DIRECT GENERAL CORP
Form 10-Q
May 10, 2005

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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 March 31, 2005

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 þ No o

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 21,745,097 shares of common stock, no par value, at May 9, 2005.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

DIRECT GENERAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
	(In thousands, except per share amounts)	
Revenues		
Premiums earned	$ 101,913	$ 83,007
Finance income	12,171	12,761
Commission and service fee income	14,267	13,495
Net investment income	3,329	2,276
Net realized gains on securities and other	31	69
Total revenues	131,711	111,608
Expenses		
Insurance losses and loss adjustment expenses	75,882	60,825
Selling, general and administrative costs	32,784	25,240
Interest expense	1,310	1,352
Total expenses	109,976	87,417
Income before income taxes	21,735	24,191
Income tax expense	8,152	9,173
Net income	13,583	15,018
Net income available to common shareholders	$ 13,583	$ 15,018
Earnings per Share		
Basic earnings per common share	$ 0.61	$ 0.70
Diluted earnings per common share	$ 0.61	$ 0.67

See notes to condensed consolidated financial statements.

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DIRECT GENERAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	(Unaudited) March 31, 2005	December 31, 2004
	(In thousands)	
Assets		
Investments:		
Debt securities available-for-sale at fair value (amortized cost $337,091 and $334,770 at March 31, 2005 and December 31, 2004, respectively)	$ 331,728	$ 334,816
Short-term investments	2,022	1,663
Total investments	333,750	336,479
Cash and cash equivalents	117,719	70,988
Finance receivables, net	256,687	214,180
Reinsurance balances receivable	34,832	35,671
Prepaid reinsurance premiums	31,208	29,544
Deferred policy acquisition costs	14,771	12,666
Income taxes recoverable		7,177
Deferred income taxes	22,705	20,040
Property and equipment	16,471	15,823
Goodwill, net	26,943	22,188
Other assets	23,597	22,696
Total assets	$ 878,683	$ 787,452
Liabilities and Shareholders Equity		
Loss and loss adjustment expense reserves	$ 122,728	$ 124,858
Unearned premiums	266,376	223,303
Reinsurance balances payable and funds held	37,657	33,996
Accounts payable and accrued expenses	15,323	11,949
Income taxes payable	673	
Notes payable	173,286	135,626
Capital lease obligations	3,460	3,772
Other liabilities	14,167	8,867
Total liabilities	633,670	542,371
Shareholders equity		
Common stock, no par; authorized shares 100,000.0; issued shares 21,997.5 and 22,360.0 at March 31, 2005 and December 31, 2004, respectively	99,791	109,163
Retained earnings	148,869	136,178
Accumulated other comprehensive (loss) income:		

Net unrealized (depreciation) appreciation on investment securities	(3,486)	30
Net loss on cash flow hedge	(161)	(290)
Total shareholders equity	245,013	245,081
Total liabilities and shareholders equity	$ 878,683	$ 787,452

See notes to condensed consolidated financial statements.

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DIRECT GENERAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended March 31,	
	2005	**2004**
	(In thousands)	
Operating activities		
Net income	$ 13,583	$ 15,018
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized gains on securities and other	(31)	(69)
Depreciation and amortization	1,616	1,331
Deferred income taxes	(841)	(1,983)
Changes in operating assets and liabilities:		
Finance receivables	(42,507)	(52,513)
Reinsurance balances receivable	839	(7,614)
Prepaid reinsurance premiums	(1,664)	309
Deferred policy acquisition costs	(2,105)	(667)
Income taxes recoverable/payable	7,850	7,595
Loss and loss adjustment expense reserves	(2,130)	714
Unearned premiums	43,073	54,051
Reinsurance balances payable and funds held	3,661	6,321
Accounts payable and accrued expenses	3,374	(690)
Other	4,400	(4,608)
Net cash provided by operating activities	29,118	17,195
Investing activities		
Proceeds from sales and maturities of debt securities available-for-sale	22,132	54,504
Purchase of debt securities available-for-sale	(24,766)	(67,775)
Payable for securities	625	8,680
Net purchases of short-term investments	(359)	(309)
Purchase of property and equipment, net	(2,220)	(1,678)
Purchase of insurance agency assets	(4,799)	
Purchase of life insurance company		(7,330)
Net cash used in investing activities	(9,387)	(13,908)
Financing activities		
Repurchase of common stock	(9,999)	
Issuance of common stock	543	425
Net proceeds from borrowings	37,800	28,000
Payment of principal on borrowings	(452)	(404)
Payment of dividends on common stock	(892)	(861)
Net cash provided by financing activities	27,000	27,160

Net increase in cash and cash equivalents	46,731	30,447
Cash and cash equivalents at beginning of period	70,988	87,342
Cash and cash equivalents at end of period	$ 117,719	$ 117,789

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 and primarily in 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 period ended March 31, 2005 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, 2004.

