

DIRECT GENERAL CORP

Form 10-Q

May 09, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q**

(Mark One)

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

For the quarterly period ended March 31, 2006

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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 20,347,675 shares of common stock, no par value, at May 5, 2006.

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**DIRECT GENERAL CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Unaudited)

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(In thousands, except per share amounts)</b>	
<b>Revenues</b>		
Premiums earned	\$ 101,888	\$ 101,913
Finance income	11,763	12,171
Commission and service fee income	14,053	14,267
Net investment income	4,124	3,329
Net realized (losses) gains on securities and other	(1,015)	31
 Total revenues	 130,813	 131,711
 <b>Expenses</b>		
Insurance losses and loss adjustment expenses	77,217	75,882
Selling, general and administrative costs	36,206	32,784
Interest expense	2,678	1,310
 Total expenses	 116,101	 109,976
 Income before income taxes	 14,712	 21,735
Income tax expense	5,552	8,152
 Net income	 \$ 9,160	 \$ 13,583
 <b>Earnings per Share</b>		
Basic earnings per common share	\$ 0.45	\$ 0.61
Diluted earnings per common share	\$ 0.45	\$ 0.61

See notes to condensed consolidated financial statements.

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

	(Unaudited)	
	March 31, 2006	December 31, 2005
	(In thousands)	
<b>Assets</b>		
Investments:		
Debt securities available-for-sale at fair value (amortized cost \$395,760 and \$395,159 at March 31, 2006 and December 31, 2005, respectively)	\$ 384,590	\$ 388,032
Short-term investments	3,173	3,688
Total investments	387,763	391,720
Cash and cash equivalents	111,022	64,527
Finance receivables, net	263,762	214,796
Reinsurance balances receivable	23,060	27,083
Prepaid reinsurance premiums	12,025	24,440
Goodwill and other tangible assets, net	31,621	31,621
Deferred policy acquisition costs	20,264	13,804
Income taxes recoverable	719	4,692
Deferred income taxes	22,611	21,915
Property and equipment, net	17,531	18,346
Other assets	26,832	28,068
Total assets	\$ 917,210	\$ 841,012
<b>Liabilities and Shareholders Equity</b>		
Loss and loss adjustment expense reserves	\$ 132,517	\$ 131,408
Unearned premiums	263,659	214,715
Reinsurance balances payable and funds held	20,228	32,024
Accounts payable and accrued expenses	17,587	12,550
Notes payable	179,337	153,009
Debentures payable	41,238	41,238
Capital lease obligations	2,291	2,636
Payable for securities	495	3,187
Other liabilities	15,795	12,713
Total liabilities	673,147	603,480
Shareholders equity		
Common stock, no par; authorized shares 100,000.0; issued shares 20,347.7 and 20,339.2 at March 31, 2006 and December 31, 2005, respectively	70,048	69,700
Retained earnings	180,126	171,780
Accumulated other comprehensive (loss) income:		
Net unrealized depreciation on investment securities	(7,260)	(4,633)
Net gain on cash flow hedge	1,149	685

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Total shareholders' equity	244,063	237,532
Total liabilities and shareholders' equity	\$ 917,210	\$ 841,012

See notes to condensed consolidated financial statements.

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

	<b>Three Months Ended March</b>	
	<b>31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>	
<b>Operating activities</b>		
Net income	\$ 9,160	\$ 13,583
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized losses (gains) on securities and other	1,015	(31)
Depreciation and amortization	2,294	1,616
Deferred income taxes	469	(841)
Changes in operating assets and liabilities:		
Finance receivables, net	(48,966)	(42,507)
Reinsurance balances receivable	4,023	839
Prepaid reinsurance premiums	12,415	(1,664)
Deferred policy acquisition costs	(6,460)	(2,105)
Income taxes recoverable/payable	3,973	7,850
Loss and loss adjustment expense reserves	1,109	(2,130)
Unearned premiums	48,944	43,073
Reinsurance balances payable and funds held	(11,796)	3,661
Accounts payable and accrued expenses	5,037	3,374
Other	5,359	4,400
Net cash provided by operating activities	26,576	29,118
<b>Investing activities</b>		
Proceeds from sales and maturities of debt securities available-for-sale	22,205	22,132
Purchase of debt securities available-for-sale	(23,710)	(24,766)
Payable for securities	(2,692)	625
Net purchases of short-term investments	(198)	(359)
Purchase of property and equipment, net	(879)	(2,220)
Purchase of insurance agency assets		(4,799)
Net cash used in investing activities	(5,274)	(9,387)
<b>Financing activities</b>		
Repurchase of common stock		(9,999)
Issuances of common stock	23	543
Net proceeds from borrowings	27,000	37,800
Payment of principal on borrowings	(1,016)	(452)
Payment of dividends on common stock	(814)	(892)
Net cash provided by financing activities	25,193	27,000
Net increase in cash and cash equivalents	46,495	46,731

