs of Rs. 64,000 million and Rs. 37,000 million respectively; a new MD & CEO and two new EDs were recruited; a new business plan was approved by the Board. 1 am pleased to report that IDFC now stands poised to go public and thereby not only make good on its promise to provide an exit mechanism for existing shareholders, but more importantly to access new sources of capital to fund its future growth plans.

Overview of Recent Performance and fiscal 2005 highlights

In its seven years since inception, IDFC has established its credentials as a key player in India's infrastructure sector. IDFC has not only made a mark as an innovative project financier, but also as provider of advisory services to private and public sector clients, and as an objective sounding board on key policy issues relating to the infrastructure sector.

During fiscal 2002 to 2005, IDFC's net loans grew in excess of fifty percent per annum. At Rs. 84,000 million, today's balance sheet comprises a project finance book that is one of the largest of any financial institution in the country. IDFC's annual disbursements in 2005 accounted, by our estimates, for about a third of all infrastructure related project financing in the country during the year.

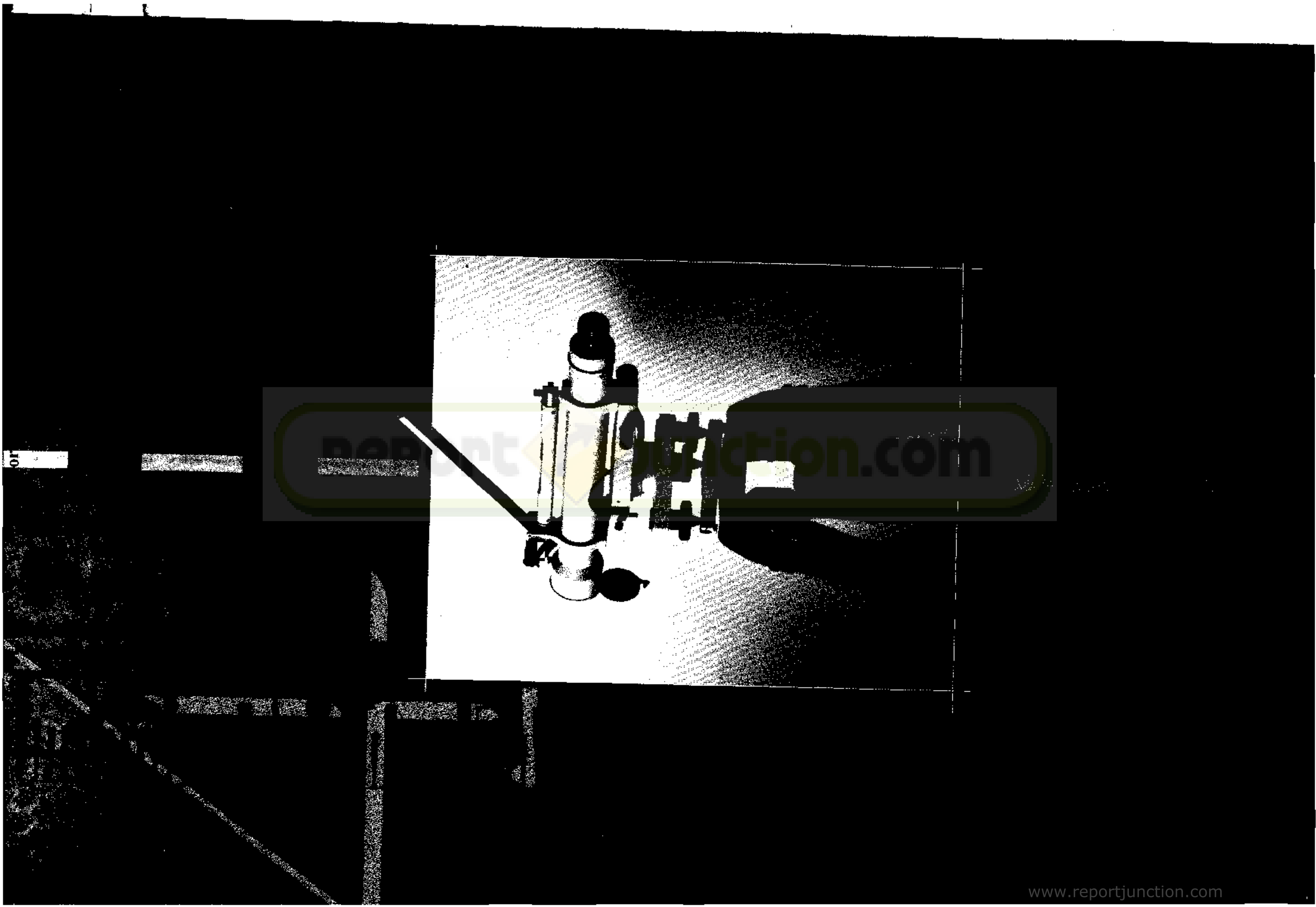
On a cumulative basis, as on March 31, 2005, IDFC had approved assistance of close to Rs. 250 billion to 198 projects. In fiscal 2005. IDFC approved financial assistance to 59 projects. Approvals to the energy sector in the fiscal were the highest and constituted about 28% of total. IDFC's total exposure to infrastructure projects was Rs. 124 billion, of which energy was the highest (34%), followed by telecommunications (27%) and transportation (26%).

