DIRECT GENERAL CORP
Form 10-Q
August 10, 2004

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2004

or

o **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 þ No o

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 22,349,246 shares of common stock, no par value, at August 6, 2004.

TABLE OF CONTENTS

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

DIRECT GENERAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
	(In thousands except per share amounts)			
Revenues				
Premiums earned	$ 93,297	$ 53,776	$ 176,304	$ 101,451
Finance income	12,702	11,220	25,463	22,447
Commission and service fee income	11,980	7,499	25,475	15,998
Net investment income	2,621	1,550	4,897	2,931
Net realized gains (losses) on securities and other	(9)	1,655	60	1,921
Total revenues	120,591	75,700	232,199	144,748
Expenses				
Insurance losses and loss adjustment expenses	68,262	40,191	129,087	74,989
Selling, general and administrative costs	25,148	17,651	50,388	34,982
Interest expense	1,539	1,805	2,891	3,372
Total expenses	94,949	59,647	182,366	113,343
Income before income taxes	25,642	16,053	49,833	31,405
Income tax expense	9,624	5,919	18,797	11,461
Net income	16,018	10,134	31,036	19,944
Preferred stock dividends Series B		141		281

Net income available to common shareholders	$ 16,018	$ 9,993	$ 31,036	$ 19,663
Earnings per Share				
Basic earnings per common share	$ 0.72	$ 0.82	$ 1.42	$ 1.62
Diluted earnings per common share	$ 0.70	$ 0.58	$ 1.37	$ 1.14

See notes to condensed consolidated financial statements.

Table of Contents

DIRECT GENERAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	(Unaudited) June 30, 2004	December 31, 2003
	(In thousands)	
Assets		
Investments:		
Debt securities available-for-sale at fair value (amortized cost $298,150 and $263,929 at June 30, 2004 and December 31, 2003, respectively)	$ 293,871	$ 264,998
Short-term investments	2,038	1,322
Total investments	295,909	266,320
Cash and cash equivalents	95,681	87,342
Finance receivables, net	236,302	201,271
Reinsurance balances receivable	48,471	57,472
Prepaid reinsurance premiums	44,902	56,397
Deferred policy acquisition costs	12,366	11,432
Income taxes recoverable	4,366	
Deferred income taxes	22,621	18,539
Property and equipment	14,460	13,775
Goodwill, net	22,188	20,840
Other assets	23,170	17,766
Total assets	$ 820,436	$ 751,154
Liabilities and Shareholders Equity		
Loss and loss adjustment expense reserves	$ 116,629	$ 112,618
Unearned premiums	248,636	213,250
Reinsurance balances payable and funds held	49,529	62,223
Accounts payable and accrued expenses	12,838	13,105
Income taxes payable		2,369
Notes payable	152,690	148,946
Capital lease obligations	4,063	4,556
Payable for securities	1,569	
Other liabilities	14,000	16,692
Total liabilities	599,954	573,759

Shareholders equity		
Common stock, no par; authorized shares 100,000.0; issued shares 22,349.2 and 21,350.6 at June 30, 2004 and December 31, 2003, respectively	108,769	91,853
Retained earnings	115,018	85,735
Accumulated other comprehensive income (loss):		
Net unrealized (depreciation) appreciation on investment securities	(2,781)	695
Net loss on cash flow hedge	(524)	(888)
Total shareholders equity	220,482	177,395
Total liabilities and shareholders equity	$ 820,436	$ 751,154

See notes to condensed consolidated financial statements.

