



SOLUTIONS

UNIVERSAL AMERICAN FINANCIAL CORP.
2004 Annual Report

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CORPORATE OVERVIEW

Universal American Financial Corp. offers a broad array of health insurance and managed care products and services, primarily to the growing senior population. Our company operates in the United States and Canada, where we are better known by the names of our insurance companies and services.

48%
INCREASE IN
NET INCOME

16.7%
RETURN
ON EQUITY*

\$982
million
PREMIUM IN
FORCE

FINANCIAL HIGHLIGHTS

(in thousands, except per share data)
as of or for years ended December 31,

	2004	2003	2002
Income Statement and Other Data			
Premium In Force	\$ 981,700	\$ 792,107	\$ 691,170
Total Revenues	735,345	522,748	331,523
Pretax Income	96,468	66,479	44,030
Net Income	\$ 63,871	\$ 43,052	\$ 30,127
Return on Equity*	16.7%	15.2%	13.2%
Per Share Data (Diluted)			
Net Income	\$ 1.13	\$ 0.78	\$ 0.56
Book Value	6.71	5.55	4.77
Balance Sheet Data			
Total Assets	\$ 2,017,088	\$ 1,780,948	\$ 1,401,668
Stockholders' Equity	419,421	345,738	286,769

*Excludes realized gains and losses and the effect of FAS 115.

TO OUR SHAREHOLDERS

Simply stated, 2004 was an outstanding year for Universal American. Our financial results were excellent and we were able to make significant strategic advances during a time of change and opportunity in our primary market.

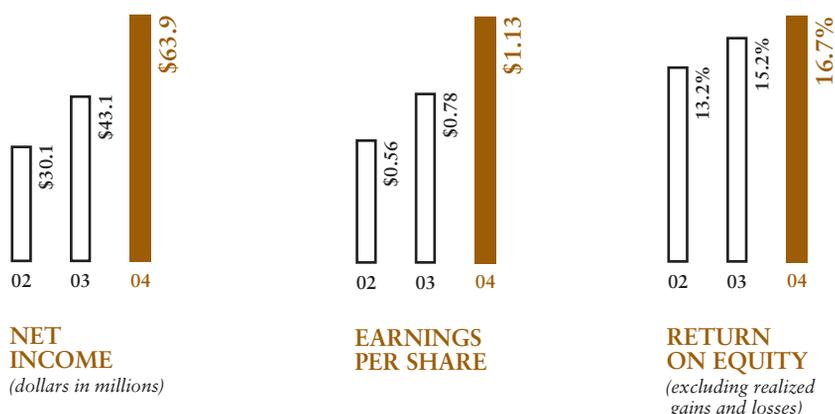
THE SENIOR MARKET

More than a decade ago, we identified the senior market as the primary arena in which to build our company, and we continue to expand our products and distribution to meet the needs of this growing market. The aging of America is no longer an event that is far out in the future. Baby boomers are now starting to retire, and by the end of this decade, the population of Americans over age 65 will start to accelerate rapidly. In the past couple of years, the coming impact of this inevitable demographic wave has begun to receive the political attention it requires. While there are many different views about how to deal with the issues of health care for seniors and retirement security, there is a growing consensus that these will be the most important domestic issues this country will face over the next several decades. We cannot predict exactly what solutions will come out of the political process, but we can predict with absolute certainty that the senior population will continue to grow, and with it the demand for health care and financial products designed for this segment will grow as well.

Universal American is not only creating and selling products to meet the current needs of seniors; we are also building the essential skill sets that will be valuable as the needs of this population and the related governmental policies inevitably change.

Health Insurance for Seniors Our core strategy is to provide health insurance products to the Medicare market. Traditionally, Medicare Supplement has been the core product in our senior health portfolio. Even though the Medicare Supplement market is highly competitive, the profitability of our block of business has continued to grow because we are adept at the basic skills that determine profitability. Over the past decade, we have built an enviable franchise in this market based upon powerful distribution, opportunistic acquisitions, low cost administration and vigilant risk management.

The Medicare Modernization Act of 2003 (“MMA”) brought significant attention to the health insurance system for our country’s 42 million Medicare beneficiaries. For Universal American, this change required us to re-examine our position in the senior market and adapt our strategy to be able to maintain and accelerate our growth. Even though the legislation offers new incentives to managed care programs (now called Medicare Advantage) that may compete with traditional Medicare Supplement products, we remain confident that our Medicare Supplement business will continue to prosper since millions of senior Americans will opt to remain in the traditional program that features free choice of doctors and hospitals. This will be particularly true in small cities and rural areas - our primary markets - which generally do not offer managed



care options. We estimate that more than 80% of our Medicare Supplement business is written outside of metropolitan areas.