3. Acquisitions

During January 2005, the Company acquired certain assets of All American General Agency, Inc., operating primarily under the name AMCO, and the assets of two other insurance agencies, collectively operating through 82 sales offices in the state of Texas. The assets acquired included customer records and renewal rights and the operating assets of the sales offices used to conduct their agency business. The total purchase price, the majority of which is recorded as goodwill, was $5,380,000 and may be increased by a future contingent payment of up to $500,000. The acquisition of the 82 sales offices increased the Company s future minimum lease commitments having an initial or remaining term of more than one year by approximately $3.1 million.

4. Common Stock Repurchase

On January 31, 2005, the Company announced that its Board of Directors approved the repurchase of up to $20,000,000 of its outstanding common stock. As of March 31, 2005, the Company had repurchased 493,350 shares of its outstanding common stock for an aggregate price of approximately $10,000,000.

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 $190.0 million revolving credit facility under substantially similar terms and extended its maturity for an additional three-year period to June 30, 2007. As of March 31, 2005, the amount outstanding under the facility was $173.0 million. The Company 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, 2005.

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6. Earnings Per Share

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

	Three Months Ended March 31, 2005		2004	
	(In thousands, except per share amounts)			
Numerator:				
Net income available to common shareholders	$	13,583	$	15,018
Denominator:				
Weighted average common shares outstanding		22,272.3		21,503.0
Dilutive stock options		125.6		834.1
Weighted average common shares outstanding for purposes of computing diluted earnings per common share		22,397.9		22,337.1
Basic earnings per common share	$	0.61	$	0.70
Diluted earnings per common share	$	0.61	$	0.67

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. Employee stock options granted at less than the market price at the date of grant and options granted to non-employees are expensed. During the first quarter of 2005, the Company recorded $84,000 of expense related to options granted to both employees and non-employees to purchase 115,000 shares at an exercise price of $31.00 per share that was less than the current market price at the time of grant.

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

	Three Months Ended March 31, 2005		2004	
	(In thousands, except per share amounts)			
Net income available to common shareholders, as reported	$	13,583	$	15,018
Deduct: Total stock-based employee compensation expense determined under the fair value based method, net of related tax effects		(218)		(252)

Net income available to common shareholders, pro forma	$ 13,365	$ 14,766
Income for purposes of computing diluted earnings per share common, as reported	$ 13,583	$ 15,018
Deduct: Total stock-based employee compensation expense determined under the fair value based method, net of related tax effects	(218)	(252)
Income for purposes of computing diluted earnings per share common, pro forma	$ 13,365	$ 14,766

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	Three Months Ended March 31,			
	2005		2004	
	(In thousands, except per share amounts)			
Earnings per share				
Basic as reported	$	0.61	$	0.70
Basic pro forma	$	0.60	$	0.69
Diluted as reported	$	0.61	$	0.67
Diluted pro forma	$	0.60	$	0.66

8. Contingencies

The Company is named as defendant in various legal actions arising in the ordinary course of business. During the first quarter of 2005, the Company and certain of our officers and directors were named as defendants in six purported securities class action lawsuits and six shareholder derivative class actions. The Company 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.

9. Subsequent Events

In April 2005, the Company signed a purchase agreement to acquire a property and casualty company the assets of which consist of licenses to conduct property and casualty business in 38 states and the District of Columbia and debt securities. The proposed acquisition is pending regulatory approval. The purchase price is estimated to be $10.3 million of which approximately $4.3 million is expected to be allocated to the value of the licenses and recorded as goodwill.

10. 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. However, in December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, which will affect the manner in which the Company accounts for its share-based payment arrangements, including stock options. Accordingly, effective January 1, 2006, the Company will be required to expense the cost resulting from all share-based payment arrangements in its financial statements. The Company is currently in the process of determining the impact this standard will have on its financial statements.

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

This Management s Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Company s discussion presented under the caption Management s Discussion and Analysis of Financial Condition and Results of Operations that is available in the Annual Report on Form 10-K for the year ended December 31, 2004 filed with the Securities and Exchange Commission.

Overview of Operating Results

Net income decreased 9.3% to $13.6 million or $0.61 per share, on a diluted basis, for the three months ended March 31, 2005, as compared to net income of $15.0 million or $0.67 per share, on a diluted basis, in the first quarter of 2004. The annualized return on average equity was 22% during the first quarter, which exceeds our stated long-term objective of 20%. The first quarter results included a slightly higher loss ratio and higher expense ratios. The higher expense ratio was impacted by an increase in operating expenses of approximately $2.4 million from our expansions in Texas, Missouri and Virginia, as compared to the prior year quarter. The increases in costs were partially offset by a $1.0 million increase in net investment income. For the quarter, gross premiums written decreased 4.6% to $161.3 million from $169.0 million in the same period in 2004, including a decrease of approximately $2.2 million associated with the reduction in premiums in the Miami, Florida market. We experienced an increase in renewal policies over the prior year quarter, which partially offset the decrease in new business policies.

