

DIRECT GENERAL CORP

Form 10-Q

May 14, 2004

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2004

or

- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _____ to _____

Commission File Number: 000-50360

DIRECT GENERAL CORPORATION

(Exact name of registrant as specified in its charter)

Tennessee

62-1564496

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer Identification No.)

1281 Murfreesboro Road, Nashville, TN

37217

(Address of principal executive offices)

(Zip Code)

(615) 399-0600

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes No

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 22,268,757 shares of common stock, no par value, at May 12, 2004.

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| | Three Months Ended March 31, | |
|---|---|---------------|
| | 2004 | 2003 |
| | (In thousands, except per share amounts) | |
| Revenues | | |
| Premiums earned | \$ 83,007 | \$ 47,675 |
| Finance income | 12,761 | 11,227 |
| Commission and service fee income | 13,495 | 8,499 |
| Net investment income | 2,276 | 1,381 |
| Net realized gains on securities and other | 69 | 266 |
| | <u>111,608</u> | <u>69,048</u> |
| Expenses | | |
| Insurance losses and loss adjustment expenses | 60,825 | 34,798 |
| Selling, general and administrative costs | 25,240 | 17,331 |
| Interest expense | 1,352 | 1,567 |
| | <u>87,417</u> | <u>53,696</u> |
| Income before income taxes | 24,191 | 15,352 |
| Income tax expense | 9,173 | 5,542 |
| | <u>15,018</u> | <u>9,810</u> |
| Preferred stock dividends Series B | | <u>140</u> |

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| | | |
|---|-------------------|-------------------|
| Net income available to common shareholders | \$ 15,018 | \$ 9,670 |
| | <u> </u> | <u> </u> |
| Earnings per Share | | |
| Basic earnings per common share | \$ 0.70 | \$ 0.80 |
| | <u> </u> | <u> </u> |
| Diluted earnings per common share | \$ 0.67 | \$ 0.56 |
| | <u> </u> | <u> </u> |

See notes to condensed consolidated financial statements.

Table of Contents**DIRECT GENERAL CORPORATION AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

| | (Unaudited) | December |
|--|-------------------|-------------------|
| | March 31, | 31, |
| | 2004 | 2003 |
| | <u> </u> | <u> </u> |
| | (In thousands) | |
| Assets | | |
| Investments: | | |
| Debt securities available-for-sale at fair value (amortized cost \$280,690 and \$263,929, at March 31, 2004 and December 31, 2003, respectively) | \$285,375 | \$ 264,998 |
| Short-term investments | 1,631 | 1,322 |
| | <u> </u> | <u> </u> |
| Total investments | 287,006 | 266,320 |
| Cash and cash equivalents | 117,789 | 87,342 |
| Finance receivables, net | 253,784 | 201,271 |
| Reinsurance balances receivable | 65,086 | 57,472 |
| Prepaid reinsurance premiums | 56,088 | 56,397 |
| Deferred policy acquisition costs | 12,099 | 11,432 |
| Deferred income taxes | 18,975 | 18,539 |
| Property and equipment | 14,185 | 13,775 |
| Goodwill, net | 22,188 | 20,840 |
| Other assets | 27,293 | 17,766 |
| | <u> </u> | <u> </u> |
| Total assets | \$874,493 | \$ 751,154 |
| | <u> </u> | <u> </u> |
| Liabilities and Shareholders Equity | | |
| Loss and loss adjustment expense reserves | \$ 113,332 | \$ 112,618 |
| Unearned premiums | 267,301 | 213,250 |
| Reinsurance balances payable and funds held | 68,544 | 62,223 |
| Accounts payable and accrued expenses | 12,463 | 13,105 |
| Income taxes payable | 9,964 | 2,369 |
| Notes payable | 176,819 | 148,946 |
| Capital lease obligations | 4,279 | 4,556 |
| Payable for securities | 8,680 | |
| Other liabilities | 18,778 | 16,692 |
| | <u> </u> | <u> </u> |
| Total liabilities | 680,160 | 573,759 |
| | <u> </u> | <u> </u> |

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| | | |
|--|-------------------|-------------------|
| Shareholders' equity | | |
| Preferred stock, no par; authorized shares 10,000.0; no shares issued | | |
| Common stock, no par; authorized shares 100,000.0; issued shares 21,657.7 and 21,350.6 at March 31, 2004 and December 31, 2003, respectively | 92,278 | 91,853 |
| Retained earnings | 99,892 | 85,735 |
| Accumulated other comprehensive income (loss): | | |
| Net unrealized appreciation on investment securities | 3,046 | 695 |
| Net loss on cash flow hedge | (883) | (888) |
| | <u> </u> | <u> </u> |
| Total shareholders' equity | 194,333 | 177,395 |
| | <u> </u> | <u> </u> |
| Total liabilities and shareholders' equity | \$874,493 | \$751,154 |
| | <u> </u> | <u> </u> |

See notes to condensed consolidated financial statements.