Universal American has also embraced the revitalized Medicare Advantage program as an additional avenue of growth that builds on the expertise that we possess. To accelerate our entry into this market, we acquired Heritage Health Systems, Inc. in May 2004. Heritage operates Medicare Advantage plans in Houston and several other counties in southeastern Texas, in close association with several physician organizations. We believe that the Heritage model, which emphasizes partnerships with physicians and a commitment to individual care management, will prosper in the coming years in current markets as well as in new ones. In addition, we began in 2004 to offer Medicare Advantage Private Fee-For-Service plans in two of our markets. By offering Medicare Advantage as well as Medicare Supplement products, we are well positioned to serve the increasing need for health care coverage for the growing senior population.

We are also energized about the opportunity to market the new prescription drug benefit authorized by the MMA. Recently, we announced a strategic alliance with PharmaCare, the pharmacy benefit management subsidiary of CVS Corporation, to offer this government-sponsored insurance plan. We have a potent network of independent general agents and career agents that can distribute the product, 315,000 policyholders who are ideal candidates to acquire this new coverage, and the possibility of extending our marketing reach through an association with the largest retail drug chain in the country.

With our existing strength in the Medicare Supplement market, our growing presence in the Medicare Advantage market and the potential of the prescription drug insurance market that will emerge in 2006, we believe that we are in an excellent strategic position to benefit from the enormous opportunities that exist in the senior health insurance market.

THE SELF-EMPLOYED MARKET

Pennsylvania Life and PennCorp Life (Canada) have built a unique and highly profitable business offering supplemental health insurance products to the underserved self-employed market in the United States and Canada. Despite the fact that new sales and revenues in this segment of our business have grown slowly, profits and cash flow remained strong in 2004 due to improved risk management and the recent strength in the Canadian dollar. We are particularly optimistic that we can regain our sales momentum in Canada since we have revamped our sales management and augmented our product line.

DISTRIBUTION

Much of our success is attributable to the potent distribution network that we have built over the past several years. In the United States, we now have more than 28,000 independent agents in 35 states who distribute our senior market products and, in 2004, wrote more than \$101 million of new premium. We also have more than 2,100 career agents in the United States and Canada who produced in excess of \$58 million of new premium in 2004.

“By offering Medicare Advantage as well as Medicare Supplement products, we are **well positioned to serve** the increasing need for health care coverage for the **growing senior population.**”

We are particularly enthusiastic about the roll-out of our Senior Solutions® concept to the career agents. We are optimistic this branding effort will enhance our agent recruiting and increase consumer awareness of our product offerings.

While the Heritage acquisition would have been successful on its own, our Senior Solutions offices in southeastern Texas are now responsible for 35% of the new sales of Medicare Advantage products in Texas and are a major factor in the accelerated growth that Heritage has experienced since the acquisition.

ADMINISTRATIVE SERVICES

Our senior administrative services division, CHCS Services, plays a significant financial, operational and strategic role in our company. Most important, we count on CHCS Services to deliver predictable and growing profits and cash flow derived from fees, in contrast to the risk-based revenues in our insurance entities. We are able to leverage the expertise gained through administering senior health care products and providing geriatric care management services for our own companies and external clients to provide efficient and cost-effective service for this market.

RISK MANAGEMENT

Pricing and Underwriting Disciplined pricing and underwriting are the fundamental components that determine the profitability of our insurance products. We constantly monitor our results to make sure that our underwriting is sound and that our products are adequately priced.

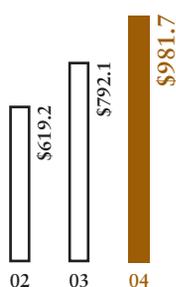
Reinsurance In the past, Universal American was an active and astute buyer of quota share reinsurance to leverage capital and mitigate severity risk. However, as our capital base has grown, we are able to absorb more net premium and have reduced the amount of business, especially Medicare Supplement, that we cede to reinsurers.

Investment Portfolio The objective of our investment management is to generate secure and predictable cash flows to support our policy liabilities, without exposing our principal to undue risk. In the past two years, our challenge has been to produce adequate investment income in a low interest rate environment. While we do not like to make predictions on the direction of interest rates, we built cash during particularly low interest rate periods and have the liquidity to benefit from the rising interest rate environment that appears to have begun in 2005.

The credit quality of our portfolio continues to be quite strong. As of year end 2004, we had less than 1% of our portfolio invested in bonds that are rated lower than investment grade (as defined by Standard & Poor's).

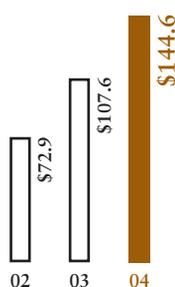
ACQUISITIONS

Our ability to make acquisitions that advance our strategic and financial goals has been a core competence and a primary factor in our growth in recent years. The acquisition of Heritage in 2004 is the latest example of our approach and success in this area. We will continue to be aggressive in our search for acquisitions but we will also be disciplined in our decision-making and execution.