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Cash and cash equivalents at beginning of period	64,527	70,988
Cash and cash equivalents at end of period	\$ 111,022	\$ 117,719

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 and primarily in the southeastern United States. Direct General Corporation owns five property/casualty insurance companies, two life/health insurance companies, two premium finance companies, twelve insurance agencies, two administrative service companies and one company that provides non-insurance consumer products and services. Direct General Corporation and its subsidiaries are sometimes collectively referred to herein as the Company.

**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 period ended March 31, 2006 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, 2005.

**3. Notes Payable**

The Company maintains a \$190.0 million revolving credit facility with a consortium of banks to fund the working capital of the Company's premium finance operations. As of March 31, 2006, the amount outstanding under the facility, which matures on June 30, 2007, was \$177.0 million. Direct General Corporation also has a \$30.0 million revolving credit facility available to support its operations and strategic initiatives. No amounts were outstanding under this facility as of March 31, 2006.

**4. Earnings Per Share**

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

	<b>Three Months Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(In thousands, except per share amounts)</b>	
Numerator:		
Net income	\$ 9,160	\$ 13,583
Denominator:		
Weighted average common shares outstanding	20,343.4	22,272.3
Dilutive stock options	41.3	125.6
Weighted average common shares outstanding for purposes of computing diluted earnings per common share	20,384.7	22,397.9
Basic earnings per common share	\$ 0.45	\$ 0.61

Diluted earnings per common share	\$	0.45	\$	0.61
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**Table of Contents****5. Stock Options**

The Company has historically used and plans to continue to use stock options as a component of its overall compensation to employees. The Company may grant incentive stock options that qualify for certain favorable tax treatment under Section 422 of the Internal Revenue Code of 1986. It may also grant stock options that do not qualify for such favorable tax treatment. The Company generally grants employee incentive stock options at an exercise price equal to the market price at the date of grant.

Effective January 1, 2006, the Company adopted the provisions of the Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, which was issued in December 2004 and is effective for periods beginning after June 15, 2005. This statement requires the Company to expense the cost resulting from all share-based payment arrangements, including employee stock options, in its financial statements. The Company adopted the provisions of this statement using the modified prospective approach. This approach requires that compensation expense to be recorded for all unvested stock options and restricted stock that exist upon adoption of the statement as these options vest. New stock options that are granted are recognized as expense in the financial statements based on their fair values at the grant date. The Company recorded pre-tax compensation expense of \$0.3 million for the first three months of 2006.

Prior to the adoption of the provisions of this statement, the Company followed the provisions of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, to account for its employee stock option activity in the financial statements.

If the accounting for compensation expense based on the fair value of stock options at the grant date as prescribed by SFAS No. 123 would have been in effect for prior periods, net income available to common shareholders and basic and diluted earnings per share would have been reported as presented in the following table.

	<b>Three Months ended March 31, 2005</b>
	(in thousands, except per share amounts)
Net income, as reported	\$ 13,583
Deduct: Total stock-based employee compensation expense determined under the fair value based method, net of related tax effects	(218)
Net income, pro forma	\$ 13,365
Income for purposes of computing diluted earnings per share common, as reported	\$ 13,583
Deduct: Total stock-based employee compensation expense determined under fair value based method, net of related tax effects	(218)
Income for purposes of computing diluted earnings per share common, pro forma	\$ 13,365
Earnings per share	
Basic as reported	\$ 0.61
Basic pro forma	\$ 0.60

Diluted as reported	\$	0.61
Diluted pro forma	\$	0.60

A summary of the status of the Company's stock option plans as of March 31, 2006 and the components of the change for the period are as follows:

	<b>Number of Shares</b>
Options outstanding January 1, 2006 (385,300 exercisable)	970,700
Granted	20,000
Exercised	8,500
Forfeited	18,000
Options outstanding March 31, 2006 (377,700 exercisable)	964,200

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The Company uses the Black-Scholes pricing model to calculate the fair value of the options awarded as of the date of grant based on the following factors:

	<b>2006</b>	<b>2005</b>
Expected option term	5 years	5 years
Annualized volatility rate	21.0%	31.5%
Risk-free rate of return	4.57%	4.12%
Fair value at the date of grant (weighted-average)	\$ 15.57	\$ 18.06
Dividend yield	0.77%	0.66%
Black-Scholes value	26.0%	32.9%

**6. Comprehensive Income**

Total comprehensive income was \$7.0 million and \$10.2 million for the three months ended March 31, 2006 and 2005, respectively.

