

DIRECT GENERAL CORP

Form 10-Q

November 09, 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 September 30, 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: 22,360,046 shares of common stock, no par value, at November 8, 2004.

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	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
	<b>(In thousands except per share amounts)</b>			
<b>Revenues</b>				
Premiums earned	\$ 97,318	\$58,366	\$273,622	\$159,817
Finance income	11,695	11,246	37,158	33,693
Commission and service fee income	11,874	8,287	37,349	24,285
Net investment income	2,789	1,681	7,686	4,612
Net realized gains on securities and other	86	1,512	146	3,433
	<hr/>	<hr/>	<hr/>	<hr/>
Total revenues	123,762	81,092	355,961	225,840
	<hr/>	<hr/>	<hr/>	<hr/>
<b>Expenses</b>				
Insurance losses and loss adjustment expenses	71,765	43,189	200,852	118,178
Selling, general and administrative costs	28,393	18,423	78,781	53,405
Interest expense	1,257	1,562	4,148	4,934
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Total expenses	101,415	63,174	283,781	176,517
	<hr/>	<hr/>	<hr/>	<hr/>
Income before income taxes	22,347	17,918	72,180	49,323
Income tax expense	7,999	6,182	26,796	17,643
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Net income	14,348	11,736	45,384	31,680
Preferred stock dividends Series B		64		345
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Net income available to common shareholders	\$ 14,348	\$11,672	\$ 45,384	\$ 31,335

	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Earnings per Share</b>				
Basic earnings per common share	\$ 0.64	\$ 0.70	\$ 2.06	\$ 2.29
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Diluted earnings per common share	\$ 0.63	\$ 0.58	\$ 2.00	\$ 1.70
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

See notes to condensed consolidated financial statements.

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

	<b>(Unaudited) September 30, 2004</b>	<b>December 31, 2003</b>
	<b>(In thousands)</b>	
<b>Assets</b>		
Investments:		
Debt securities available-for-sale at fair value (amortized cost \$311,266 and \$263,929 at September 30, 2004 and December 31, 2003, respectively)	\$ 312,287	\$ 264,998
Short-term investments	1,661	1,322
	<hr/>	<hr/>
Total investments	313,948	266,320
Cash and cash equivalents	88,613	87,342
Finance receivables, net	224,600	201,271
Reinsurance balances receivable	48,395	57,472
Prepaid reinsurance premiums	40,287	56,397
Deferred policy acquisition costs	12,053	11,432
Income taxes recoverable	2,535	
Deferred income taxes	21,817	18,539
Property and equipment	15,694	13,775
Goodwill, net	22,188	20,840
Other assets	24,842	17,766
	<hr/>	<hr/>
Total assets	\$ 814,972	\$ 751,154
	<hr/>	<hr/>
<b>Liabilities and Shareholders Equity</b>		
Loss and loss adjustment expense reserves	\$ 120,186	\$ 112,618
Unearned premiums	236,100	213,250
Reinsurance balances payable and funds held	45,569	62,223
Accounts payable and accrued expenses	12,653	13,105
Income taxes payable		2,369
Notes payable	146,559	148,946
Capital lease obligations	3,833	4,556
Other liabilities	12,312	16,692
	<hr/>	<hr/>
Total liabilities	577,212	573,759
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Shareholders' equity		
Common stock, no par; authorized shares 100,000.0; issued shares 22,360.0 and 21,350.6 at September 30, 2004 and December 31, 2003, respectively	108,884	91,853
Retained earnings	128,471	85,735
Additional Paid-in Capital	196	
Accumulated other comprehensive income (loss):		
Net unrealized appreciation on investment securities	663	695
Net loss on cash flow hedge	(454)	(888)
	<u>          </u>	<u>          </u>
Total shareholders' equity	<u>237,760</u>	<u>177,395</u>
Total liabilities and shareholders' equity	<u>\$814,972</u>	<u>\$751,154</u>

See notes to condensed consolidated financial statements.