TOTAL PREMIUM IN FORCE

(dollars in millions)



NET PREMIUMS ISSUED

(dollars in millions)

There are several reasons why our acquisition strategy has worked well. First, we have consistently stayed within financial parameters that require our transactions to be immediately accretive. Next, we perform rigorous and comprehensive due diligence to mitigate the risk of a negative surprise. Finally, we are dedicated to integrating our acquisitions into our existing operations as quickly as possible.

CAPITAL STRUCTURE

Our increased profits and cash flow have enabled us to support our continued growth. We generate a sufficient amount of capital internally to support internal growth, and the predictability and diversity of our cash flows allow us to access the capital markets on an increasingly favorable basis to support our acquisition activity.

We are particularly pleased that we have been able to finance our recent acquisitions without diluting our equity base, thus increasing our earnings per share and returns on equity. In recognition of our improved capital position, we obtained the financing required for the Heritage acquisition as a result of receiving an investment grade rating from Standard & Poor's.

CORPORATE GOVERNANCE

In 2004, like all public companies, we went through the thorough analysis necessary to comply with the financial control requirements of section 404 of the Sarbanes-Oxley Act of 2002. While it would be disingenuous to say that we welcomed the extent (and financial cost) of the 404 certification process, our company embraced the spirit of

the requirements and made constructive use of the rigorous examination to further strengthen our controls and procedures.

THE RESULTS

In 2004, we achieved record results in all aspects of our business. Revenues grew by 41%, profits grew by 48%, earnings per share grew by 44%, diluted book value per share grew by 21%, and most significantly, return on equity, excluding realized gains, grew to 16.7%. Of equal importance to these achievements, we have further strengthened our strategic plan, which enables us to be optimistic about future results.

In closing, I would like to thank all those who have contributed to the success of Universal American. We have assembled a powerful distribution force and we appreciate the essential role our agents play in our achievements. In addition, we have more than 1,200 skilled and dedicated employees who understand the importance of efficient execution and superior service to our most valuable asset: the nearly 900,000 insureds who rely on the promises that we make to them. I am gratified that our share price has reflected our improved financial and strategic position, thus rewarding our shareholders who have also placed their trust in us.

RICHARD A. BARASCH

Chairman and Chief Executive Officer

STRENGTH IN NUMBERS

For Universal American, the numbers tell a compelling story. Forty-two million Americans are now enrolled in Medicare, a number that will greatly increase in the years ahead. Also, the insurance needs of North America's 18 million self-employed remain substantially unmet. That is why we are focusing on these opportunities, and why our numbers, too, tell a powerful story. In 2004, our premium in force grew 24%, earnings per share increased 44%, and return on equity rose to 16.7%.