**7. Contingencies**

The Company is named as defendant in various legal actions arising in the ordinary course of business. In addition, the Company and certain of our officers and directors are named as defendants in a putative securities class action lawsuit and two shareholder derivative actions. The Company believes it has meritorious defenses to these actions and intends to vigorously defend each of these lawsuits. However, all litigation is unpredictable and the ultimate outcome of these cases is uncertain. These matters are in their early procedural stages, and thus the Company is unable to predict the likelihood or range of our potential liability or the potential financial impact on our future operations, if we are not able to successfully defend these cases.

**8. Recent Accounting Pronouncements**

The Company periodically reviews recent accounting pronouncements issued by the Financial Accounting Standards Board, American Institute of Certified Public Accountants, Emerging Issues Task Force, and Staff Accounting Bulletins issued by the United States Securities and Exchange Commission to determine the potential impact on the Company's financial statements. Based on its most recent review, the Company has determined that the majority of these recently issued accounting standards either do not apply to the Company or will not have a material impact on its financial statements.

**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, 2005 filed with the Securities and Exchange Commission.*

**Overview of Operating Results**

Net income decreased 32.4% to \$9.2 million or \$0.45 per share, on a diluted basis, for the three months ended March 31, 2006, as compared to net income of \$13.6 million or \$0.61 per share, on a diluted basis, in the first quarter of 2005. The annualized return on average equity was 14.9% during the first quarter of 2006. The loss ratio for the current quarter was 75.8% and the expense ratio was 12.8% resulting in an 88.6% combined ratio. Comparatively, the loss and expense ratios in the first quarter of 2005 were 74.5% and 7.5%, respectively, resulting in a combined ratio of 82.0%. The higher expense ratio was impacted by an increase in operating expenses of approximately \$2.3 million from our expansions in Texas, Missouri and Virginia, as compared to the prior year quarter, higher interest expense and lower ceded commissions. The increases in costs were partially offset by a \$0.8 million increase in net investment income. Net income in the current quarter was adversely impacted by after-tax net realized losses on investments of \$0.6 million or \$0.03 per diluted share. In addition, the Company adopted the new accounting standard regarding share-based payments, which resulted in a \$0.3 million pre-tax expense of stock options.

**Summary of Key Measures of Financial Results**

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

(\$ in millions)	Three Months Ended March 31,		% Change
	2006 (Unaudited)	2005	
<b>Selected Financial Data</b>			
Gross premiums written	\$ 160.6	\$ 161.3	(0.4)
Ancillary income	25.8	26.5	(2.6)
Net investment income	4.1	3.3	24.2
Gross revenues	\$ 190.5	\$ 191.1	(0.3)
Ceded premiums written	2.6	(18.0)	(114.4)
Change in net unearned premiums	(61.3)	(41.4)	(48.1)
Net realized losses on securities and other	(1.0)		NM
Total revenues	\$ 130.8	\$ 131.7	(0.7)
Net income	\$ 9.2	\$ 13.6	(32.4)
<b>Key Financial Ratios</b>			
Loss ratio - net	75.8%	74.5%	
Expense ratio - net	12.8%	7.5%	
Combined ratio - net	88.6%	82.0%	

Ancillary income to net operating expenses	66.4%	77.5%
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***Explanation of Key Measurers***

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

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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.

*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.

*Seasonality.* The months of February and March generally represent some of the highest premium production months of the year as many of our customers have more disposable cash as a result of income tax refunds. As a result, gross premiums written are generally the highest during the first quarter of the year. Typically, the Company generally experiences its lowest level of gross premiums written during the second quarter of the year as cancellations on the business written in the first quarter occur. Since the majority of our business is financed, finance receivables and unearned premiums increase during the first quarter. In addition, there are corresponding increases in notes payable and cash as our premium finance subsidiaries draw on the revolving line of credit with our banks to settle balances



due to our insurance subsidiaries. Since these settlements occur at the end of the month, our insurance subsidiaries hold a high level of cash that has yet to be permanently invested in the long term portfolio.