Table of Contents**DIRECT GENERAL CORPORATION AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

| | Three Months Ended March 31, | |
|---|---|-----------------|
| | 2004 | 2003 |
| | (In thousands) | |
| Operating activities | | |
| Net income | \$ 15,018 | \$ 9,810 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Net realized gains on securities and other | (69) | (266) |
| Depreciation and amortization | 1,331 | 1,160 |
| Deferred income taxes | (1,983) | (2,543) |
| Changes in operating assets and liabilities: | | |
| Finance receivables | (52,513) | (50,477) |
| Reinsurance balances receivable | (7,614) | 5,004 |
| Prepaid reinsurance premiums | 309 | (24,656) |
| Deferred policy acquisition costs | (667) | (2,069) |
| Income taxes recoverable/payable | 7,595 | 2,543 |
| Loss and loss adjustment expense reserves | 714 | 5,098 |
| Unearned premiums | 54,051 | 52,865 |
| Reinsurance balances payable and funds held | 6,321 | 16,508 |
| Accounts payable and accrued expenses | (690) | (462) |
| Other | (4,608) | 8,436 |
| | <u>17,195</u> | <u>20,951</u> |
| Investing activities | | |
| Proceeds from sales and maturities of debt securities available-for-sale | 54,504 | 8,481 |
| Purchase of debt securities available-for-sale | (67,775) | (23,955) |
| Payable for securities | 8,680 | |
| Net purchases of short-term investments | (309) | (2,000) |
| Purchase of property and equipment, net | (1,678) | (678) |
| Purchase of life insurance company | (7,330) | |
| | <u>(13,908)</u> | <u>(18,152)</u> |
| Financing activities | | |
| Issuances of common stock | 425 | |

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| | | |
|--|-------------------|-------------------|
| Proceeds from borrowings | 28,000 | 10,000 |
| Payment of principal on borrowings | (404) | (1,754) |
| Payment of stock dividends | (861) | (140) |
| | <u> </u> | <u> </u> |
| Net cash provided by financing activities | 27,160 | 8,106 |
| | <u> </u> | <u> </u> |
| Net increase in cash and cash equivalents | 30,447 | 10,905 |
| Cash and cash equivalents at beginning of period | 87,342 | 87,027 |
| | <u> </u> | <u> </u> |
| Cash and cash equivalents at end of period | <u>\$ 117,789</u> | <u>\$ 97,932</u> |

See notes to condensed consolidated financial statements.

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DIRECT GENERAL CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Nature of Operations

Direct General Corporation, headquartered in Nashville, Tennessee, is a financial services holding company whose principal operating subsidiaries provide non-standard personal automobile insurance, term life insurance, premium finance and other consumer products and services primarily on a direct basis throughout most of the southeastern United States. Direct General Corporation owns four property/casualty insurance companies, two life/health insurance companies, two premium finance companies, twelve insurance agencies, two administrative service companies and one company that provides non-insurance consumer products and services.

2. Basis of Presentation

The unaudited consolidated financial statements included herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (GAAP) have been condensed or omitted pursuant to such rules and regulations. The consolidated financial statements reflect all normal recurring adjustments which were, in the opinion of management, necessary for a fair statement of the results for the interim periods presented. The results of operations for the period ended March 31, 2004 are not necessarily indicative of the results expected for the full year. These unaudited consolidated financial statements and the notes thereto should be read in conjunction with the Company's audited financial statements and accompanying notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2003.

Effective August 11, 2003, the Company effected a stock split pursuant to which each outstanding share of the Company's common stock became 12 new shares of common stock. The Company has adjusted all share and per share amounts in the accompanying financial statements to reflect the 12 for 1 split.

3. Acquisitions

On January 30, 2004, the Company acquired an inactive life insurance company for a total purchase price of \$7.3 million of which approximately \$1.3 million was attributable to goodwill. The assets of this life insurance company consist of licenses to conduct life and/or accident and health insurance business in 43 states and the District of Columbia and debt securities.

4. Secondary Offering

On March 23, 2004, the Company completed a secondary offering whereby selling shareholders sold 3,314,015 shares of the Company's common stock. As result of the exercise of the over-allotment option by the underwriters of the secondary offering, the Company issued and sold an additional 497,102 common shares in April 2004, which resulted in net proceeds to the Company (after deducting issuance costs) of approximately \$16.0 million.

5. Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share:

| | Three Months Ended March 31, | |
|--|---|-------------------|
| | 2004 | 2003 |
| | (In thousands, except per share amounts) | |
| Numerator: | | |
| Net income available to common shareholders | \$ 15,018 | \$ 9,670 |
| Dividends paid to preferred shareholders | | 260 |
| | <u> </u> | <u> </u> |
| Income for purposes of computing diluted earnings per common share | <u>\$ 15,018</u> | <u>\$ 9,930</u> |
| Denominator: | | |
| Weighted average common shares outstanding | 21,503.0 | 12,119.1 |
| Dilutive stock options | 834.1 | 310.7 |
| Dilutive preferred stock | | 5,264.0 |
| | <u> </u> | <u> </u> |
| Weighted average common shares outstanding for purposes of computing diluted earnings per common share | <u>22,337.1</u> | <u>17,693.8</u> |
| Basic earnings per common share | <u>\$ 0.70</u> | <u>\$ 0.80</u> |
| Diluted earnings per common share | <u>\$ 0.67</u> | <u>\$ 0.56</u> |

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The Company follows the provisions of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, to account for its stock option activity in the financial statements. The Company granted all employee stock options currently outstanding at an exercise price equal to the market price at the date of grant and, therefore, under APB 25, no compensation expense is recorded. The Company follows the disclosure provisions of Statement of Financial Accounting Standards (SFAS) 123, Accounting for Stock-Based Compensation.