42 million

AMERICANS ENROLLED IN MEDICARE ⁽¹⁾

47 million

SENIOR AMERICANS ESTIMATED BY 2015 ⁽²⁾

#1

SENIORS RATE FINANCIAL SECURITY
AS THEIR NUMBER ONE CONCERN ⁽³⁾

18 million

SELF-EMPLOYED PEOPLE IN THE U.S. & CANADA ⁽⁴⁾

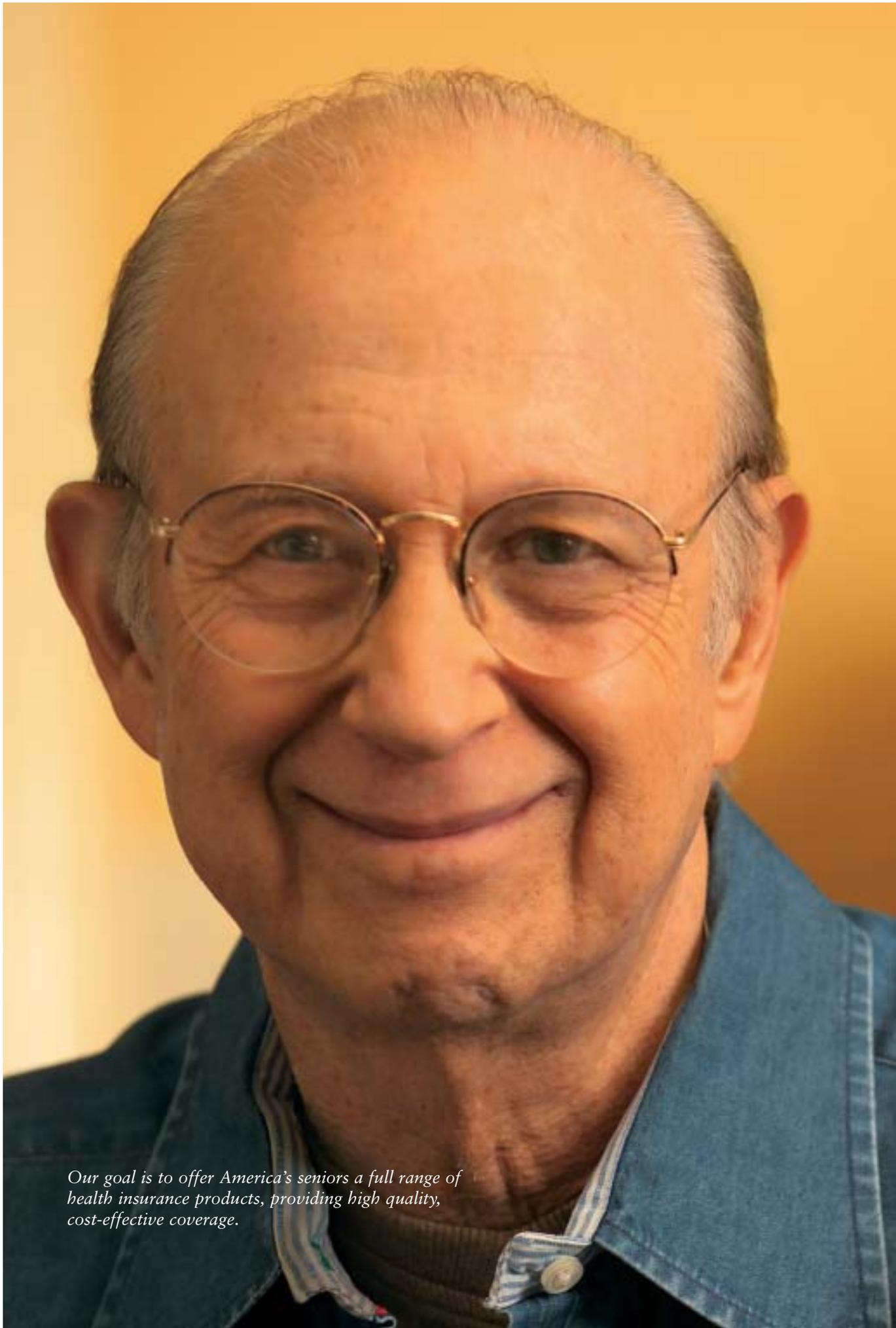
Sources:

⁽¹⁾ Centers for Medicare & Medicaid Services website (www.cms.gov).

⁽²⁾ U.S. Census Bureau, 2004.

⁽³⁾ 2001 Legislative Survey on Senior Citizens' issues, performed by The Seniors Coalition.

⁽⁴⁾ Small Business Administration 2002 and Labour Force Survey by Statistics Canada 2001.



Our goal is to offer America's seniors a full range of health insurance products, providing high quality, cost-effective coverage.

HEALTH INSURANCE SOLUTIONS FOR SENIORS

At Universal American, our primary focus is to serve the needs of the growing senior market. With 42 million Americans now eligible for Medicare, this market is poised to surge in the years ahead as the baby boomer generation ages.

Our goal is to offer America's seniors a full range of health insurance products, providing high quality, cost-effective coverage. We offer our customers choices that suit their financial considerations and provide health care options with which they will be comfortable.

Our company is one of the nation's leading underwriters of Medicare Supplement and Medicare Select. At year end, we had 315,000 policyholders, generating annual premiums of approximately \$575 million. We have assembled one of the largest Medicare Select hospital networks in the country, with 275 hospitals under contract in 21 states.

The 2003 Medicare Modernization Act promised fair and reliable reimbursement to private companies offering managed care plans to individuals eligible for Medicare. After careful study, we determined that these Medicare Advantage programs were a logical next step for Universal American.

In April 2004, our American Progressive subsidiary began offering Medicare

Advantage Private Fee-For-Service plans in two of our strongest states; first in New York, and shortly thereafter, in Pennsylvania. As a result of our purchase of Heritage Health Systems in May 2004, we also sell Medicare Advantage HMO plans in Houston and Beaumont, Texas. We quickly integrated Heritage into our company, and saw enrollment increase from 16,000 members to over 19,000 by year end. We envision that Heritage, with its experienced management and its model of working closely with providers, will serve as a base for our further expansion of Medicare Advantage programs.

The Medicare Modernization Act also established a subsidized prescription drug benefit to be offered by insurance companies, starting in 2006. We look forward to providing this coverage both in our Medicare Advantage programs and as a stand-alone product through a strategic alliance with PharmaCare, a subsidiary of CVS Corporation, the nation's leading pharmacy retailer with 5,400 stores.



A NATIONAL, MULTI-CHANNEL DISTRIBUTION NETWORK

To effectively deliver our broad range of products, we have built a national, multi-faceted distribution network that includes career agents and independent agents.

Universal American's career agent force consists of representatives who exclusively sell our products, through our Pennsylvania Life and Pyramid Life divisions. The cornerstone of our career agency initiative is our trade-marked Senior Solutions®, a comprehensive branding program that embodies our commitment to the senior market and provides our agents with the tools they need to succeed.