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

	<b>Nine Months Ended September 30,</b>	
	<b>2004</b>	<b>2003</b>
<b>(In thousands)</b>		
<b>Operating activities</b>		
Net income	\$ 45,384	\$ 31,680
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized gains on securities and other	(146)	(3,433)
Depreciation and amortization	4,170	3,323
Deferred income taxes	(3,495)	(5,119)
Changes in operating assets and liabilities:		
Finance receivables	(23,329)	(36,888)
Reinsurance balances receivable	9,077	(4,789)
Prepaid reinsurance premiums	16,110	(5,838)
Deferred policy acquisition costs	(621)	(2,595)
Income taxes recoverable/payable	(4,904)	(678)
Loss and loss adjustment expense reserves	7,568	18,891
Unearned premiums	22,850	43,953
Reinsurance balances payable and funds held	(16,654)	7,290
Accounts payable and accrued expenses	(500)	(510)
Other	(7,538)	(6,631)
	<u>47,972</u>	<u>38,656</u>
<b>Investing activities</b>		
Proceeds from sales and maturities of debt securities available-for-sale	100,308	72,833
Purchase of debt securities available-for-sale	(144,712)	(199,236)
Payable for securities		50,542
Net (sales) purchases of short-term investments	(339)	1,003
Purchase of property and equipment, net	(5,901)	(2,998)
Purchase of life insurance company	(7,330)	
	<u>(57,974)</u>	<u>(77,856)</u>
<b>Financing activities</b>		

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Issuances of common stock	17,031	72,493
Net (payment) proceeds from borrowings	(1,872)	27,676
Payment of principal on borrowings	(1,238)	(11,382)
Payment on stock dividends	(2,648)	(345)
Purchase of treasury stock		(33)
	<u>          </u>	<u>          </u>
Net cash provided by financing activities	11,273	88,409
	<u>          </u>	<u>          </u>
Net increase in cash and cash equivalents	1,271	49,209
Cash and cash equivalents at beginning of period	87,342	87,027
	<u>          </u>	<u>          </u>
Cash and cash equivalents at end of period	\$ 88,613	\$ 136,236
	<u>          </u>	<u>          </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, thirteen insurance agencies, two administrative service companies and one company that provides non-insurance consumer products and services.

**2. Basis of Presentation**

The unaudited condensed 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 unaudited condensed 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 three and nine months ended September 30, 2004 are not necessarily indicative of the results that may be expected for the full year. These unaudited condensed 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 consisted of licenses to conduct life and/or accident and health insurance business in 43 states and the District of Columbia and debt securities.

In October 2004, the Company gave notice of its intention to exercise the option to purchase certain assets of All American General Agency, Inc., a non-standard automobile insurance agency in Texas operating primarily under the name AMCO. The effective date of the acquisition is expected to be on or about December 31, 2004. The assets being acquired include customer records and renewal rights and the operating assets of approximately 65 sales offices used to conduct their automobile insurance agency business.

**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 a 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. Notes Payable**

The Company maintains a revolving credit facility with a consortium of banks to fund the working capital of the Company's premium finance operations. On July 1, 2004, the Company renewed its \$190 million revolving credit facility under substantially similar terms and extended its maturity for an additional three-year period to June 30, 2007. As of September 30, 2004, the amount outstanding under the facility was \$146.0 million.