Table of Contents

DIRECT GENERAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Six Months Ended June 30,	
	2004	2003
	(In thousands)	
Operating activities		
Net income	$ 31,036	$ 19,944
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized gains on securities and other	(60)	(1,921)
Depreciation and amortization	2,675	2,341
Deferred income taxes	(2,406)	(4,256)
Changes in operating assets and liabilities:		
Finance receivables	(35,031)	(37,057)
Reinsurance balances receivable	9,001	(1,736)
Prepaid reinsurance premiums	11,495	(19,850)
Deferred policy acquisition costs	(934)	(688)
Income taxes recoverable/payable	(6,735)	(2,459)
Loss and loss adjustment expense reserves	4,011	14,558
Unearned premiums	35,386	42,347
Reinsurance balances payable and funds held	(12,694)	13,690
Accounts payable and accrued expenses	(315)	(964)
Other	(4,486)	6,307
Net cash provided by operating activities	30,943	30,256
Investing activities		
Proceeds from sales and maturities of debt securities available-for-sale	85,104	49,948
Purchase of debt securities available-for-sale	(116,235)	(98,489)
Payable for securities	1,569	
Net (purchases) sales of short-term investments	(716)	2,745
Purchase of property and equipment, net	(3,297)	(1,698)
Purchase of life insurance company	(7,330)	
Net cash used in investing activities	(40,905)	(47,494)
Financing activities		
Issuances of common stock	16,804	
Proceeds from borrowings	4,066	45,218
Payment of principal on borrowings	(815)	(3,354)

Payment of stock dividends	(1,754)	(281)
Net cash provided by financing activities	18,301	41,583
Net increase in cash and cash equivalents	8,339	24,345
Cash and cash equivalents at beginning of period	87,342	87,027
Cash and cash equivalents at end of period	$ 95,681	$ 111,372

See notes to condensed consolidated financial statements.

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 six months ended June 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 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 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 June 30, 2004, the amount outstanding under the facility was $152.0 million.

Table of Contents

6. Earnings Per Share

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

	Three months ended June 30		Six months ended June 30	
	2004	2003	2004	2003
	(In thousands, except per share amounts)			
Numerator:				
Net income available to common shareholders	$ 16,018	$ 9,993	$ 31,036	$ 19,663
Dividends paid to preferred shareholders		261		521
Income for purposes of computing diluted earnings per common share	$ 16,018	$ 10,254	$ 31,036	$ 20,184
Denominator:				
Weighted average common shares outstanding	22,239.2	12,119.1	21,871.1	12,119.1
Dilutive stock options	602.5	310.7	718.1	310.7
Dilutive preferred stock		5,264.0		5,264.0
Weighted average common shares outstanding for purposes of computing diluted earnings per common share	22,841.7	17,693.8	22,589.2	17,693.8
Basic earnings per common share	$ 0.72	$ 0.82	$ 1.42	$ 1.62
Diluted earnings per common share	$ 0.70	$ 0.58	$ 1.37	$ 1.14

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 :

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(In thousands, except per share amounts)			
Net income available to common shareholders, as reported	$ 16,018	$ 9,993	$ 31,036	$ 19,663
Deduct: Total stock-based employee compensation expense determined under the fair value based method, net of related tax effects	(188)	(11)	(440)	(30)
Net income available to common shareholders, pro forma	$ 15,830	$ 9,982	$ 30,596	$ 19,633
Income for purposes of computing diluted earnings per share common, as reported	$ 16,018	$ 10,254	$ 31,036	$ 20,184
Deduct: Total stock-based employee compensation expense determined under the fair value based method, net of related tax effects	(188)	(11)	(440)	(30)
Income for purposes of computing diluted earnings per share common, pro forma	$ 15,830	$ 10,243	$ 30,596	$ 20,154

Table of Contents

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(In thousands, except per share amounts)			
Earnings per share				
Basic as reported	$ 0.72	$ 0.82	$ 1.42	$ 1.62
Basic pro forma	$ 0.71	$ 0.82	$ 1.40	$ 1.62
Diluted as reported	$ 0.70	$ 0.58	$ 1.37	$ 1.14
Diluted pro forma	$ 0.69	$ 0.58	$ 1.35	$ 1.14
Weighted average common shares	22,239.2	12,119.1	21,871.1	12,119.1
Fully diluted shares	22,841.7	17,693.8	22,589.2	17,693.8

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.

Table of Contents

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.

Table of Contents

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.