The Senior Solutions brand is built on the premise that seniors today face confusing health care insurance choices. With Senior Solutions, customers can receive advice from one of our knowledgeable agents, and select from an ample array of insurance products and services designed with their needs in mind.

No other program in our industry is comparable to Senior Solutions. It has become a powerful recruiting device to attract high caliber agents to our company. In 2004, we established over 85 Senior Solutions Centers in 26 states; these are sales offices that serve as focal points for local senior market insurance expertise.

We also rely upon a network of independent agents who sell our senior market products through our general agency subsidiaries – American Pioneer Life, American Progressive, Constitution Life and Union Bankers. Much of our business in this network comes from a core group of loyal agents, with whom we have developed strong and longstanding relationships. For all our agents, we make it easy and attractive to do business with us.

The synergy between our existing agents and our new Medicare Advantage plans is an exciting component of our distribution strategy. Previously sold primarily by managed care companies, Medicare Advantage has been enthusiastically embraced by both our career and independent agents as a valuable addition to their portfolio. In 2004, our agents in Texas, New York and Pennsylvania sold approximately \$22 million in Medicare Advantage annualized premium.

With our 2004 acquisition of Heritage Health Systems, we gained a new distribution capability – direct sales. Heritage's subsidiary, SelectCare of Texas, focuses primarily on selling Medicare Advantage plans through channels such as direct mail, direct TV and informational seminars.





With Senior Solutions, customers can receive advice from one of our knowledgeable agents, and select from an ample array of insurance products and services designed with their needs in mind.

SOLUTIONS FOR SENIOR HEALTH CARE ADMINISTRATION

Our wealth of experience and deep understanding of the senior market has enabled CHCS Services, our administrative services division, to become a leader in administering senior health care products on an outsourced basis.

Insurers and managed care companies turn to CHCS Services, Inc. for a multitude of outsourcing services, customized precisely to fit their needs. We are expert at underwriting Medicare Supplement risks, evaluating long-term care patients by telephone or in person, efficiently processing claims and collecting premiums, or quickly and accurately fielding questions from policyholders – in 9 different languages.

Our teams of insurance experts and health care professionals assist clients to develop new products and programs, while our staff of over 100 call center specialists provides round-the-clock customer contact. And, more than 1,500 nurses and social workers, through our nationwide network, are available to give seniors compassionate, personalized attention and care.

Importantly, we have been an innovator in the emerging eldercare business. We have

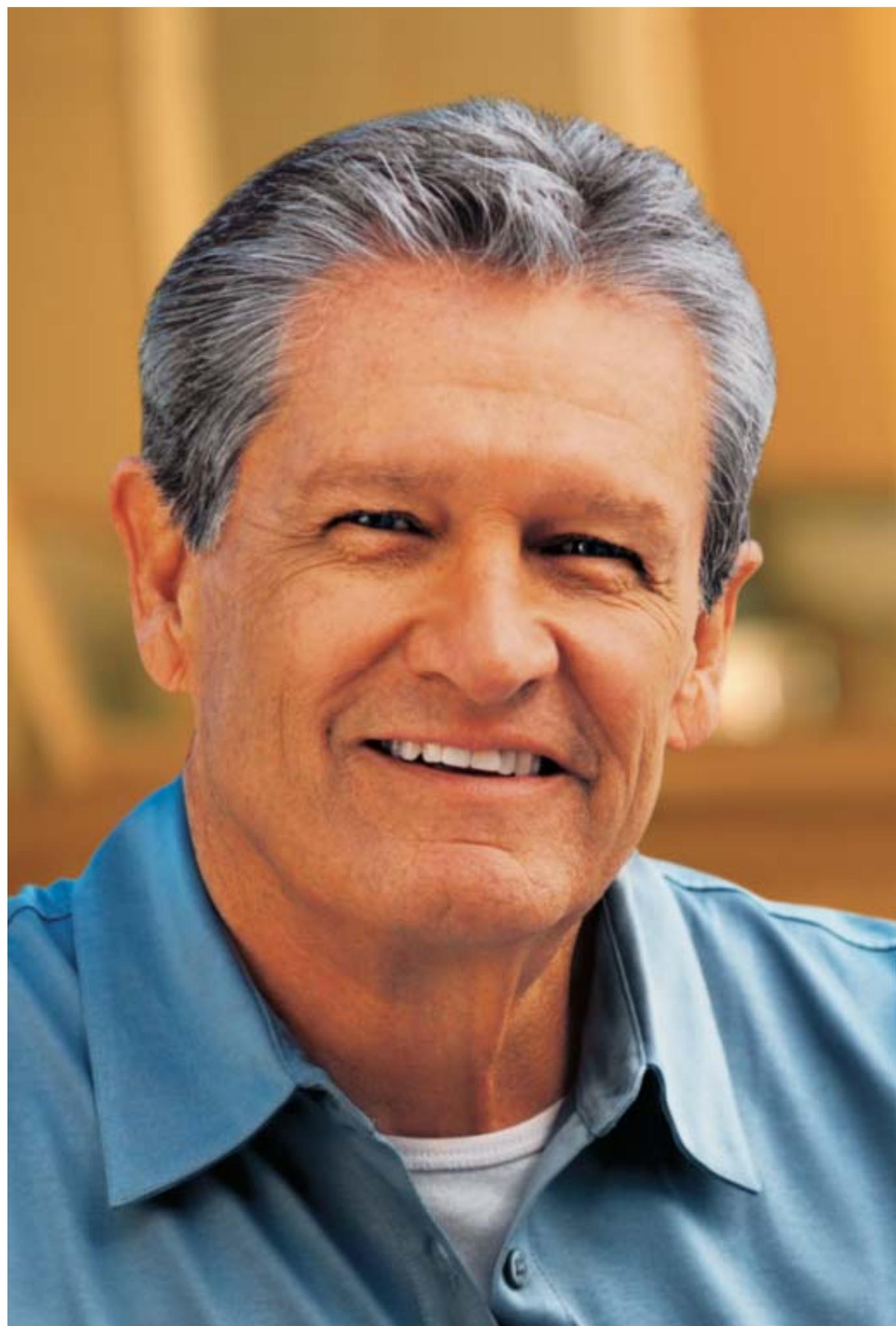
bundled an array of noninsurance geriatric care management services into Nurse NavigatorSM, our program enabling members and their families to find solutions to complex eldercare concerns. Nurse Navigator combines the services of care managers and advisors with a customer contact center, online information resources, and a network of over 4,600 providers offering discounts to senior products and services, ranging from assisted living centers to home health agencies.