In addition to its financing business, IDFC has developed a solid and an increasingly diverse base for generating non-interest revenues. IDFC has been awarded lead arranger mandates in every sector of engagement. For example, in fiscal 2005, IDFC was the lead arranger for the entire debt requirement for an LNG fired power plant in Gujarat; it led the Rs. 1,500 million toll securitisation of a completed toll road state highway in central India; it was awarded the mandate for arranging debt for two container terminals and a cargo seaport and was awarded the lead arranger mandate for the Hyderabad International Airport Project.

IDFC's infrastructure focused private equity operations have come into their own. The India Development Fund, managed by IDFC Private Equity, is the only private equity fund in the country that focuses on the infrastructure sector. Its corpus of Rs. 8,440 million is more than half invested and almost all of it is now committed to a variety of deals ranging from the port sector to hotels and the power sector.

IDFC has also used its own balance sheet to provide equity financing for infrastructure. Proprietary equity investments in IPOs and pre-IPO transactions has been a very profitable activity for IDFC. Over the past four years, the overall portfolio return for such investments has been 37% and there are significant unrealised gains still embedded in the outstanding proprietary equity book.

IDFC's credentials as an advisor were equally impressive. During the year, IDFC was financial advisor to an LNG fired power plant in Gujarat; won



an advisory mandate awarded by NHAI; was retained as a member of NHAI's Toll Strategy Committee; designed and ran the bidding process for the privatisation of solid waste collection and transportation in six zones of She MCD; was hired to appraise several projects under the National Rail Vikas Yojana and under the Industrial Infrastructure Upgradation Scheme of the Ministry of Commerce. In addition, iDeCK, IDFC's joint venture with the Government of Karnataka has been very active in the advisory space.

Finally, IDFC's considerable expertise and domain knowledge continues to be sought by policy makers in the infrastructure sector. In fiscal 2005, IDFC was closely involved with the Naresh Chandra Committee on Civil Aviation. IDFC was invited to be a member of the Prime Minister's Energy Policy Committee as well as the Government of Rajasthan's Working Group on Power. We provided key inputs and comments on the Central Electricity Regulatory Commission's consultation papers; we advised the Ministry of Road Transport and Highways on measures to make the National Highways Development Project financially sustainable and more responsive to user needs. Our views have been solicited by the Planning Commission on various topics such as Infrastructure Regulation, Minimum Subsidy Bidding and Power Sector Reform as well as by the Ministry of Finance on the use of dedicated funds for improving the delivery of infrastructure services and on the design of the proposed Special Purpose Vehicle mooted in the budget.