**Table of Contents****Results of Operations****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)	Three Months Ended March 31,		% Change
	2006 (Unaudited)	2005	
Gross premiums written			
Florida	\$ 71.0	\$ 78.1	(9.1)
Tennessee	19.7	22.3	(11.7)
Georgia	11.3	10.6	6.6
Louisiana	8.8	11.8	(25.4)
Texas	14.9	8.5	75.3
Mississippi	11.2	10.0	12.0
All other states	23.7	20.0	18.5
Gross premiums written	\$ 160.6	\$ 161.3	(0.4)
Ceded premiums written	2.6	(18.0)	(114.4)
Net premiums written	\$ 163.2	\$ 143.3	13.9
Gross premiums earned	\$ 111.7	\$ 118.2	(5.5)
Ceded premiums earned	(9.8)	(16.3)	(39.9)
Net premiums earned	\$ 101.9	\$ 101.9	
Net premiums written to gross premiums written	101.6%	88.8%	
Gross premiums earned to gross premiums written	69.6%	73.3%	
Net premiums earned to net premiums written	62.4%	71.1%	

Gross premiums written decreased slightly to \$160.6 million for the three months ended March 31, 2006 compared to \$161.3 million the first quarter of 2005. For the first quarter of 2006, gross premiums written from the sale of our core non-standard automobile insurance business decreased 1.5% to \$151.7 million while gross premiums written from the sale of our term life insurance business increased 21.9% to \$8.9 million as compared to the first quarter of 2005. Net premiums earned, a function of net premiums written over the current and prior periods, was substantially the same at \$101.9 million for the quarter in both years.

Gross premiums written in our expansion states of Texas, Missouri and Virginia increased \$9.5 million to \$18.2 million during the quarter. Gross premiums written in Texas increased 75.3% to \$14.9 million as compared to the first quarter of 2005. We continue to make progress in converting our book of business to annual policies, and as of March 31, 2006, approximately 69.9% of the book of business in Texas was written for an annual term. We also believe that our advertising initiatives have helped build our brand name, contributing to the 35.5% increase in Texas policies in force. In addition, premiums in Missouri and Virginia increased to \$3.3 million in the current quarter as compared to \$0.3 million in the first quarter of 2005 as we continue to increase our market share.

We continue to experience declines in some of our mature states, most notably Florida, Louisiana and Tennessee. We generally attribute the decline in Louisiana to a reduction in the size of the market following the hurricanes last summer. We believe that the majority of the decrease in new business policies in Florida and Tennessee was related to the increased competition for this business. Our hit ratios (the ratio of new policies issued to quotes) in these markets remain very good, but we continue to experience declines in quotes, thus driving down our new business policies. Overall, we believe that we remain competitive in these markets for our core customer; however, as with most of our states, we believe that the increased advertising and a focus on the higher credit profiles of the nonstandard market by some of the national carriers has resulted in our gross written premium declines. The percentage of policies that renew with us at the end of their term remains strong; however, the percentage of policies making it to term has declined in both states. We believe that this could also be a result of some declines in the top tier of our customer base. We are in the process of making some revisions to our advertising in Florida and Tennessee and implementing a more sophisticated pricing structure to help us compete in the upper tiers of the nonstandard market for all of our states.

We are actively pursuing a number of initiatives to increase our gross revenues. In addition to our new advertising efforts, we are beginning to offer our products through alternative distribution channels, including over the Internet and to customers who

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prefer to operate over the phone or through the mail. We have been experimenting with Internet sales through our third party Internet provider over the past two years in Florida, and we are working to expand this channel in several other states. Through our own website, we now have the ability to quote over the Internet in almost all of our states, and expect to be able to bind new policies over the Internet in all of our states by the end of the year. Gross written premiums in the first quarter of 2006 included \$2.5 million of Internet sales in Florida and over \$2 million of sales over the telephone. The telephone distribution channel is currently available in nine of our twelve states and we expect to commence offering telephone sales in Florida, North Carolina and South Carolina during the second quarter. We also continue to evaluate new insurance products that we believe will be attractive to our customers including renters , homeowners (including mobile homeowners ), motorcycle, boat, and personal watercraft policies.