While CHCS Services is a logical extension of our senior insurance activities, its steady revenue stream from recurring fees counterbalances the risk-based income of our other operations. Moreover, the knowledge we glean administering services to seniors helps us in developing our own insurance products designed specifically for that market.



A photograph showing a woman in a pink shirt leaning over an elderly woman with white hair. The woman in pink has her hands on the shoulders of the elderly woman, who is wearing a colorful, patterned sweater. They are both smiling slightly. The background features floral wallpaper.

Insurers and managed care companies turn to CHCS Services for a multitude of services. We are expert at underwriting Medicare Supplement risks and processing claims, and our nationwide network of nurses and social workers provides seniors with compassionate, personalized attention and care.



The sizable self-employed market is often neglected and underserved. Moreover, the percentage of those who are self-employed is considerably higher among older workers. This presents our agents with a natural crossover opportunity.

INSURANCE SOLUTIONS FOR THE SELF-EMPLOYED

For the growing number of self-employed – whether they are choosing independent careers, transitioning into retirement or by necessity creating alternatives to a salaried occupation – our specialty insurance products provide a vitally important financial safety net.

Today, more than ten percent of the U.S. workforce is self-employed, and the numbers are closer to eighteen percent in Canada. And yet, this sizable market is often neglected and underserved. At Universal American, we provide a full complement of specialty products targeted to the self-employed. These include supplemental health insurance, life insurance, and other products for asset accumulation and financial protection.

We focus on serving small cities and rural towns throughout North America. Over 1,000 of our career agents, in more than 100 offices, cater to the self-employed through our Pennsylvania Life subsidiary in the U.S. and PennCorp Life in Canada. We especially work with a “blue-collar” and “gray-collar” clientele, including farmers, independent contractors and other small business owners.

This steady, niche market has been highly profitable for Universal American and dovetails nicely with our other core activities. The percentage of those who are self-employed is considerably higher among older workers – age 50 and above – than among the workforce in general. This presents our agents with a natural crossover opportunity. It opens the door to selling senior market insurance products to our self-employed customers as they grow older and their lives change.

Self-employment can be a rewarding path. Statistics show that, on average, older self-employed workers are generally quite better off than their salary- and wage-earning counterparts. But self-employment also brings added responsibility, to make sure that planning for important work- and life-related matters is not overlooked. Our agents help relieve our customers of several of their pressing concerns.



EXECUTIVE TEAM

RICHARD A. BARASCH
Chairman and
Chief Executive Officer



GARY W. BRYANT
Executive Vice President and
Chief Operating Officer



ROBERT A. WAEGELEIN
Executive Vice President and
Chief Financial Officer



WILLIAM E. WEHNER
President
Pennsylvania Life

JASON J. ISRAEL
Chief Operating Officer
CHCS Services, Inc.



GARY JACOBS
President
CHCS Services, Inc.

THEODORE M. CARPENTER, JR.
Chief Executive Officer
Heritage Health Systems, Inc.