If the Company had elected to recognize stock compensation expense based on the fair value of stock options at the grant date, as prescribed by SFAS 123, net income available to common shareholders and basic and diluted earnings per share would have been reported as presented in the following table.

| | Three Months Ended March 31, | |
|--|---|-------------------|
| | 2004 | 2003 |
| | (In thousands, except per share amounts) | |
| Net income available to common shareholders, as reported | \$ 15,018 | \$ 9,670 |
| Deduct: Total stock-based employee compensation expense determined under the fair value based method, net of related tax effects | (252) | (19) |
| | <u> </u> | <u> </u> |
| Net income available to common shareholders, pro forma | <u>\$ 14,766</u> | <u>\$ 9,651</u> |
| Income for purposes of computing diluted earnings per share common, as reported | \$ 15,018 | \$ 9,930 |
| Deduct: Total stock-based employee compensation expense determined under the fair value based method, net of related tax effects | (252) | (19) |
| | <u> </u> | <u> </u> |
| Income for purposes of computing diluted earnings per share common, pro forma | <u>\$ 14,766</u> | <u>\$ 9,911</u> |
| Earnings per share | | |
| Basic as reported | <u>\$ 0.70</u> | <u>\$ 0.80</u> |

| | | | |
|---------|-------------|-------------------|-------------------|
| Basic | pro forma | \$ 0.69 | \$ 0.80 |
| | | <u> </u> | <u> </u> |
| Diluted | as reported | \$ 0.67 | \$ 0.56 |
| | | <u> </u> | <u> </u> |
| Diluted | pro forma | \$ 0.66 | \$ 0.56 |
| | | <u> </u> | <u> </u> |

7. Recent Accounting Pronouncements

The Company continually evaluates the impact of new accounting pronouncements and based on this analysis, the Company does not expect recently issued accounting standards to have a material impact on the Company's results of operations, financial condition, or cash flows.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

This Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Company's discussion presented under the caption Management's Discussion and Analysis of Financial Condition and Results of Operations that is available in the Annual Report on Form 10-K for the year ended December 31, 2003 filed with the Securities and Exchange Commission.

Overview

We are a provider of non-standard personal automobile insurance, premium finance and other insurance and non-insurance products and services. Our operations are concentrated in the southeastern part of the United States. Our business model integrates our insurance, premium finance and agency subsidiaries under one organization. Our model also emphasizes the distribution of our products and services through neighborhood sales offices staffed by salaried employee-agents as opposed to commissioned agents. The expansion of our neighborhood sales offices in selected states includes the use of independent insurance agencies, which we generally have options to acquire in the future.

Measurement of Results

We evaluate our operations by monitoring key measures of growth and profitability. We measure our growth by examining our gross revenues, which is comprised of gross premiums written and revenues from all other sources produced through our distribution system. We generally measure our operating results by examining our net income, return on equity, and our loss, expense and combined ratios. In addition, we evaluate our performance by comparing the level of our ancillary income to premiums earned and to operating expenses. The following provides further explanation of the key measures that we use to evaluate our results:

Gross Premiums Written. Gross premiums written is the sum of direct premiums written and assumed premiums written. Direct premiums written is the sum of the total policy premiums, net of cancellations, associated with policies underwritten and issued by our insurance subsidiaries. Assumed premiums written is the sum of total premiums associated with the insurance risk transferred to us by other insurance companies pursuant to reinsurance contracts. We use gross premiums written, which excludes the impact of premiums ceded to reinsurers, as a measure of the underlying growth of our insurance business from period to period.

Net Premiums Written. Net premiums written is the sum of direct premiums written and assumed premiums written less ceded premiums written. Ceded premiums written is the portion of our direct and assumed premiums that we transfer to our reinsurers in accordance with the terms of our reinsurance contracts based upon the risks they accept. We use net premiums written, primarily in relation to gross premiums written, to measure the amount of business retained after cessions to reinsurers.

Gross Revenues (a non-GAAP financial measure). Gross revenues are the sum of gross premiums written plus all other revenues (finance income, commission and service fee income, net investment income, and net realized gains (losses) on securities). We use gross revenues as the primary measure of the underlying growth of our revenue streams from period to period. Gross revenues are reconciled to total revenues in the Management's Discussion and Analysis of Financial Condition and Results of Operations Results of Operations .

Loss Ratio. Loss ratio is the ratio (expressed as a percentage) of losses and loss adjustment expenses incurred to premiums earned and measures the underwriting profitability of a company's insurance business. Loss ratio generally is measured on both a gross (direct and assumed) and net (gross less ceded) basis. We use the gross loss ratio as a measure of the overall underwriting profitability of the insurance business we write and to assess the adequacy of our

pricing. Our net loss ratio is meaningful in evaluating our financial results, which are net of ceded reinsurance, as reflected in our consolidated financial statements. Our loss ratios are generally calculated in the same way for GAAP and statutory accounting purposes.