	(Unaudited) Three Months Ended June 30,			(Unaudited) Six Months Ended June 30,		
($ in millions)	**2004**	**2003**	**% Change**	**2004**	**2003**	**% Change**
Selected Financial Data						
Gross premiums written	$ 101.8	$ 87.9	15.8	$ 270.8	$ 228.5	18.5
Ancillary income	24.7	18.7	32.1	50.9	38.4	32.6
Net investment income	2.6	1.5	73.3	4.9	3.0	63.3
Gross revenues	$ 129.1	$ 108.1	19.4	$ 326.6	$ 269.9	21.0
Ceded premiums written	(16.0)	(39.9)	(59.9)	(47.6)	(104.6)	(54.5)
Change in net unearned premiums	7.5	5.8	29.3	(46.9)	(22.5)	108.4
Net realized gains on investments		1.7	NM	0.1	1.9	(94.7)
Total revenues	$ 120.6	$ 75.7	59.3	$ 232.2	$ 144.7	60.5
Net income	$ 16.0	$ 10.1	58.4	$ 31.0	$ 19.9	55.8
Key Financial Ratios						
Loss ratio net	73.2%	74.7%		73.2%	73.9%	

Expense ratio net	2.2%	1.4%	1.3%	(0.1%)
Combined ratio net	75.4%	76.1%	74.5%	73.8%
Ancillary income to gross premiums earned	20.5%	19.0%	21.6%	20.6%
Ancillary income to net operating expenses	92.5%	95.9%	95.5%	100.0%

Overview of Operating Results

Net income increased 58.4% to $16.0 million or $0.70 per share, on a diluted basis, for the three months ended June 30, 2004 and 55.8% to $31.0 million or $1.37 per share, on a diluted basis, for the six months ended June 30, 2004 compared to the same periods in 2003. The increase in net income was primarily attributable to continued growth in premiums written and earned, growth in ancillary income and a decrease in the loss ratio. Gross revenues increased 19.4% and 21.0% for the three and six months ended June 30, 2004, respectively, compared to the same periods in 2003. Approximately $3.6 million of the increase in net income for the second quarter was attributable to the Cash Register agency offices that were acquired in November 2003. The operating expenses associated with these offices decreased by $3.8 million as a variable (commissioned based) cost structure was replaced by the largely fixed cost structure provided by our business model. In addition, these offices generated total revenues of $1.9 million primarily from the sale of ancillary insurance products which, prior to our acquisition, remained with the agency. These favorable trends were partially offset by an increase in operating expenses and a reduction in net realized gains on securities and other. Net realized gains, after tax, were insignificant for the three months and six months ended June 30, 2004, but were $1.1 million and $1.2 million or $0.06 and $0.07 per diluted share for the three and six months ended June 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 June 30, 2004	2003	% Change	(Unaudited) Six Months Ended June 30, 2004	2003	% Change
Gross premiums written						
Florida	$ 52.2	$ 46.7	11.8	$ 136.1	$ 117.6	15.7
Tennessee	13.6	13.2	3.0	37.0	34.1	8.5
Georgia	6.7	5.0	34.0	19.0	16.9	12.4
Louisiana	6.1	5.8	5.2	18.6	16.3	14.1
Texas	8.0	3.6	122.2	15.0	5.4	177.8
Mississippi	5.0	4.0	25.0	15.1	12.4	21.8
All other states	10.2	9.6	6.3	30.0	25.8	16.3
Gross premiums written	$ 101.8	$ 87.9	15.8	$ 270.8	$ 228.5	18.5
Ceded premiums written	(16.0)	(39.9)	(59.9)	(47.6)	(104.6)	(54.5)
Net premiums written	$ 85.8	$ 48.0	78.8	$ 223.2	$ 123.9	80.1
Gross premiums earned	$ 120.4	$ 98.4	22.4	$ 235.4	$ 186.2	26.4
Ceded premiums earned	(27.1)	(44.7)	(39.4)	(59.1)	(84.8)	(30.3)
Net premiums earned	$ 93.3	$ 53.7	73.7	$ 176.3	$ 101.4	73.9
Net premiums written to gross premiums written	84.3%	54.6%		82.4%	54.2%	
Gross premiums earned to gross premiums written	118.3%	111.9%		86.9%	81.5%	
Net premiums earned to net premiums written	108.7%	111.9%		79.0%	81.8%	