FINANCIAL REPORT

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SELECTED FINANCIAL DATA

Universal American Financial Corp. and Subsidiaries

<i>As of or for the Year Ended December 31, (in thousands, except per share and other data)</i>	2000 ⁽¹⁾	2001	2002	2003 ⁽²⁾	2004 ⁽³⁾
INCOME STATEMENT DATA:					
Direct premium and policyholder fees	\$ 451,323	\$ 513,575	\$ 586,686	\$ 700,415	\$ 858,921
Reinsurance premium assumed	3,055	2,549	5,075	27,042	35,682
Reinsurance premium ceded	(234,625)	(286,918)	(325,184)	(280,489)	(249,419)
Net premium and other policyholder fees	219,753	229,206	266,577	446,968	645,184
Net investment income	56,945	57,812	57,716	61,075	65,191
Realized gains	146	3,078	(5,083)	2,057	10,647
Fee and other income	7,247	10,847	12,313	12,648	14,323
Total revenues	284,091	300,943	331,523	522,748	735,345
Total benefits, claims and other deductions	251,025	257,580	287,493	456,269	638,877
Income before taxes	33,066	43,363	44,030	66,479	96,468
Net income	22,885	28,925	30,127	43,052	63,871
PER SHARE DATA:					
Earnings per share:					
Basic	0.49	0.58	0.57	0.80	1.17
Diluted	0.49	0.57	0.56	0.78	1.13
Book value per share:					
Basic	\$ 3.72	\$ 4.38	\$ 5.42	\$ 6.41	\$ 7.60
BALANCE SHEET DATA:					
Total cash and investments				\$1,286,508	\$1,378,339
Total assets				1,780,948	2,017,088
Policyholder related liabilities				1,251,055	1,343,026
Outstanding bank debt				38,172	101,063
Trust preferred securities				75,000	75,000
Shareholders' equity				345,738	419,421
DATA REPORTED TO REGULATORS⁽⁴⁾:					
Statutory capital and surplus				\$ 179,028	\$ 183,136
Asset valuation reserve				1,542	2,423
Adjusted capital and surplus				\$ 180,570	\$ 185,559

⁽¹⁾ Includes the results of American Insurance Administration Group, Inc. since its acquisition on January 6, 2000, and Capitated Health Care Services, Inc. since its acquisition on August 10, 2000.

⁽²⁾ Includes the results of Pyramid Life since its acquisition on March 31, 2003.

⁽³⁾ Includes the results of Heritage Health Systems, Inc. since its acquisition on May 28, 2004.

⁽⁴⁾ Includes capital and surplus of Penncorp Life (Canada) of C\$82,907 as of December 31, 2003 and C\$57,398 as of December 31, 2004, as reported to the Office of the Superintendent of Financial Institutions Canada, converted at the related exchange rates of C\$0.7654 per U.S. \$1.00 as of December 31, 2003 and C\$0.8320 per U.S. \$1.00 as of December 31, 2004.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Universal American Financial Corp. and Subsidiaries

INTRODUCTION

The following analysis of our consolidated results of operations and financial condition should be read in conjunction with the consolidated financial statements and related consolidated footnotes included in this report and also included in our Annual Report on Form 10-K for the year ended December 31, 2004, which is filed with the Securities and Exchange Commission. As used in this report, "Universal American," "we," "our," and "us" refer to Universal American Financial Corp. and its subsidiaries, except where the context otherwise requires or as otherwise indicated.

DISCLOSURE REGARDING FORWARD LOOKING STATEMENTS

Portions of the information in this Annual Report on Form 10-K and certain oral statements made from time to time by representatives of the Company may be considered "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995. The Company intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in Section 21E of the Exchange Act and the Private Securities Litigation Reform Act of 1995. Such forward-looking statements relate to, without limitation, the Company's future economic performance, plans and objectives for future operations and projections of revenue and other financial items. Forward-looking statements can be identified by the use of words such as "prospects," "outlook," "believes," "estimates," "intends," "may," "will," "should," "anticipates," "expects" or "plans," or the negative or other variation of these or similar words, or by discussion of trends and conditions, strategy or risks and uncertainties. Forward-looking statements are inherently subject to risks, trends and uncertainties, many of which are beyond the Company's ability to control or predict with accuracy and some of which the Company might not even anticipate. Although the Company believes that the expectations reflected in such forward-looking statements are based upon reasonable assumptions at the time made, it can give no assurance that its expectations will be achieved. Future events and actual results, financial and otherwise, may differ materially from the results discussed in the forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements.

Important factors that may cause actual results to differ materially from forward-looking statements include, but are not limited to, the risks and uncertainties set forth

in "Item 1 Business" in our Annual Report on Form 10-K for the year ended December 31, 2004, which is filed with the Securities and Exchange Commission and the following "Management's Discussion and Analysis of Financial Condition and Results of Operations". The Company assumes no obligation to update and supplement any forward-looking statements that may become untrue because of subsequent events, whether as a result of new information, future events or otherwise.