Expense Ratio. Expense ratio is the ratio (expressed as a percentage) of net operating expenses to premiums earned and measures a company's operational efficiency in producing, underwriting and administering its insurance business. For statutory accounting purposes, operating expenses of an insurance company exclude investment expenses, and are reduced by other income. There is no such industry definition for determining an expense ratio for GAAP purposes. As a result, we apply the statutory definition to calculate our expense ratio on a GAAP basis. We reduce our operating expenses by ancillary income (excluding net investment income and realized gains (losses) on securities) to calculate our net operating expenses. Due to our historically high levels of reinsurance, we calculate our expense ratio on both a gross basis (before the effect of ceded reinsurance) and a net basis (after the effect of ceded reinsurance). Although the net basis is meaningful in evaluating our financial results that are net of ceded reinsurance, as reflected in our consolidated financial statements, we believe that the gross expense ratio more accurately reflects the operational efficiency of the underlying business and is a better measure of future trends.

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Combined Ratio. Combined ratio is the sum of the loss ratio and the expense ratio and measures a company's overall underwriting profit. If the combined ratio is at or above 100, an insurance company cannot be profitable without investment income (and may not be profitable if investment income is insufficient). We use the GAAP combined ratio in evaluating our overall underwriting profitability and as a measure for comparison of our profitability relative to the profitability of our competitors.

Ancillary Income Measures. We have developed measures of our ability to generate ancillary income (finance income and commission and service fee income) that reflect the differences between our business model and those used by our competitors. We measure our ancillary income as a percentage of premiums earned and as a percentage of our operating expenses. We believe that most of our competitors only achieve point of sale contact through an independent agent and are therefore typically unable to generate significant amounts of ancillary income.

Results of Operations

The table below summarizes certain operating results and key measures we use in monitoring and evaluating our operations. The information provided is intended to summarize and supplement information contained in our consolidated financial statements and to assist the reader in gaining a better understanding of our results of operations.

| (\$ in millions) | Three Months Ended March 31, | | % Change |
|--|---------------------------------|----------|-------------|
| | 2004 | 2003 | |
| | (Unaudited) | | |
| Selected Financial Data | | | |
| Gross premiums written | \$ 169.0 | \$ 140.6 | 20.2 |
| Ancillary income | 26.3 | 19.6 | 34.2 |
| Net investment income and realized capital gains | 2.3 | 1.7 | 35.3 |
| | | | |
| Gross revenues | \$ 197.6 | \$ 161.9 | 22.1 |
| | | | |
| Ceded premiums written | (31.7) | (64.7) | (51.0) |
| Change in net unearned premiums | (54.3) | (28.2) | 92.6 |
| | | | |
| Total revenues | \$ 111.6 | \$ 69.0 | 61.7 |
| | | | |
| Net income | \$ 15.0 | \$ 9.8 | 53.1 |
| | | | |
| Key Financial Ratios | | | |
| Loss ratio net | 73.3% | 73.0% | |
| Expense ratio net | 0.4% | (1.7%) | |

| | | |
|--|-------|--------|
| | — | — |
| Combined ratio net | 73.7% | 71.3% |
| | — | — |
| Ancillary income to net operating expenses | 98.7% | 104.4% |
| | — | — |

Overview of Operating Results

Net income increased 53.1% to \$15.0 million or \$0.67 per share, on a diluted basis, for the three months ended March 31, 2004, as compared to net income of \$9.8 million or \$0.56 per share, on a diluted basis, in the first quarter of 2003. For the quarter, gross premiums written increased 20.2% fueled by substantial growth in our renewal business and modest growth in new business. Total revenues increased 61.7% driven by a significant increase in net premiums earned due to the growth in gross premiums and an increase in the percentage of business retained. During the quarter, we continued to realize the benefits from the Cash Register agency network that was acquired in November 2003 by retaining the commission income on the sale of ancillary insurance products and converting the cost structure from a commission-based structure to the largely fixed cost structure provided by our business model. The Cash Register agency offices generated additional commission and administrative fee income of \$1.6 million and term life insurance sales of \$0.2 million for us. We also recognized a \$2.6 million reduction in operating costs associated with the Cash Register business as compared to the first quarter of 2003.

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The following table presents our gross premiums written in our major markets and provides a summary of gross, ceded and net premiums written and earned for the periods presented:

| (\$ in millions) | Three Months Ended March 31, | | % Change |
|---|---------------------------------|----------|-------------|
| | 2004 | 2003 | |
| | (Unaudited) | | |
| Gross premiums written | | | |
| Florida | \$ 83.9 | \$ 70.9 | 18.3 |
| Tennessee | 23.4 | 20.9 | 12.0 |
| Georgia | 12.3 | 11.9 | 3.4 |
| Louisiana | 12.5 | 10.5 | 19.0 |
| Mississippi | 10.1 | 8.4 | 20.2 |
| Texas | 7.0 | 1.8 | 288.9 |
| All other states | 19.8 | 16.2 | 22.2 |
| | | | |
| Gross premiums written | \$ 169.0 | \$ 140.6 | 20.2 |
| Ceded premiums written | (31.7) | (64.7) | (51.0) |
| | | | |
| Net premiums written | \$ 137.3 | \$ 75.9 | 80.9 |
| | | | |
| Gross premiums earned | \$ 115.0 | \$ 87.8 | 31.0 |
| Ceded premiums earned | (32.0) | (40.1) | (20.2) |
| | | | |
| Net premiums earned | \$ 83.0 | \$ 47.7 | 74.0 |
| | | | |
| Net premiums written to gross premiums written | 81.2% | 54.0% | |
| Gross premiums earned to gross premiums written | 68.0% | 62.4% | |
| Net premiums earned to net premiums written | 60.5% | 62.8% | |
| | | | |