Even as the scale and scope of IDFC's income generating activities has grown rapidly, we have continued to manage our risks effectively and maintain high levels of operational productivity. Gross NPAs in FY 2005 were 0.7% of assets and net NPAs were zero. Our operating expense to assets ratio was 0.4%. As a result, even in an increasingly competitive environment that has put pressure on our lending margins, we have delivered superior profits. Our post-tax RoA of 4.5% remains exceptional relative to industry standards and combined with our still rather conservative leverage ratio of only 4x Tier 1 + Tier 2 capital suggests thai there is ample opportunity for us to maintain, if not improve, our Return on Equity going forward.

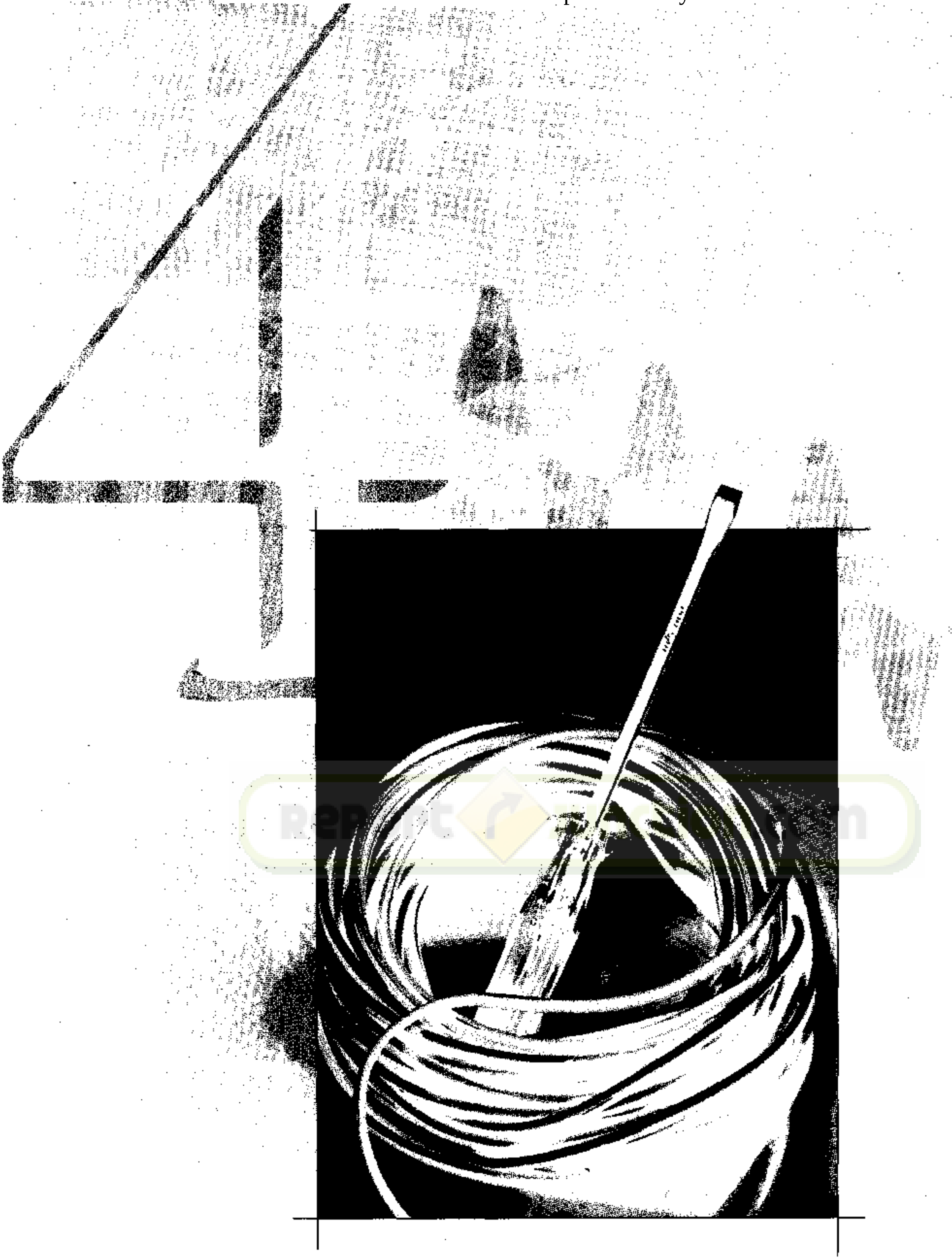
In short, IDFC has emerged as a substantial, robust and competitive platform for delivering speciality financial and advisory services to India's burgeoning infrastructure sector.