**Table of Contents****6. Earnings Per Share**

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

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
<b>(In thousands, except per share amounts)</b>				
Numerator:				
Net income available to common shareholders	\$ 14,348	\$ 11,672	\$ 45,384	\$ 31,335
Dividends paid to preferred shareholders	_____	118	_____	639
Income for purposes of computing diluted earnings per common share	<u>\$ 14,348</u>	<u>\$ 11,790</u>	<u>\$ 45,384</u>	<u>\$ 31,974</u>
Denominator:				
Weighted average common shares outstanding	22,352.1	16,734.9	22,032.6	13,674.6
Dilutive stock options	420.7	710.1	620.8	668.2
Dilutive warrants		81.5		135.6
Dilutive preferred stock	_____	2,632.0	_____	4,377.0
Weighted average common shares outstanding for purposes of computing diluted earnings per common share	<u>22,772.8</u>	<u>20,158.5</u>	<u>22,653.4</u>	<u>18,855.4</u>
Basic earnings per common share	<u>\$ 0.64</u>	<u>\$ 0.70</u>	<u>\$ 2.06</u>	<u>\$ 2.29</u>
Diluted earnings per common share	<u>\$ 0.63</u>	<u>\$ 0.58</u>	<u>\$ 2.00</u>	<u>\$ 1.70</u>

**7. Stock Options**

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 generally grants employee stock options 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 disclosed in the following table in accordance with SFAS 148, Accounting for Stock-Based Compensation-Transition and Disclosure :

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
<b>(In thousands, except per share amounts)</b>				
Net income available to common shareholders, as reported	\$14,348	\$11,672	\$45,384	\$31,335
Deduct: Total stock-based employee compensation expense determined under the fair value based method, net of related tax effects	(219)	(114)	(659)	(144)
Net income available to common shareholders, pro forma	<u>\$14,129</u>	<u>\$11,558</u>	<u>\$44,725</u>	<u>\$31,191</u>
Income for purposes of computing diluted earnings per share common, as reported	\$14,348	\$11,790	\$45,384	\$31,974
Deduct: Total stock-based employee compensation expense determined under the fair value based method, net of related tax effects	(219)	(114)	(659)	(144)
Income for purposes of computing diluted earnings per share common, pro forma	<u>\$14,129</u>	<u>\$11,676</u>	<u>\$44,725</u>	<u>\$31,830</u>

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	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
	<b>(In thousands, except per share amounts)</b>			
Earnings per share				
Basic as reported	\$0.64	\$0.70	\$2.06	\$2.29
	—	—	—	—
Basic pro forma	\$0.63	\$0.69	\$2.03	\$2.28
	—	—	—	—
Diluted as reported	\$0.63	\$0.58	\$2.00	\$1.70
	—	—	—	—
Diluted pro forma	\$0.62	\$0.58	\$1.97	\$1.69
	—	—	—	—

**8. 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 ancillary income (finance income and commission and service fee income) and net investment income (excluding 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)	(Unaudited) Three Months Ended September 30,			(Unaudited) Nine Months Ended September 30,		
	2004	2003	% Change	2004	2003	% Change
<b>Selected Financial Data</b>						
Gross premiums written	\$106.9	\$103.7	3.1	\$377.7	\$ 332.2	13.7
Ancillary income	23.6	19.5	21.0	74.5	58.0	28.4
Net investment income	2.8	1.7	64.7	7.7	4.6	67.4
Gross revenues	\$133.3	\$124.9	6.7	\$459.9	\$ 394.8	16.5
Ceded premiums written	(17.5)	(29.7)	(41.1)	(65.1)	(134.3)	(51.5)
Change in net unearned premiums	7.9	(15.6)	(150.6)	(38.9)	(38.1)	2.1
Net realized gains on investments	0.1	1.5	(93.3)	0.1	3.4	(97.1)
Total revenues	\$123.8	\$ 81.1	52.7	\$356.0	\$ 225.8	57.7
Net income	\$ 14.3	\$ 11.7	22.2	\$ 45.4	\$ 31.7	43.2
<b>Key Financial Ratios</b>						
Loss ratio net	73.7%	74.0%		73.4%	73.9%	

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Expense ratio net	<u>6.2%</u>	<u>0.8%</u>	<u>3.1%</u>	<u>0.2%</u>
Combined ratio net	<u>79.9%</u>	<u>74.8%</u>	<u>76.5%</u>	<u>74.1%</u>
Ancillary income to gross premiums earned	19.8%	19.1%	21.0%	20.1%
Ancillary income to net operating expenses	<u>79.5%</u>	<u>97.5%</u>	<u>89.8%</u>	<u>99.5%</u>