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.

	Three Months Ended March 31,		
($ in millions)	**2005**	**2004**	**% Change**
	(Unaudited)		
Selected Financial Data			
Gross premiums written	$ 161.3	$ 169.0	(4.6)
Ancillary income	26.5	26.3	0.8
Net investment income	3.3	2.3	43.5
Gross revenues	$ 191.1	$ 197.6	(3.3)
Ceded premiums written	(18.0)	(31.7)	(43.2)
Change in net unearned premiums	(41.4)	(54.3)	(23.8)
Total revenues	$ 131.7	$ 111.6	18.0
Net income	$ 13.6	$ 15.0	(9.3)

Key Financial Ratios

Loss ratio net	74.5%	73.3%
Expense ratio net	7.5%	0.4%
Combined ratio net	82.0%	73.7%
Ancillary income to net operating expenses	77.7%	98.7%

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 by our insurance subsidiaries. Assumed premiums written is the sum of total premiums associated with the insurance risk transferred

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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.

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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:

	Three Months Ended March 31,		
($ in millions)	2005	2004	% Change
	(Unaudited)		
Gross premiums written			
Florida	$ 78.1	$ 83.9	(6.9)
Tennessee	22.3	23.4	(4.7)
Georgia	10.6	12.3	(13.8)
Louisiana	11.8	12.5	(5.6)
Mississippi	10.0	10.1	(1.0)
Texas	8.5	7.0	21.4
All other states	20.0	19.8	1.0
Gross premiums written	$ 161.3	$ 169.0	(4.6)
Ceded premiums written	(18.0)	(31.7)	(43.2)
Net premiums written	$ 143.3	$ 137.3	4.4
Gross premiums earned	$ 118.2	$ 115.0	2.8
Ceded premiums earned	(16.3)	(32.0)	(49.1)
Net premiums earned	$ 101.9	$ 83.0	22.8
Net premiums written to gross premiums written	88.8%	81.2%	
Gross premiums earned to gross premiums written	73.3%	68.0%	
Net premiums earned to net premiums written	71.1%	60.5%	

Gross premiums written decreased $7.7 million or 4.6% for the three months ended March 31, 2005 compared to the first quarter of 2004. For the first quarter of 2005, gross premiums written from the sale of our core non-standard automobile insurance business decreased 5.5% to $154.0 million while gross premiums written from the sale of our term life insurance business increased 21.7% to $7.3 million as compared to the first quarter of 2004. Gross premiums earned, a function of gross premiums written over the current and prior periods, increased 2.8% to $118.2 million in first quarter of 2005 versus the same period in 2004.

The decrease in gross premiums written included a decrease of approximately $2.2 million related to our decision, in October 2004, to cease writing new business policies in the Miami, Florida market. Overall, new business policies issued decreased by approximately 7%, which included the decrease in Miami new business that was partially offset by a 20% increase in renewal policies issued. We believe that the majority of the decrease in new business policies, outside Miami, was related to the increased competition for this business as reflected by the volume of calls to our Baton Rouge call center being down from the same period in 2004. However, we have seen an increase in the conversion rate of quotes to policies issued, which partially offset the decline in call volume.

We believe that the number of nonstandard and standard automobile insurers that heavily use both television and radio advertising media have substantially increased in recent months, which contributed to our reduced call volume. We believe that this increased competition for media advertising has impacted the effectiveness of our advertising approach that has historically focused on a saturation of daytime network television complemented by yellow-page advertising. We also believe that a number of larger, national carriers that have predominantly operated in the standard market, are having some success in attracting a portion of our customer base as they have directly or indirectly expanded their target market to include a portion of the nonstandard market through their increased media advertising. One of the trends that we are closely monitoring is our mix of full coverage business, which includes physical damage coverage, as opposed to liability only policies. In certain states, particularly North and South Carolina, we have started to see a decline in the percentage of full coverage business, which we believe may be indicative of a portion of our customer base moving to the standard carriers.

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Consistent with our ongoing review of rates by coverage and state, we plan to make minor adjustment to our rates in certain states in an effort to improve our new business growth and stabilize our mix of full coverage versus liability only business. In response to the increased competition, we have recently hired a national advertising company to assist us in developing new marketing strategies to address the changing competitive landscape in many of our existing markets. We initially expect to test these new strategies in Tennessee and, if they are successful, we plan to implement them in our other existing states shortly thereafter.