Gross premiums written increased \$28.4 million or 20.2% for the three months ended March 31, 2004 compared to the first quarter of 2003. The increase in gross premiums written reflected increases of approximately \$23.2 million in our existing states and \$5.2 million in our expansion state, Texas. The premium growth in our existing states was

driven by increases in renewal policies in Florida, Arkansas and South Carolina and new business policies in Tennessee, Mississippi and South Carolina. There was minimal impact from rate increases in our existing states. Gross written premiums from the sale of our core non-standard automobile insurance business increased 19.4% to \$163.0 million while gross premiums written from the sale of our term life insurance business increased 46.3% to \$6.0 million as compared to the first quarter of 2003. Gross premiums earned, a function of gross premiums written over the current and prior periods, increased 31.0% to \$115.0 million in first quarter of 2004 versus the same period in 2003.

Gross premiums written in Texas continue to increase and are in line with our expectations to produce approximately \$40 million for the year. We expect to begin our initial advertising campaign in Texas in the third quarter of 2004, which is likely to involve the co-branding of Direct and the Texas independent agency network that we have an option to acquire the assets of at the end of 2004.

The growth in net premiums written and earned is a function of gross premiums written and earned less ceded premiums written and earned. The increased capitalization of our insurance subsidiaries enabled us to retain more business and, as a result, the ratio of net premiums written to gross premiums written increased to 81.2% during the first quarter of 2004 as compared to 54.0% in the first quarter of 2003. We expect to retain 80% to 90% of our gross premiums written in 2004.

Ancillary Income

Ancillary income for the three months ended March 31, 2004 increased 34.2% to \$26.3 million compared to the corresponding period in 2003. Approximately \$1.6 million of this increase was due to an increase in commission and service fee income on products sold by the Cash Register agency offices, which were acquired in the fourth quarter of 2003. During the first quarter of 2004, the penetration in the sales of ancillary insurance products increased, while premium finance income grew largely as a result of an increase in average finance receivables outstanding. The increase in finance income will not correspond proportionately with the increase in premiums earned since, in Texas, we are currently only issuing one-month policies and are not financing premiums. The ratio of ancillary income to gross premiums earned was 22.9% and 22.3% for the first quarter of 2004 and 2003,

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respectively, while the ratio of ancillary income to operating expenses decreased to 98.7% in the 2004 period from 104.4% in the 2003 period. Because operating expenses are net of ceded reinsurance commissions received and we have been reducing our level of reinsurance, our net operating expenses have increased resulting in a lower ratio of ancillary income to operating expenses.

Net Investment Income

Net investment income was \$2.3 million for the three months ended March 31, 2004 compared to \$1.4 million for the first quarter of 2003. The increase was due primarily to an increase in average invested assets partially offset by a decrease in investment yields. Average invested assets increased 95.5% to \$265.7 million in the first quarter of 2004 from \$135.2 million in the first quarter of 2003; however, the average investment yield decreased to 3.5% in the first quarter of 2004 from 4.3% in the corresponding period in 2003.

Realized Gains on Securities and Other

We realized gross gains of \$0.2 million and gross losses of \$0.2 million on the sale of securities for the three months ended March 31, 2004. Comparatively, we realized gross gains on debt securities of \$0.3 million and no gross losses for the comparable period in 2003. There was no impact on realized losses attributable to adjustments for other than temporary impairment of securities still held during these periods.

In the first quarter of 2004, we also realized gross gains of \$0.5 million and gross losses of \$0.8 million on closed contracts in our trading portfolio. The trading portfolio primarily consists of futures contracts, swaps, and other derivative instruments. This represents a speculative investment and does not represent a hedge; accordingly, all open contracts are marked to market with the change in market values included in net realized gains on securities and other in our consolidated statement of operations. During the quarter, the market value on open contracts increased by \$0.3 million, which was included in net realized gains on securities and other. As of March 31, 2004, we had open contracts with gross unrealized gains of \$0.2 million and gross unrealized losses of \$0.1 million.

Expenses

Insurance Losses and Loss Adjustment Expenses

Insurance losses and loss adjustment expenses increased to \$60.8 million for the three months ended March 31, 2004 from \$34.8 million for the same period in 2003. Net loss ratios for the first quarter of 2004 and 2003 were 73.3% and 73.0%, respectively. The Company's quarterly analysis of reserves resulted in a slight increase to prior year reserves, which increased the net loss ratio by 0.4 points in the first quarter of 2004. During the first quarter of 2003, the Company recognized \$0.8 million of favorable development on prior years' reserves, which reduced the net loss ratio by 1.7 points. The net loss ratios, excluding the impact of the adjustments to prior years' reserves, were 72.9% and 74.7% for the three months ended March 31, 2004 and 2003, respectively. The impact of catastrophic losses in both the first quarter of 2004 and 2003 was minimal.