***Overview of Operating Results***

Net income increased 22.2% to \$14.3 million or \$0.63 per share, on a diluted basis, for the three months ended September 30, 2004 and 43.2% to \$45.4 million or \$2.00 per share, on a diluted basis, for the nine months ended September 30, 2004 compared to the same periods in 2003. The increase in net income during the quarter, was primarily attributable to continued growth in premiums written and earned, and growth in ancillary income, which were partially offset by an increase in operating expenses. Total revenues increased 52.7% to \$123.8 million in the current quarter and operating expenses increased 48.5% to \$29.7 million. The loss ratio for the quarter improved slightly to 73.7% from 74.0% in the prior year quarter, even though losses for the current quarter included hurricane losses of \$2.3 million or approximately 2.4 points. Gross revenues increased 6.7% and 16.5% for the three and nine months ended September 30, 2004, respectively, compared to the same periods in 2003. Net realized gains, after tax, were \$0.1 million for both the three months and nine months ended September 30, 2004, but were \$1.0 million and \$2.2 million or \$0.05 and \$0.12 per diluted share for the three and nine months ended September 30, 2003, respectively.

**Table of Contents***Revenues**Premiums*

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)	(Unaudited) Three Months Ended September 30,			(Unaudited) Nine Months Ended September 30,		
	2004	2003	% Change	2004	2003	% Change
Gross premiums written						
Florida	\$ 53.2	\$ 53.3	(0.2)	\$189.3	\$ 170.9	10.8
Tennessee	14.6	15.0	(2.7)	51.6	49.1	5.1
Georgia	6.7	7.3	(8.2)	25.7	24.2	6.2
Louisiana	7.6	7.7	(1.3)	26.2	24.0	9.2
Texas	7.8	4.7	66.0	22.8	10.1	125.7
Mississippi	5.0	4.8	4.2	20.1	17.2	16.9
All other states	12.0	10.9	10.1	42.0	36.7	14.4
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Gross premiums written	\$106.9	\$103.7	3.1	\$377.7	\$ 332.2	13.7
Ceded premiums written	(17.5)	(29.7)	(41.1)	(65.1)	(134.3)	(51.5)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net premiums written	\$ 89.4	\$ 74.0	20.8	\$312.6	\$ 197.9	58.0
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Gross premiums earned	\$119.4	\$102.1	16.9	\$354.8	\$ 288.3	23.1
Ceded premiums earned	(22.1)	(43.7)	(49.4)	(81.2)	(128.5)	(36.8)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net premiums earned	\$ 97.3	\$ 58.4	66.6	\$273.6	\$ 159.8	71.2
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net premiums written to gross premiums written	83.6%	71.4%		82.8%	59.6%	
Gross premiums earned to gross premiums written	111.7%	98.5%		93.9%	86.8%	
Net premiums earned to net premiums written	108.8%	78.9%		87.5%	80.7%	
	<u>          </u>	<u>          </u>		<u>          </u>	<u>          </u>	

Gross premiums written increased \$3.2 million or 3.1% and \$45.5 million or 13.7% for the three and nine months ended September 30, 2004, respectively, compared to the same periods in 2003. Gross written premiums from the sale of our core non-standard automobile insurance business increased 2.4% and 12.9% for the three and nine month periods ended September 30, 2004, respectively, while gross premiums written from the sale of our term life insurance business increased 22.2% to \$4.4 million and 39.6% to \$14.1 million for the first three and nine months of 2004, respectively. Gross premiums earned, a function of gross premiums written over the current and prior periods, increased 16.9% and 23.1% in the three and nine months ended September 30, 2004, respectively, as compared to the same periods in 2003.