***Ancillary Income***

Ancillary income for the three months ended March 31, 2006 decreased 2.6% to \$25.8 million compared to the corresponding period in 2005. Increases in our ancillary income (which were primarily from the sale of our Direct prepaid Visa® debit cards and from commissions and administrative fees on the sales of ancillary insurance products) were more than offset by decreases in commissions received from fronting carriers and by lower finance income. However, finance income as a percentage of gross premiums earned actually increased to 10.5% in the first quarter of 2006 as compared to 10.3% in the same period in 2005 primarily as a result of an increase in finance income in Texas.

The ratio of ancillary income to gross premiums earned was 23.1% and 22.4% for the first quarter of 2006 and 2005, respectively, while the ratio of ancillary income to operating expenses decreased to 66.4% in the 2006 period from 77.5% in the 2005 period. Because operating expenses are net of ceded reinsurance commissions received and we have been reducing our level of reinsurance, our net operating expenses have increased, resulting in a lower ratio of ancillary income to operating expenses.

***Net Investment Income***

Net investment income was \$4.1 million for the three months ended March 31, 2006 compared to \$3.3 million for the first quarter of 2005. The increase was due primarily to an increase in average invested assets and a slightly higher investment yield as a result of the increasing interest rate environment and slightly longer portfolio duration. Average invested assets increased 19.8% to \$394.7 million in the first quarter of 2006 from \$329.5 million in the first quarter of 2005. The average investment yield increased to 4.2% in the first quarter of 2006 from 4.0% in the corresponding period in 2005.

***Realized Gains on Securities and Other***

We realized no gross gains and gross losses of \$0.3 million on the sale of fixed maturity securities for the three months ended both March 31, 2006 and 2005. There was no impact on realized losses attributable to adjustments for other than temporary impairment of securities still held during either of these periods.

In the first quarter of 2006, we realized gross gains of \$0.8 million and gross losses of \$0.5 million on closed contracts in our trading portfolio, as compared to gross gains of \$0.4 million and gross losses of \$0.5 million in the first quarter of 2005. 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 (losses) gains on securities and other in our condensed consolidated statement of operations. During the quarter, the market value on open contracts decreased by \$1.0 million, which was included in net realized (losses) gains on securities and other. The first quarter of 2005 included mark to market gains of \$0.4 million on the trading portfolio. As of March 31, 2006, we had open contracts with gross unrealized gains of \$0.5 million and gross unrealized losses of \$1.3 million for a net unrealized loss of \$0.8 million.

***Expenses******Insurance Losses and Loss Adjustment Expenses***

Insurance losses and loss adjustment expenses increased to \$77.2 million for the three months ended March 31, 2006 from \$75.9 million for the same period in 2005. The loss ratio for the current quarter was 75.8%, which included 0.5 points of favorable development on prior years reserves. Comparatively, the loss ratio for the first quarter of 2005 was 74.5%, which included 0.8 points of adverse reserve development.

The increase in the current accident quarter loss ratio as compared to the first quarter of 2005 was generally related to some increases in severity in property damage, comprehensive and collision coverages. We believe that the majority of this increase is associated with increased labor rates for vehicle repairs. Partially offsetting these increases were increased salvage recoveries, particularly on collision claims. Consistent with our expectations, the frequency trends for personal injury protection coverage in

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Florida have declined as compared to the first quarter of 2005. We generally attribute this improvement to the Company's decision, in October 2004, to cease writing new business policies in the Miami market.

The majority of our favorable reserve development of \$0.5 million in the current quarter related to lower than expected ultimate frequency for personal injury protection losses in Florida. This favorable development was partially offset by an overall increase to our Louisiana reserves focused on the last two accident quarters of 2005. The increase in Louisiana included all coverages, but was not related to last year's hurricanes.

With respect to the second quarter of 2006, we currently expect to incur pretax losses of approximately \$1.0 million related to the tornados and hailstorms that struck Tennessee and other portions of the southeast in early April.

*Operating Expenses*

Operating expenses increased 14.0% to \$38.9 million for the three months ended March 31, 2006, compared to \$34.1 million for the same period of 2005. Collectively, the operating expenses associated with salaries, rent and advertising in our expansion states represented an increase of approximately \$2.3 million over the first quarter of 2005. Approximately half of this increase occurred in Texas and the remainder in Missouri and Virginia. The increase is generally the result of an increase in the number of sales offices in each of these states, and a higher level of advertising and variable costs related to the increased premium volumes, net of amounts capitalized as deferred policy acquisition costs. Operating expenses in our mature states increased \$0.9 million as compared to the first quarter of 2005, primarily consisting of an increase in advertising costs and a reduction in ceding commissions received from reinsurers, net of amounts capitalized as deferred policy acquisition costs. Interest expense increased by \$1.4 million as the result of interest on the junior subordinated debentures that were issued in September 2005 and an increase in interest rates related to our revolving credit facility.