Overall, our countrywide frequency and severity trends were relatively flat for the current quarter. We have been closely monitoring increases in claims frequency, particularly in the personal injury protection coverage in the Miami, Florida market over the past few quarters. We increased rates for personal injury protection coverages and have been actively challenging those claims believed to be fraudulent. As a result of these efforts, coupled with a substantial reduction in new business in the Miami, Florida market, we have begun to experience an improvement in the loss trends for the personal injury protection coverage in Florida. The loss ratio for our Texas business continues to be slightly better than our countrywide average for our existing states.

Operating Expenses

Operating expenses increased 40.7% to \$26.6 million for the three months ended March 31, 2004, compared to \$18.9 million for the same period of 2003. This increase in operating expenses was substantially lower than the 61.6% increase in total revenues primarily as a result of the reduction in operating costs associated with the acquisition of Cash Register agency offices in Florida. Operating expenses for the quarter reflected a \$2.6 million reduction in selling, general and administrative costs associated with the Cash Register business as the cost structure for this business was converted from a variable structure with commissioned independent agents to the largely fixed cost structure provided by our business model. The increase in operating costs compared to the first quarter of 2003 was driven by a reduction in ceded reinsurance commissions received of \$5.4 million and a \$4.9 million increase in other operating costs primarily associated with our growth in Texas and increased premium volumes in our existing states.

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Income Taxes

Our effective tax rates were 37.9% and 36.1% for the three-month periods ended March 31, 2004 and 2003, respectively. The increase in our effective tax rate is primarily due to an increase in state income taxes and a reduction in tax-exempt interest.

Financial Condition

Liquidity and Capital Resources

Sources and Uses of Funds

We are organized as a holding company system with all of our operations being conducted by our wholly-owned insurance, premium finance, agency, administrative and consumer product subsidiaries. Accordingly, Direct General Corporation receives cash through loans from banks, issuance of equity securities, subsidiary dividends and other transactions. We may use the proceeds from these sources to contribute to the capital of our insurance subsidiaries and premium finance company in order to support premium growth, to repurchase our common stock, to retire our outstanding indebtedness, to pay interest, dividends, and taxes, and for other business purposes.

Our operating subsidiaries' primary sources of funds are premiums received, finance income, commission and service fee income, investment income, borrowings under credit facilities and proceeds from the sale and redemption of investments. Funds are used to pay claims and operating expenses, to pay interest and principal repayments under the terms of our indebtedness for borrowed money, to purchase investments and to pay dividends to Direct General Corporation. We had positive cash flow from operations of approximately \$17.2 million and \$21.0 million in the first three months of 2004 and 2003, respectively. We expect our cash flows to be positive in both the short-term and reasonably foreseeable future.

Financing and Capital

During the first quarter of 2004, one of our insurance subsidiaries purchased an inactive life insurance company for a total purchase price of \$7.3 million. The life company has licenses in 43 states and the District of Columbia and we plan to sell our life insurance product in North Carolina, Texas and future expansion states through this entity. We also invested an additional \$5.5 million in our insurance subsidiaries to support premium growth and the increased retention of the business. During the first quarter of 2004, we paid a common stock dividend totaling \$0.9 million.

As of March 31, 2004, the maximum aggregate amount available under our revolving credit agreement used to support our premium finance operations was \$190.0 million and the amount outstanding was \$176.0 million. . Based on communications with our lenders, we expect to renew this facility for an additional two-year period when the facility matures on June 30, 2004. We do not expect any material changes in the underlying terms of the agreement.

In April 2004, we sold an additional 497,102 shares of common stock and received net proceeds of \$16.0 million after offering expenses in conjunction with a secondary offering. The proceeds from this offering will be used to further capitalize our insurance subsidiaries and for general corporate purposes.

Reinsurance

The increased capitalization of our insurance subsidiaries enabled us to reduce our quota share cession percentage. As a result, we ceded 18.8% of our gross premiums written to reinsurers in the three months ended March 31, 2004 as compared to 46.0% in the first quarter of 2003. Our quota share reinsurance agreement for 2004 also provides for

adjustments to the cession percentage during the year. We plan to cede between 10% and 20% of our gross premiums written to reinsurers during 2004.

Investments

Debt securities. Our investment portfolio primarily consists of debt securities, all classified as available-for-sale and carried at market value with unrealized gains and losses reported in our financial statements as a separate component of shareholders' equity on an after-tax basis. As of March 31, 2004, our investment portfolio of \$285.4 million included \$4.7 million in net unrealized gains. The effective duration of our investment portfolio was 4.1 years at March 31, 2004.