Gross premiums written in Texas increased 21.4% over the first quarter of 2004 largely as a result of our advertising campaigns and the increase in the number of sales offices in this market. In March 2005, we began issuing twelve-month policies in some of our Texas offices. We expect to continue to convert our monthly policies in Texas to annual policies over the remainder of the year. We have started to see a positive impact from our advertising programs in Texas, and our new advertising firm is helping us develop a campaign to specifically target the Hispanic market in Texas.

The growth in net premiums written and earned is a function of gross premiums written and earned less ceded premiums written and earned. We continued to increase our retention of our business during the first quarter of 2005 and, as a result, the ratio of net premiums written to gross premiums written increased to 88.8% as compared to 81.2% in the first quarter of 2004. We expect to retain 88% to 90% of our gross premiums written in 2005.

We are actively pursuing a number of initiatives to increase our gross revenues. In addition to our new advertising efforts, we are also exploring the possibility of offering our products through alternative distribution channels, including over the Internet and to customers who prefer to operate through the mail. We have been experimenting with Internet sales over the past year in Florida, and we are working to expand this channel in several other states. 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. In order to facilitate the future expansion of our Direct General business model into additional states, we recently entered into an agreement to acquire a property and casualty shell insurance company with licenses in 38 states and the District of Columbia. This acquisition, which is currently pending regulatory approval, will provide us with a property and casualty insurance license in these states. The acquisition of these licenses will provide us a valuable tool that will allow us to more efficiently move into new markets. As a result of these growth initiatives and the additional initiatives we expect to introduce during the second quarter and the remainder of the 2005, we are optimistic that our gross revenues should increase during the second half of the year; however, growth is expected to be flat or down slightly throughout the second quarter of 2005.

Ancillary Income

Ancillary income for the three months ended March 31, 2005 increased 0.8% to $26.5 million compared to the corresponding period in 2004. The majority of this increase was attributable to the success of our Direct prepaid Visa® debit card. We issued more than 57,000 cards during the quarter and revenues from the product were $0.6 million. The increase in revenues from the debit card was largely offset by a $0.6 million reduction in finance income primarily as a result of a decrease in down payments. We expect that the reduction in down payments could negatively impact the level of finance income to gross premiums earned in certain states; however, finance income should be positively impacted from our growth in Texas as we convert more of our Texas policies from monthly policies to annual policies and finance them through our premium finance company.

The ratio of ancillary income to gross premiums earned was 22.4% and 22.9% for the first quarter of 2005 and 2004, respectively, while the ratio of ancillary income to operating expenses decreased to 77.7% in the 2005 period from 98.7% in the 2004 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 $3.3 million for the three months ended March 31, 2005 compared to $2.3 million for the first quarter of 2004. 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 24.0% to $329.5 million in the first quarter of 2005 from $265.7 million in the first quarter of 2004. The average investment yield increased to 4.0% in the first quarter of 2005 from 3.5% in the corresponding period in 2004.

Realized Gains on Securities and Other

We realized no gross gains and gross losses of $0.3 million on the sale of securities for the three months ended March 31, 2005. Comparatively, we realized gross gains on debt securities of $0.2 million and gross losses of $0.2 million for the comparable period in 2004. There was no impact on realized losses attributable to adjustments for other than temporary impairment of securities still held during these periods.

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In the first quarter of 2005, we also realized gross gains of $0.4 million and gross losses of $0.5 million on closed contracts in our trading portfolio. The trading portfolio primarily consists of futures contracts, swaps, and other derivative instruments. This represents a speculative investment and does not represent a hedge; accordingly, all open contracts are marked to market with the change in market values included in net realized gains on securities and other in our condensed consolidated statement of operations. During the quarter, the market value on open contracts increased by $0.4 million, which was included in net realized gains on securities and other. As of March 31, 2005, we had open contracts with gross unrealized gains of $0.5 million and gross unrealized losses of $0.2 million.

Expenses

Insurance Losses and Loss Adjustment Expenses

Insurance losses and loss adjustment expenses increased to $75.9 million for the three months ended March 31, 2005 from $60.8 million for the same period in 2004. The majority of this increase was related to the increase in net premiums earned. Net loss ratios for the first quarter of 2005 and 2004 were 74.5% and 73.3%, respectively. The Company s quarterly analysis of reserves resulted in an increase to prior year reserves of $0.8 million, which increased the net loss ratio by 0.8 points in the first quarter of 2005. The increase in prior period reserves was primarily associated with the last two accident quarters of 2004 and was a result of an increase in the expected average ultimate payments on personal injury protection PIP claims in Florida and increases in expected frequency and severity of physical damage claims, primarily in Tennessee and Georgia. The increase