The increase in gross premiums written primarily reflected growth in our expansion state of Texas while gross premiums written in our existing states were flat overall. We have exercised our option to acquire the assets of approximately 65 sales offices in Texas from All American General Agency, Inc. ( AMCO ). In August, we began a limited advertising campaign in Texas, which initially involved the co-branding of Direct and AMCO. Co-branding with the AMCO name did not produce the level of new business that we expected. We believe that this was generally due to AMCO's poor brand name recognition resulting from a lack of advertising in recent years. As a result, we have made the decision to shift from co-branding to a focus on branding the Direct name, through both television and yellow page advertising. We are also developing additional sales offices in areas of Texas not currently served by the AMCO agency and expect to commence operations in our initial sales offices in Missouri and Virginia during the fourth quarter.

The premium growth in our existing states was impacted by the hurricanes that disrupted normal business operations in Florida and other states. Approximately 110 of our sales offices were closed for a day or more during the quarter, which we estimate resulted in a \$2.4 to \$2.8 million reduction in gross premiums written. In addition, many of our Florida customers experienced unexpected financial demands that slowed insurance purchases. We have not seen much downward pressure on rates by our competitors. However, in many of our remaining existing states, our growth has leveled off and we are seeing increased competition primarily in the form of increased advertising. In response, we made adjustments to our premium finance payment plans in several states in October and plan revisions to our advertising campaigns in order to attract more business.

The growth in net premiums written and earned is a function of gross premiums written and earned less ceded premiums written and earned. The ratio of net premiums written to gross premiums written increased to 83.6% and 82.8% for the three and nine months ended September 30, 2004. Comparatively, this ratio was only 71.4% and 59.6% for the corresponding periods in 2003,

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which was prior to the infusion of additional capital into our insurance subsidiaries from the proceeds raised in our initial public offering in the third quarter of 2003. We expect to retain approximately 85% of our gross premiums written in 2004. For 2005, we expect to slightly increase our retention to approximately 88%.

*Ancillary Income*

Ancillary income for the three and nine months ended September 30, 2004 was \$23.6 million and \$74.5 million, respectively, which represents an increase of 21.0% and 28.4%, respectively, compared to the corresponding periods in 2003. Commission and service fee income on products sold by the Cash Register agency offices, which were acquired in the fourth quarter of 2003, represented approximately \$1.4 million and \$4.6 million of the increase over the prior year quarter and year to date, respectively. In response to the multiple hurricanes that occurred during the third quarter of 2004, all insurance companies and premium finance companies were ordered by the Florida Department of Financial Services to grant an extension of the grace period until October 15<sup>th</sup> for any Florida customers whose payments were due between August 10<sup>th</sup> and October 15<sup>th</sup>. As a result of these orders, no additional late or cancellation fees could be charged during this period, which reduced our finance income by approximately \$1.0 million in the quarter.

The ratio of ancillary income to gross premiums earned was 19.8% and 19.1% for the third quarter of 2004 and 2003, respectively, while the ratio of ancillary income to operating expenses decreased to 79.5% in the 2004 period from 97.5% in the 2003 period. For the nine months ended September 30, 2004 and 2003, the ratio of ancillary income to gross premiums earned was 21.0% and 20.1%, respectively, and the ratio of ancillary income to operating expenses was 89.8% and 99.5%, respectively. The increase in ancillary income as a percentage of gross premiums earned is largely attributable to the increase in ancillary income produced by the Cash Register offices. The decline in the ratio of ancillary income to operating expenses is primarily associated with the increased retention of the business. 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. In addition, the reduction in finance income related to the extended grace periods in Florida reduced the ratio of ancillary income to operating expenses by 3.4 points and 1.3 points, for the three and nine months ended September 30, 2004.