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The following table shows the composition by our internal industry classification of the amortized cost, gross unrealized gains, gross unrealized losses and fair value of debt securities available-for-sale as of March 31, 2004:

| (\$ in millions) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|-------------------|------------------------------|-------------------------------|----------------|
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 61.9 | \$ 0.6 | \$ 0.2 | \$ 62.3 |
| Obligations of states and political subdivisions | 50.7 | 2.0 | 0.1 | 52.6 |
| Corporate debt securities | | | | |
| Banks and financial institutions | 53.0 | 1.1 | 0.1 | 54.0 |
| Credit cards and auto loans | 59.7 | 0.5 | 0.2 | 60.0 |
| Industrial | 34.8 | 0.7 | 0.1 | 35.4 |
| Telecommunications | 12.1 | 0.3 | | 12.4 |
| Utilities and Electric Services | 8.5 | 0.2 | | 8.7 |
| | <u>168.1</u> | <u>2.8</u> | <u>0.4</u> | <u>170.5</u> |
| Corporate debt securities | | | | |
| Total | <u>\$280.7</u> | <u>\$ 5.4</u> | <u>\$ 0.7</u> | <u>\$285.4</u> |

The amortized cost and fair value of debt securities available-for-sale as of March 31, 2004, by contractual maturity, is shown below:

| (\$ in millions) | Amortized Cost | Fair Value |
|------------------------|-------------------|----------------|
| Years to maturity: | | |
| One or less | \$ 7.3 | \$ 7.3 |
| After one through five | 140.5 | 142.5 |
| After five through ten | 99.5 | 101.9 |
| After ten | <u>33.4</u> | <u>33.7</u> |
| Total | <u>\$ 280.7</u> | <u>\$285.4</u> |

The Securities Valuation Office of the National Association of Insurance Commissioners (NAIC) evaluates the bond investments of insurers for regulatory reporting purposes and assigns securities to one of six investment

categories called NAIC designations. The NAIC designations parallel the credit ratings of the Nationally Recognized Statistical Rating Organizations for marketable bonds. NAIC designations 1 and 2 include bonds considered to be investment grade, rated BBB- or higher by Standard & Poor's (S&P). NAIC designations 3 through 6 include bonds considered below investment grade, rated BB+ or lower by S&P. All of the debt securities in our portfolio were rated investment grade by the NAIC and S&P as of March 31, 2004. Investment grade securities generally bear lower yields and lower degrees of risk than those that are unrated or are rated non-investment grade.

The quality distribution of our investment portfolio as of March 31, 2004 was as follows:

(\$ in millions)

| NAIC | | | | |
|---------------|-----------------------|-----------------------|-------------------|------------------------|
| Rating | S&P Rating | Amortized Cost | Fair Value | % of Fair Value |
| 1 | AAA | \$124.5 | \$126.2 | 44.2% |
| 1 | AA | 29.4 | 30.5 | 10.7% |
| 1 | A | 61.8 | 63.0 | 22.1% |
| 2 | BBB | 33.1 | 33.6 | 11.8% |
| 1 | Agency | 31.9 | 32.1 | 11.2% |
| | | 280.7 | 285.4 | 100.0% |

We evaluate the risk versus reward tradeoffs of investment opportunities, measuring their effects on the stability, diversity, overall quality and liquidity of our investment portfolio. The primary market risk exposure to our debt securities portfolio is interest rate risk, which is limited by managing duration to a defined range of three to four years. Interest rate risk includes the risk from movements in the underlying market rate and in credit spreads of the respective sectors of debt securities held in our portfolio. The fair value of our fixed maturity portfolio is directly impacted by changes in market interest rates.

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The following table provides information about our investments that are sensitive to interest rate risk and provides estimates of expected changes in fair value based upon a 100 basis-point increase and decrease in market interest rates as of March 31, 2004:

| (\$ in millions) | -100 Basis Point Change | Fair Value | +100 Basis Point Change |
|-------------------------------------|-------------------------------|---------------|-------------------------------|
| Debt securities, available for sale | \$ 297.2 | \$ 285.4 | \$ 273.5 |

Short-term investments. We have a managed trading account with a commodities trading company and, as of March 31, 2004, the total fair value of open trades in this account was a \$0.1 million loss, which represents less than 1% of our entire investment portfolio. We invest in commodities, primarily cattle futures and swaps. U.S. Treasury securities of \$1.7 million, included in short-term investments and cash of \$1.0 million, included in cash and cash equivalents, are held as collateral for this account. We recognized net realized losses of \$0.3 million on closed contracts and a \$0.3 million gain on open contracts during the first quarter of 2004. Because this is a speculative investment and not a hedge, both the realized gains on closed contracts and the change in the fair value of open contracts are reported as net realized gains on securities and other in our consolidated statement of operations.

Cash and cash equivalents. Our balance in cash and cash equivalents was \$117.8 million as of as of March 31, 2004, which was approximately 35% higher than the balance of cash held at December 31, 2003. The increase was primarily attributable to the seasonality of the business.

Forward-Looking Statements

This report contains 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. All statements made in the report, other than statements of historical fact, are forward-looking statements. You can identify these statements from our use of the words may, should, could, potential, continue, plan, forecast, estimate, project, believe, expect, target, is likely, will, or the negative of these terms, and similar expressions. These statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements may include, among other things:

statements and assumptions relating to future growth, earnings, earnings per share and other financial performance measures, as well as management's short-term and long-term performance goals;

statements relating to the anticipated effects on results of operations or financial condition from recent and expected developments or events;

statements relating to our business and growth strategies; and

any other statements or assumptions that are not historical facts.