Gross premiums written increased $13.9 million or 15.8% and $42.3 million or 18.5% for the three and six months ended June 30, 2004, respectively, compared to the same periods in 2003. The increase in gross premiums written reflected growth primarily from renewal policies in our existing states and new business growth in our expansion state of Texas. The premium growth in our existing states also included increases in new business policies in Georgia in conjunction with some modifications to our payment plans implemented after the second quarter of 2003 and Georgia s efforts to reduce its number of uninsured motorists. We also continue to build market share in Mississippi and South Carolina. There was minimal impact from rate changes in our existing states. Gross written premiums from the sale of our core non-standard automobile insurance business increased 14.7% and 17.6% for the three and six month periods ended June 30, 2004, respectively, while gross premiums written from the sale of our term life insurance business increased 54.2% to $3.7 million and 49.2% to $9.7 million for the first three and six months of 2004, respectively. The Cash Register agency offices, which were acquired in November 2003, have produced $1.2 million of life premiums for us through the first six months of 2004. These offices did not sell our life product prior to the acquisition. Gross premiums earned, a function of gross premiums written over the current and prior periods, increased 22.4% and 26.4% in the three and six months ended June 30, 2004, respectively, as compared to the same periods in 2003.

In early August, we commenced our initial advertising campaign in Texas, which involves 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. We have also begun to install our agency systems into some of the independent agency offices in Texas in anticipation of our acquisition of these offices at the end of the year. In addition to Texas, we are proceeding with our expansion into Missouri and Virginia. We are currently negotiating leases for sales office space in both states and expect to begin operations in the fourth quarter 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 ratio of net premiums written to gross premiums written increased to 84.3% and 82.4% for the three and six months ended June 30, 2004. Comparatively, this ratio was only 54.6% and 54.2% for the corresponding periods in 2003, 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.

Table of Contents

Ancillary Income

Ancillary income for the three and six months ended June 30, 2004 was $24.7 million and $50.9 million, respectively, which represents an increase of 32.1% and 32.6%, 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 $1.7 million and $3.3 million of the increase over the prior year quarter and year to date, respectively. During the second quarter of 2004, 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 20.5% and 19.0% for the second quarter of 2004 and 2003, respectively, while the ratio of ancillary income to operating expenses decreased slightly to 92.5% in the 2004 period from 95.9% in the 2003 period. For the six months ended June 30, 2004 and 2003, the ratio of ancillary income to gross premiums earned was 21.6% and 20.6%, respectively, and the ratio of ancillary income to operating expenses was 95.6% and 100.0%, 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.

Net Investment Income

Net investment income increased to $2.6 million from $1.5 million for the three months ended June 30, 2004 compared to the same period of 2003. The increase was due primarily to an increase in invested assets partially offset by a decrease in investment yields. For the six months ended June 30, 2004, net investment income increased to $4.9 million from $3.0 million in the corresponding period in 2003. The return on the portfolio for the six months ended June 30, 2004 and 2003 was 1.8% and 2.0%, respectively. Average invested assets increased 89.2% to $280.4 million in the first six months of 2004 from $148.2 million in the first six months of 2003.

Realized Gains (Losses) on Securities

Net realized losses on securities were insignificant for the three months ended June 30, 2004 as compared to net realized gains of $1.7 million in the corresponding period in 2003. We realized gross gains of $0.1 million and $0.2 million and gross losses of $0.6 million and $0.7 million on the sale of securities for the three and six month periods ended June 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 $1.7 million and $1.9 million for the three and six month periods ended June 30, 2003, respectively, with no gross realized losses during either period. 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. Approximately $1.2 million of the gains during the second quarter of 2003 were precipitated by our decision to reduce our investment in Georgia municipal obligations. 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 six month periods ended June 30, 2004, we also realized gross gains of $0.9 million and $1.4 million and gross losses of $0.8 million and $1.6 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 six months ended June 30, 2004, the market value on open contracts increased by $0.4 million and $0.7 million, respectively, which was included in net realized gains on securities and other. As of June 30, 2004, we had open contracts with gross unrealized gains of $0.4 million and gross unrealized losses of $0.1 million.