*Net Investment Income*

Net investment income increased to \$2.8 million from \$1.7 million for the three months ended September 30, 2004 compared to the same period of 2003. The increase in investment income was due primarily to an increase in average invested assets. For the nine months ended September 30, 2004, net investment income increased to \$7.7 million from \$4.6 million in the corresponding period in 2003. The year to date increase in investment income was consistent with the 65.7% increase in average invested assets to \$288.9 million in the first nine months of 2004 from \$174.3 million in the first nine months of 2003. The return on the portfolio for the nine months ended September 30, 2004 and 2003 was 3.6% and 3.9%, respectively.

*Realized Gains (Losses) on Securities*

Net realized gains on securities were insignificant for the three months ended September 30, 2004 as compared to net realized gains of \$0.4 million in the corresponding period in 2003. We realized gross gains of \$0.1 million and \$0.3 million and gross losses of \$0.1 million and \$0.8 million on the sale of securities for the three and nine month periods ended September 30, 2004, respectively. The majority of these gains and losses were attributable to the sale of selected securities in favor of securities that offered more attractive yields and income potential. Comparatively, we realized gross gains of \$0.6 million and \$2.5 million for the three and nine month periods ended September 30, 2003, respectively, offset by gross realized losses of \$0.2 million for both periods. The prior year to date gross gains were

primarily attributable to the sale of certain securities as we repositioned our bond portfolio based on our investment guidelines for changes in market conditions and other factors. There was no impact on realized losses attributable to adjustments for other than temporary impairment of securities still held during these periods.

In the three and nine month periods ended September 30, 2004, we also realized gross gains of \$0.8 million and \$2.3 million and gross losses of \$0.3 million and \$2.0 million, respectively, 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. For the three and nine months ended September 30, 2004, the market value on open contracts decreased by \$0.4 million and increased by \$0.3 million, respectively, which was included in net realized gains on securities and other. As of September 30, 2004, we had open contracts with gross unrealized gains of \$0.1 million and gross unrealized losses of \$0.1 million.

**Table of Contents*****Expenses******Insurance Losses and Loss Adjustment Expenses***

Insurance losses and loss adjustment expenses increased to \$71.8 million for the three months ended September 30, 2004 from \$43.2 million for the same period in 2003. Net loss ratios for the third quarter of 2004 and 2003 were 73.7% and 74.0%, respectively. During the quarter, we recognized catastrophe losses totaling \$2.3 million associated with the four hurricanes that struck Florida and the Southeastern United States. The impact of weather related losses in the third quarter of 2003 was minimal. The Company's quarterly analysis of reserves resulted in an increase to the reserves for prior accident quarters of \$0.9 million or 0.9 points in the third quarter of 2004, which was primarily associated with the personal injury protection coverage in Florida. In comparison, the loss ratio for the third quarter of 2003 was increased by approximately 0.4 points of adverse reserve development.

For the nine months ended September 30, 2004, insurance losses and loss adjustment expenses increased to \$200.9 million from \$118.2 million in the corresponding 2003 period and the net loss ratios were 73.4% and 73.9%, respectively. The impact of weather related losses in both the first nine months of 2004 and 2003 was approximately 0.8 points on the respective loss ratios. Our 2004 year to date loss ratio was adversely impacted by approximately 1.5 points due to the strengthening of prior year reserves. The majority of this strengthening centered on an increase in the frequency and severity trends for the personal injury protection coverage, particularly in the Miami, Florida market, where we continue to experience high levels of fraudulent activity. For the nine months ended September 30, 2003, the loss ratio included approximately 0.2 points of favorable development on prior year's reserves. The accident year loss ratio, which excludes the impact of prior year reserve development, improved to 71.9% in 2004 from 74.1% in 2003, primarily as a result of a modestly higher level of premiums earned per exposure on both the personal injury protection and physical damage coverages. Overall, we have seen a small improvement in severity trends that were partially offset by a minor increase in claims frequency.