We believe that our expectations are based on reasonable assumptions. However, these forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause our actual results,

performance or achievements, or industry results, to differ materially from our expectations of future results, performance or achievements expressed or implied by these forward-looking statements. In addition, our past results of operations do not necessarily indicate our future results. We discuss these and other uncertainties in the Business Risks Related to our Business section of the Annual Report on Form 10-K for the year ended December 31, 2003 filed with the Securities and Exchange Commission on March 4, 2004.

You should not place undue reliance on any forward-looking statements. These statements speak only as of the date of this report. Except as otherwise required by applicable laws, we undertake no obligation to publicly update or revise any forward-looking statements or the risk factors described in this report, whether as a result of new information, future events, changed circumstances or any other reason after the date of this report.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Please see the caption Financial Condition Liquidity and Capital Resources in Part I FINANCIAL INFORMATION, Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations of this report for a description of our quantitative and qualitative disclosures about market risks.

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Item 4. Controls and Procedures.

Our management, with the participation of our chief executive officer and chief financial officer, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of the end of the period covered by this report. Based on that evaluation, the chief executive officer and chief financial officer have concluded that our disclosure controls and procedures are effective to ensure that material information relating to us and our consolidated subsidiaries is made known to such officers by others within these entities, particularly during the period this report was prepared, in order to allow timely decisions regarding required disclosure. There have not been any changes in our internal control over financial reporting during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1. Legal Proceedings.

We and our subsidiaries are named from time to time as defendants in various legal actions that are incidental to our business and arise out of or are related to claims made in connection with our insurance policies, claims handling, premium finance agreements and other contracts, and employment related disputes. The plaintiffs in some of these lawsuits have alleged bad faith or extracontractual damages and some have claimed punitive damages. We believe that the resolution of these legal actions will not have a material adverse effect on our financial position or results of operations.

During 2003, we entered into a voluntary settlement agreement regarding all aspects of two proposed class actions filed in Tennessee state courts alleging, among other things, that certain business practices relating to our premium finance and insurance operations were unlawful. The settlement became final on June 9, 2003. Out of over 1.1 million settlement class members to whom notices of the settlement were sent, approximately 130 persons gave notice that they elected not to participate in the settlement (opt-out). None of the class members objected to the settlement. The Tennessee court has determined that the majority of the purported opt-out notices were timely and properly submitted. The majority of the opt-out class members are represented by a single law firm, which recently filed a multi-plaintiff lawsuit against us and several of our subsidiaries in Holmes County, Mississippi. This lawsuit is in the early procedural stages, and the ultimate outcome of this case is uncertain. We intend to vigorously defend this lawsuit.

William C. Adair, Jr., our Chairman, Chief Executive Officer and President has been named as a defendant in a lawsuit filed in Tennessee state court in November 2003. The complaint alleges that Mr. Adair induced the plaintiff to market a Health Plan, that Mr. Adair made certain misrepresentations to the plaintiff and that Mr. Adair breached a contract that resulted in a loss of commissions to the plaintiff. Based on these allegations, plaintiff is seeking compensatory damages and an unspecified amount of punitive damages. We are not named as a defendant in this lawsuit; however, the plaintiff has recently filed a motion to name one of our subsidiary companies, Direct General Insurance Company, as a defendant. This lawsuit against Mr. Adair is still in the early procedural stages, and the ultimate outcome of this case is uncertain. If we or any of our subsidiaries are named as a defendant in this lawsuit, we will vigorously defend against any claims.

In addition to legal actions that are incidental to our business, one or more of our subsidiaries has been named as a defendant in a number of currently pending putative class action lawsuits. Please see the caption Business Legal Proceeding included in our Annual Report on Form 10-K for the year ended December 31, 2003 filed with the Commission on March 9, 2004 for a description of these legal actions.

Item 6. Exhibits and Reports on Form 8-K.

(a) List of exhibits:

- 31.1 Rule 13a-14(a) Certifications of CEO (pursuant to Section 302 of the Sarbanes-Oxley Act of 2002).
- 31.2 Rule 13a-14(a) Certifications of CFO (pursuant to Section 302 of the Sarbanes-Oxley Act of 2002).
- 32.1 Rule 1350 Certifications of CEO (pursuant to Section 906 of the Sarbanes-Oxley Act of 2002).

32.2 Rule 1350 Certifications of CFO (pursuant to Section 906 of the Sarbanes-Oxley Act of 2002).

(b) Reports of Form 8-K:

(i) Current Report on Form 8-K filed on February 11, 2004 to report earnings for the quarter ended December 31, 2003.

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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 authorized.

| | |
|--------------|---|
| May 14, 2004 | DIRECT GENERAL CORPORATION (Registrant) By: /s/ William C. Adair, Jr. |
| <hr/> | <hr/> |
| Date | (Signature) Name: William C. Adair, Jr. |
| | <hr/> |
| | Title: Chairman, Chief Executive Officer and President |
| | <hr/> |
| May 14, 2004 | By: /s/ Barry D. Elkins |
| <hr/> | <hr/> |
| Date | (Signature) Name: Barry D. Elkins |
| | <hr/> |
| | Title: Senior Vice President and Chief Financial Officer |
| | <hr/> |