*Stock Options*

Effective January 1, 2006, the Company adopted the provisions of the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, which was issued in December 2004 and became effective for periods beginning after June 15, 2005. This statement requires the Company to expense the cost resulting from all share-based payment arrangements, including employee stock options, in its financial statements. The Company has adopted the provisions of this statement using the modified prospective approach. This approach requires that compensation expense to be recorded for all unvested stock options and restricted stock that exist upon adoption of the statement as these options vest. New stock options that are granted are recognized as expense in the financial statements based on their fair values at the grant date. The Company recorded compensation expense of \$0.3 million for the first three months of 2006.

*Income Taxes*

Our effective tax rates were 37.7% and 37.5% for the three-month periods ended March 31, 2006 and 2005, respectively.

**Table of Contents****Financial Condition*****Liquidity and Capital Resources******Sources and Uses of Funds***

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

Our operating subsidiaries' primary sources of funds are premiums received, finance income, commission and service fee income, investment income, borrowings under credit facilities and proceeds from the sale and redemption of investments. Funds are used to pay claims and operating expenses, to pay interest and principal repayments under the terms of our indebtedness for borrowed money, to purchase investments and to pay dividends to Direct General Corporation. We had positive cash flow from operations of approximately \$26.6 million and \$29.1 million in the first three months of 2006 and 2005, respectively. We expect our cash flows to be positive in both the short-term and reasonably foreseeable future.

***Financing and Capital***

Although there is \$10.0 million remaining under the stock repurchase plan approved by the Board last year, no stock repurchases were made during the quarter. During the first quarter of 2006, we also paid a common stock dividend totaling \$0.8 million.

As of March 31, 2006, 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 \$177.0 million. We believe that this facility, which matures on June 30, 2007, is sufficient to support our premium finance operations through the end of the year. Direct General Corporation also has a \$30.0 million revolving credit facility available to support its operations and strategic initiatives. No amounts were outstanding under this facility as of March 31, 2006.

***Reinsurance***

The increased capitalization of our insurance subsidiaries has enabled us to eliminate our use of quota share reinsurance in 2006. In the first quarter of 2005, we ceded 11.2% of our gross premiums written to reinsurers.

***Investments***

***Debt securities.*** Our investment portfolio primarily consists of debt securities, all classified as available-for-sale and carried at market value with unrealized gains and losses reported in our financial statements as a separate component of shareholders' equity on an after-tax basis. As of March 31, 2006, our investment portfolio of \$384.6 million included \$11.2 million in net unrealized losses. The effective duration of our investment portfolio was 4.4 years at March 31, 2006.

As of March 31, 2006, our investment portfolio included gross unrealized gains of \$0.3 million and gross unrealized losses of \$11.5 million. During the quarter, net unrealized losses on our investment portfolio increased by \$4.0 million, which is included in accumulated other comprehensive income, net of applicable taxes, in the stockholders' equity section of the balance sheet. Our quarterly procedures include an examination of our investment portfolio for evidence of impairment. The assessment of whether such impairment has occurred is based on management's evaluation, on an individual security basis, of the underlying reasons for the decline in fair value. In such cases, changes in fair value are discussed with our investment advisors and evaluated to determine the extent to which such changes are attributable to interest rates, market-related factors other than interest rates, as well as financial conditions, business prospects and other fundamental factors specific to the issuer. Declines attributable to issuer fundamentals are reviewed in further detail. When one of our securities has a decline in fair value that is determined to be other than temporary, we reduce the carrying value of such security to its current fair value as required by GAAP.

Based upon our analysis, we believe that we will recover all contractual principal and interest payments related to those securities that currently reflect unrealized losses and that we have the ability to hold these securities until they mature or recover in value. Should either of these beliefs change with regard to a particular security, a charge for

impairment would likely be required. While it is not possible to accurately predict if or when a specific security will become impaired, charges for other than temporary



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impairment could be material to our results of operations in a future period. Management believes it is not likely that future impairment charges will have a significant effect on our liquidity.