Over the past several quarters, we adjusted premium rates and increased the involvement of our special investigations unit in an attempt to combat the continued fraud problems in the Miami market, which represents approximately 5% of our total Florida premium volume. While the rate increases we implemented have resulted in a reduction in exposures in this market, we are still not satisfied with the level of losses on new business. As a result, our sales offices in the Miami market are no longer accepting applications for new business. We will, however, continue to service our profitable renewal book of business out of these offices.

***Operating Expenses***

Operating expenses increased 48.5% to \$29.7 million for the three months ended September 30, 2004, compared to \$20.0 million for the same period of 2003. The increase in operating costs compared to the third quarter of 2003 was driven by a reduction in ceded reinsurance commissions received of \$3.7 million and a \$6.0 million increase in other operating costs primarily associated with our growth and expansion, increased employee health and corporate insurance costs, increased advertising costs, and increased professional services costs related to the implementation of the Sarbanes-Oxley Act, all of which were partially offset by a reduction in the operating costs of the Cash Register agency offices in Florida.

For the nine months ended September 30, 2004, operating expenses increased 42.2% to \$82.9 million from \$58.3 million in the comparable period in 2003. The increase in operating expenses was primarily attributable to a \$14.6 million reduction in ceded reinsurance commissions received and a \$10.0 million increase in other operating costs associated with increased premium volumes and expansion including approximately \$4.7 million of net expenses attributable to our growth in Texas. We also experienced higher levels of employee health costs, corporate insurance costs, and professional services costs related to the implementation of the Sarbanes-Oxley Act, which were partially



offset by an overall reduction in operating costs for the Cash Register agency offices.

*Income Taxes*

Our effective tax rates were 35.8% and 34.5% for the three month periods ended September 30, 2004 and 2003, respectively. The effective tax rates for the nine months ended September 30, 2004 and 2003 were 37.1% and 35.8%, respectively. The increase in our effective tax rate over the corresponding periods in the prior year was 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*

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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 \$48.0 million and \$38.7 million for the nine months ended September 30, 2004 and 2003, respectively. We expect our cash flows from operations to be positive in both the short-term and reasonably foreseeable future.

### *Financing and Capital*

During the first nine months of 2004, we received \$17.0 million from the issuance of common stock including approximately \$16.0 million from the sale of 497,102 shares sold in our secondary stock offering. The remaining proceeds were primarily associated with common stock issued to employees in conjunction with their exercise of common stock options.

During the three and nine months ended September 30, 2004, we paid common stock dividends of \$0.9 million and \$2.6 million, respectively. Comparatively, we did not pay common stock dividends prior to our initial public offering of common stock in 2003, but did pay preferred stock dividends of \$0.1 million and \$0.3 million for the three and nine months ended September 30, 2003. All of the preferred shares outstanding were converted to common shares in conjunction with the initial public offering.

As of September 30, 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 \$146.0 million. This facility matures on June 30, 2007. We believe that we will be able to increase the size of this facility as necessary in order to meet the working capital needs of our finance operations.

### *Reinsurance*

The increased capitalization of our insurance subsidiaries enabled us to reduce our quota share cession percentage. As a result, we ceded 16.4% of our gross premiums written to reinsurers in the three months ended September 30, 2004 as compared to 28.6% in the third quarter of 2003. For the first nine months of 2004, we ceded 17.2% of our gross premiums written to reinsurers as compared to 40.4% for the corresponding period in 2003. We plan to cede approximately 15% and 12% of our gross premiums written to reinsurers during 2004 and 2005, respectively.