Prospects for the infrastructure sector - poised for a take-off

There is now widespread consensus about the need to address infrastructure bottlenecks if India is to sustain the momentum of high economic growth. The Government has been showing increasing commitment to developing the country's infrastructure by adopting a strategy of attracting private capital into the sector, inducing competition where feasible, and allowing its own role to change from provider and financier to that of a facilitator.

A range of policy initiatives, some new and some revived, have contributed to a sense of optimism about the growth and development of the infrastructure sector.

The spectacular progress of the telecom sector that began in the late 1990s continued apace with the tele-density rising from 2.8 in fiscal 2000 to 7.4 in fiscal 2004 and further to 9.1 in fiscal 2005, with the impetus for growth conning from a private sector



eager to meet growing consumer demand in an environment of rising competition and falling tariffs. To facilitate the future growth of this sector and help meet its substantial capital needs, the Government increased the FDI ceiling in a wide range of telecom services from 49% to 74%. We can expect to see a fresh wave of consolidation and increased demand for acquisition as well as capital expenditure financing in the coming years.

Prospects for the power sector also seem better than in recent years. The deterioration of performance of SEBs appears to have been arrested for now and the emergence of nationwide power trading has been a very significant development allowing surplus utilities and generators to sell to deficit areas. The door has now been opened to greater competition in the power sector. It is a matter of time before various State Governments succumb to the accumulating pressure to follow up on the framework for reform encapsulated in the Electricity Act of 2003. Meanwhile investment demand in the sector is picking up with 4000 MW of new capacity having been commissioned in fiscal 2005 and prospects for privatisation of power distribution looking more promising.

Several initiatives in the transport sector should catalyse major investments in this sector. The success of Phase 1 of the NHDP is paving the way for accelerated completion of Phase II and initiation of Phase III which will focus on up-grading of over 10,000 kms of national highways under the BOT method. In parallel, an initiative has also been launched to restructure NHAI to become a more effective facilitator of PPPs in the sector. The Government has thus clearly signaled its desire to attract private capital into road development and this can be expected to generate significant new financing opportunities.

In the ports sector, a draft policy covering development of major and minor ports, shipping and inland waterways as well private sector participation is being formulated in consultation with stakeholders. The Sagar Mala project envisages setting up new ports, modernising existing ones and connecting major ports with the country's main road arteries including the Golden Quadrilateral. Meanwhile, given rapid growth in shipping traffic, private investment in minor ports continues to gain momentum. More importantly, the need for containerisation is generating growing opportunities for privatisation of container handling facilities.

Civil aviation has seen significant reform momentum in the past year. Entry barriers have been lowered in the airline industry and this has already resulted in growing competition with new entrants eager to do business. The policy of liberalisation has contributed to a marked acceleration in domestic and international air traffic which grew by 25% and 18% respectively in fiscal 2005. Further, two greenfield airport projects in Bangalore and Hyderabad have been bid out and the GoI initiative to modernise the Delhi and Mumbai airports with private sector support have also seen significant progress.

Finally, fiscal 2005 saw significant policy initiatives in the areas of industrial and commercial infrastructure primarily through a relaxation of requirements for FDI participation in real estate development and passage of the Central Government's SEZ bill. This is already generating very significant interest from private investors looking for opportunities not only in the rapidly expanding hotel sector, but also in the areas of township development and IT parks.

Although there is always the risk of policy setbacks, all indications are that India's infrastructure sector is now poised for rapid growth in the years to come.