The following table shows the composition by our internal industry classification of the amortized cost, gross unrealized gains, gross unrealized losses and fair value of debt securities available-for-sale as of March 31, 2006:

(\$ in millions)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses Less than 12 months	Greater than 12 months	Fair Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 70.3	\$	\$ 0.9	\$ 1.3	\$ 68.1
Obligations of states and political subdivisions	71.3	0.2	0.3	0.6	70.6
Corporate debt securities					
Banks and financial institutions	96.7		0.9	2.5	93.3
Credit cards and auto loans	78.4	0.1	0.7	1.2	76.6
Industrial	47.7		0.4	1.5	45.8
Telecommunications	15.9		0.1	0.5	15.3
Utilities and Electric Services	15.5		0.1	0.5	14.9
Corporate debt securities	254.2	0.1	2.2	6.2	245.9
Total	\$ 395.8	\$ 0.3	\$ 3.4	\$ 8.1	\$ 384.6

The amortized cost and fair value of debt securities available-for-sale as of March 31, 2006, by contractual maturity, is shown below:

(\$ in millions)	Amortized Cost	Fair Value
Years to maturity:		
One or less	\$ 12.6	\$ 12.5
After one through five	178.3	173.8
After five through ten	120.2	116.0
After ten	84.7	82.3
Total	\$ 395.8	\$ 384.6

The Securities Valuation Office of the National Association of Insurance Commissioners ( NAIC ) evaluates the bond investments of insurers for regulatory reporting purposes and assigns securities to one of six investment categories called NAIC designations. The NAIC designations parallel the credit ratings of the Nationally Recognized Statistical Rating Organizations for marketable bonds. NAIC designations 1 and 2 include bonds considered to be investment grade, rated BBB- or higher by Standard & Poor's ( S&P ). NAIC designations 3 through 6 include bonds considered below investment grade, rated BB+ or lower by S&P. All of the debt securities in our portfolio were rated investment grade by the NAIC and S&P as of March 31, 2006. Investment grade securities generally bear lower yields and lower degrees of risk than those that are unrated or are rated non-investment grade.

The quality distribution of our investment portfolio as of March 31, 2006 was as follows:

(\$ in millions)

	<b>NAIC Rating</b>	<b>S&amp;P Rating</b>	<b>Amortized Cost</b>	<b>Fair Value</b>	<b>% of Fair Value</b>
1		AAA	\$ 156.6	\$ 153.0	39.8%
1		AA	32.4	31.8	8.3%
1		A	102.6	99.1	25.8%
2		BBB	34.9	33.6	8.7%
1		Agency	69.3	67.1	17.4%
			\$ 395.8	\$ 384.6	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 and a half years. Interest rate risk includes the risk

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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 March 31, 2006:

(\$ in millions)	<b>-100 Basis Point Change</b>	<b>Fair Value</b>	<b>+100 Basis Point Change</b>
Debt securities, available for sale	\$ 401.1	\$ 384.6	\$ 368.1

*Short-term investments.* We have a managed trading account with a commodities trading company and, as of March 31, 2006, the total fair value of open trades in this account was a \$0.8 million loss, which represents less than 1% of our entire investment portfolio. We invest in commodities, primarily cattle futures and swaps. U.S. Treasury securities of \$2.6 million, included in short-term investments and cash of \$2.7 million, included in cash and cash equivalents, are held as collateral for this account. We recognized a net realized gain of \$0.3 million on closed contracts and a \$1.0 million loss on open contracts during the first quarter of 2006. 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 (losses) gains on securities and other in our consolidated statement of operations.

*Cash and cash equivalents.* Our balance in cash and cash equivalents was \$111.0 million as of as of March 31, 2006, which was 72.1% higher than the balance of cash held at December 31, 2005. The increase was primarily attributable to the seasonality of the business.

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**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, 2005 filed with the Securities and Exchange Commission on March 15, 2006.

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.

In addition to legal actions that are incidental to our business, we and one or more of our subsidiaries have 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, 2005 filed with the Securities and Exchange Commission on March 15, 2006.

**Item 6. 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).

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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)

May 9, 2006

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

Date

(Signature)

Name: William C. Adair, Jr.

Title: Chairman and Chief Executive Officer

May 9, 2006

By: /s/ J. Todd Hagely

Date

(Signature)

Name: J. Todd Hagely

Title: Senior Vice President and Chief Financial  
Officer

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