### *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 September 30, 2004, our investment portfolio of \$312.3 million included \$1.0 million in net unrealized gains. The effective duration of our investment portfolio was 4.1 years at September 30, 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 September 30, 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	\$52.9	\$ 0.3	\$ 0.5	\$52.7
Obligations of states and political subdivisions	50.0	1.5	0.1	51.4
Corporate debt securities				
Banks and financial institutions	58.6	0.5	0.5	58.6
Credit cards and auto loans	80.7	0.2	0.7	80.2
Industrial	36.7	0.4	0.3	36.8

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(\$ in millions)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Insurance	8.0	0.1	0.1	8.0
Telecommunications	11.4	0.2	0.1	11.5
Utilities and electric services	13.0	0.2	0.1	13.1
	<hr/>	<hr/>	<hr/>	<hr/>
Corporate debt securities	208.4	1.6	1.8	208.2
	<hr/>	<hr/>	<hr/>	<hr/>
Total	\$311.3	\$ 3.4	\$ 2.4	\$312.3
	<hr/>	<hr/>	<hr/>	<hr/>

The amortized cost and fair value of debt securities available-for-sale as of September 30, 2004, by contractual maturity, is shown below:

(\$ in millions)	Amortized Cost	Fair Value
Years to maturity:		
One or less	\$ 6.0	\$ 6.0
After one through five	163.7	163.7
After five through ten	99.0	100.1
After ten	42.6	42.5
	<hr/>	<hr/>
Total	\$311.3	\$312.3
	<hr/>	<hr/>

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 September 30, 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 September 30, 2004 was as follows:

(\$ in millions)				
NAIC Rating	S&P Rating	Amortized Cost	Fair Value	%

1	AAA	\$126.3	\$126.3	40.5%
1	AA	34.8	35.4	11.3%
1	A	78.9	79.2	25.4%
2	BBB	36.1	36.3	11.6%
1	Agency	35.2	35.1	11.2%
		<u>311.3</u>	<u>312.3</u>	<u>100.0%</u>

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.

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 September 30, 2004:

(\$ in millions)	-100 Basis Point Change	Fair Value	+100 Basis Point Change
Debt securities, available-for-sale	<u>\$ 325.0</u>	<u>\$312.3</u>	<u>\$ 299.6</u>

*Short-term investments.* We have a managed trading account with a commodities trading company and, as of September 30, 2004, the total fair value of open trades in this account was slightly negative. 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 \$1.6 million, included in cash and cash equivalents, are held as collateral for this account. We recognized net realized gains of \$0.5 million on closed contracts and a decrease in net unrealized gains of \$0.4 million on open contracts for the third 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 (losses) on securities and other in our consolidated statement of operations.

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*Cash and cash equivalents.* Our balance in cash and cash equivalents was \$88.6 million as of September 30, 2004, which was approximately 1.5% higher than the balance of cash held at December 31, 2003.

## **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 9, 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.

## **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 quarterly 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 determined that the majority of the purported opt-out notices were timely and properly submitted. The majority of the opt-out class members were represented by a single law firm, which filed a multi-plaintiff lawsuit against us. During the third quarter of 2004, we entered into a voluntary settlement agreement regarding all aspects of the opt-out lawsuit. The settlement did not have a material effect on our results for the third quarter of 2004.

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. For descriptions of these legal actions, please see the caption Business Legal Proceeding included in our Annual Report on Form 10-K for the year ended December 31, 2003 ( Form 10-K ) filed with the Securities and Exchange Commission ( SEC ) on March 9, 2004 and our periodic reports filed with the SEC under the Securities Exchange Act of 1934 since the filing of our Form 10-K.

**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 on Form 8-K:

- (i) Current Report on Form 8-K filed on August 4, 2004 to report earnings for the quarter ended June 30, 2004 (Item 12. Results of Operations and Financial Condition).



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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.

DIRECT GENERAL CORPORATION  
(Registrant)

November 8, 2004

By: /s/ William C. Adair, Jr.

\_\_\_\_\_  
Date

\_\_\_\_\_  
(Signature)

Name: William C. Adair, Jr.

Title: Chairman, Chief Executive Officer and President

November 8, 2004

By: /s/ Barry D. Elkins

\_\_\_\_\_  
Date

\_\_\_\_\_  
(Signature)

Name: Barry D. Elkins

Title: Senior Vice President and Chief Financial Officer