Expenses

Insurance Losses and Loss Adjustment Expenses

Insurance losses and loss adjustment expenses increased to $68.3 million for the three months ended June 30, 2004 from $40.2 million for the same period in 2003. Net loss ratios for the second quarter of 2004 and 2003 were 73.2% and 74.7%, respectively. The Company s quarterly analysis of reserves resulted in an increase to the reserves for prior accident quarters of $0.7 million or 0.7 points in the second quarter of 2004. During the quarter, we strengthened prior year reserves, primarily associated with the personal injury protection coverage in Florida, by approximately $2.0 million and reduced reserves associated with accidents occurring in the first quarter of 2004 by approximately $1.3 million due to lower than expected frequency trends for property and physical damage coverages primarily in Florida. In comparison, the loss ratio for the second quarter of 2003 was increased by approximately 2.2 points of weather related losses and by 0.5 points of adverse reserve development. The impact of weather related losses in the second quarter of 2004 was minimal.

For the six months ended June 30, 2004, insurance losses and loss adjustment expenses increased to $129.1 million from $75.0 million in the corresponding 2003 period and the net loss ratios were 73.2% and 73.9%, respectively. Our year to date loss ratio was adversely impacted by approximately 1.3 points due to the strengthening of prior year reserves. The impact of catastrophic losses for the first six months of 2004 was minimal. For the six months ended June 30, 2003, the loss ratio included approximately 1.2 points of weather related losses that were partially offset by 0.5 points of favorable development on prior year s reserves.

Overall, for the first six months of 2004, our countrywide frequency and severity trends were relatively flat for the personal injury protection and property damage coverages as compared to 2003; however, we have seen a slight improvement in the frequency for the bodily injury and physical damage coverages. 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. These trends appear to have stabilized and we are starting to see the benefits from the rate increases that we implemented in October 2003 and May 2004. 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 36.9% to $26.7 million for the three months ended June 30, 2004, compared to $19.5 million for the same period of 2003. This increase in operating expenses was substantially lower than the 59.3% 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 $3.8 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 second quarter of 2003 was driven by a reduction in ceded reinsurance commissions received of $5.5 million and a $5.5 million increase in other operating costs primarily associated with corporate insurance and employee health insurance costs, our growth in Texas and increased premium volumes in our existing states.

For the six months ended June 30, 2004, operating expenses increased 38.8% to $53.3 million from $38.4 million in the comparable period in 2003. The increase in operating expenses was primarily attributable to a $10.9 million reduction in ceded reinsurance commissions received and other increases in operating costs associated with increased premium volumes totaling $10.4 million, which were partially offset by a $6.4 million reduction in operating costs associated with the Cash Register agency offices.

Income Taxes

Our effective tax rates were 37.5% and 36.9% for the three month periods ended June 30, 2004 and 2003, respectively. The effective tax rates for the six months ended June 30, 2004 and 2003 were 37.7% and 36.5%, 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

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

Table of Contents

approximately $30.9 million and $30.3 million for the six months ended June 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 six months of 2004, we received $16.7 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 six months ended June 30, 2004, we paid common stock dividends of $0.9 million and $1.7 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 six months ended June 30, 2003. All of the preferred shares outstanding were converted to common shares in conjunction with the initial public offering.

As of June 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 $152.0 million. We renewed this facility for an additional three-year period on July 1, 2004. We believe that this facility will be sufficient to meet the working capital needs of our finance operations.

Reinsurance

The increased capitalization of our insurance subsidiaires enabled us to reduce our quota share cession percentage. As a result, we ceded 15.7% of our gross premiums written to reinsurers in the three months ended June 30, 2004 as compared to 45.4% in the second quarter of 2003. For the first six months of 2004, we ceded 17.6% of our gross premiums written to reinsurers as compared to 45.8% for the corresponding period in 2003. We plan to cede approximately more than 15% 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 June 30, 2004, our investment portfolio of $293.9 million included $4.3 million in net unrealized losses. The effective duration of our investment portfolio was 4.1 years at June 30, 2004.

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 June 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	$ 49.9	$ 0.1	$ 1.1	$ 48.9
Obligations of states and political subdivisions	50.3	0.9	0.4	50.8
	57.6	0.2	1.5	56.3

Corporate debt securities Banks and financial institutions				
Credit cards and auto loans	77.0	0.1	1.2	75.9
Industrial	34.6	0.1	0.9	33.8
Insurance	6.8		0.2	6.6
Telecommunications	12.5	0.1	0.3	12.3
Utilities and Electric Services	9.5		0.2	9.3
Corporate debt securities	198.0	0.5	4.3	194.2
Total	$ 298.2	$ 1.5	$ 5.8	$ 293.9

13

Table of Contents

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

($ in millions)	Amortized Cost	Fair Value
Years to maturity:		
One or less	$ 7.4	$ 7.4
After one through five	152.4	150.6
After five through ten	99.8	97.9
After ten	38.6	38.0
Total	$ 298.2	$293.9

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 June 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 June 30, 2004 was as follows:

($ in millions) NAIC Rating	S&P Rating	Amortized Cost	Fair Value	%
1	AAA	$121.7	$120.4	41.0%
1	AA	36.0	35.9	12.2%
1	A	73.8	72.2	24.5%
2	BBB	35.7	34.9	11.9%
1	Agency	31.0	30.5	10.4%
		$298.2	$293.9	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.

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 June 30, 2004:

($ in millions)	**-100 Basis Point Change**	**Fair Value**	**+100 Basis Point Change**
Debt securities, available-for-sale	$ 305.8	$ 293.9	$ 281.9

Short-term investments. We have a managed trading account with a commodities trading company and, as of June 30, 2004, the total fair value of open trades in this account was $0.3 million, 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 $1.1 million, included in cash and cash equivalents, are held as collateral for this account. We recognized net realized losses of $0.2 million on closed contracts and an increase in net unrealized gains of $0.7 million on open contracts for the second 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.

Cash and cash equivalents. Our balance in cash and cash equivalents was $95.7 million as of June 30, 2004, which was approximately 9.5% higher than the balance of cash held at December 31, 2003. The increase was primarily attributable to the growth in business.

Table of Contents

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.

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.

As we anticipated, one of our subsidiary companies, Direct General Insurance Company (DGIC), has recently been added as a defendant to the previously disclosed lawsuit filed against William C. Adair, Jr., our Chairman, Chief Executive Officer and President in Tennessee state court in November 2003. The original complaint alleged 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. The amended complaint alleges additionally that such alleged actions of Mr. Adair were in his capacity as an officer of DGIC and were on behalf of DGIC. Based on these allegations, plaintiff is seeking compensatory damages and an unspecified amount of punitive damages from each of the named defendants. This lawsuit is still in the early procedural stages, and the ultimate outcome of this case is uncertain. We intend to vigorously defend this lawsuit.

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 May 10, 2004 to report earnings for the quarter ended March 31, 2004 (Item 12. Results of Operations and Financial Condition).

(ii) Current Report on Form 8-K filed on June 8, 2004 to report the adoption of a personal trading plan in accordance with the Securities and Exchange Commission s Rule 10b5-1 (Item 5. Other Events).

Table of Contents

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)

August 9, 2004 Date	By:	/s/ William C. Adair, Jr. (Signature)
	Name:	William C. Adair, Jr.
	Title:	Chairman, Chief Executive Officer and President
August 9, 2004 Date	By:	/s/ Barry D. Elkins (Signature)
	Name:	Barry D. Elkins
	Title:	Senior Vice President and Chief Financial Officer