The following discussion and analysis presents a review of the Company as of December 31, 2004 and its results of operations for the fiscal years ended December 31, 2004, 2003 and 2002.

OVERVIEW

Our principal business segments are based on product and include: Senior Market Health Insurance, Senior Managed Care – Medicare Advantage, Specialty Health Insurance, Life Insurance/Annuities and Senior Administrative Services. We also report the activities of our holding company in a separate segment. Previously, we reported our segments based on distribution channel. Our former Senior Market Brokerage and Career Agency segments have been replaced with the three new segments: Senior Market Health Insurance, Life Insurance/Annuity and Specialty Health Insurance. Our Senior Managed Care – Medicare Advantage and Senior Administrative Services segments will be unchanged. We believe that this new segmentation will provide even greater clarity to our results. Reclassifications have been made to conform prior year amounts to the current year presentation. A description of these segments follows:

Senior Market Health Insurance – This segment consists primarily of our Medicare Supplement business and other senior market health products distributed through our career agency sales force and through our network of independent general agencies.

Senior Managed Care – Medicare Advantage – Our Senior Managed Care – Medicare Advantage segment includes the operations of Heritage and our other initiatives in managed care for seniors. Heritage operates Medicare Advantage plans in Houston and Beaumont Texas, and our Medicare Advantage private fee-for-service plan in New York and Pennsylvania.

Specialty Health Insurance – Our Specialty Health Insurance segment includes specialty health insurance products, primarily fixed benefit accident and sickness disability insurance, sold to the middle-income self-employed mar-

ket in the United States and Canada. This segment also includes certain products that we no longer sell, such as long term care and major medical. This segment's products are distributed primarily by our career agents.

Life Insurance/Annuities – This segment includes all of the life insurance and annuity business sold in the United States. This segment's products include senior, traditional and universal life insurance and fixed annuities and are distributed through both independent general agents and our career agency distribution systems.

Senior Administrative Services – Our administrative services subsidiary, CHCS Services, acts as a third party administrator and service provider of senior market insurance products and geriatric care management for both affiliated and unaffiliated insurance companies. The services provided include policy underwriting and issuance, telephone and face-to-face verification, policyholder services, claims adjudication, case management, care assessment and referral to health care facilities.

Corporate – Our Corporate segment reflects the activities of our holding company, including debt service, certain senior executive compensation, and compliance with regulatory requirements resulting from our status as a public company.

Intersegment revenues and expenses are reported on a gross basis in each of the operating segments but eliminated in the consolidated results. These intersegment revenues and expenses affect the amounts reported on the individual financial statement line items, but are eliminated in consolidation and do not change income before taxes. The significant items eliminated include intersegment revenue and expense relating to services performed by the Senior Administrative Services segment for our other segments and interest on notes payable or receivable between the Corporate segment and the other operating segments.

Critical Accounting Policies

Our consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP"). The preparation of our financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the amounts of assets and liabilities and disclosures of assets and liabilities reported by us at the date of the financial statements and the revenues and expenses reported during the reporting period. As additional information becomes available or actual amounts become determinable, the recorded estimates may be revised and reflected in operating results. Actual results could differ from those estimates. Accounts that, in our judgment, are most critical to the preparation of our financial statements include policy liabilities and accruals, deferred policy acquisition costs, intangible assets, valuation of

certain investments and deferred income taxes. There have been no changes in our critical accounting policies during the current quarter.

Policy related liabilities We calculate and maintain reserves for the estimated future payment of claims to our policyholders using the same actuarial assumptions that we use in the pricing of our products. For our accident and health insurance business, we establish an active life reserve for expected future policy benefits, plus a liability for due and unpaid claims, claims in the course of settlement and incurred but not reported claims. Many factors can affect these reserves and liabilities, such as economic and social conditions, inflation, hospital and pharmaceutical costs, changes in doctrines of legal liability and extra contractual damage awards. Therefore, the reserves and liabilities we establish are based on extensive estimates, assumptions and prior years' statistics. When we acquire other insurance companies or blocks of insurance, our assessment of the adequacy of acquired policy liabilities is subject to similar estimates and assumptions. Establishing reserves involves inherent uncertainties, and it is possible that actual claims could materially exceed our reserves and have a material adverse effect on our results of operations and financial condition. Our net income depends significantly upon the extent to which our actual claims experience is consistent with the assumptions we used in setting our reserves and pricing our policies. If our assumptions with respect to future claims are incorrect, and our reserves are insufficient to cover our actual losses and expenses, we would be required to increase our liabilities resulting in reduced net income and shareholders' equity.

Deferred policy acquisition costs The cost of acquiring new business, principally non-level commissions and agency production, underwriting, policy issuance, and associated costs, all of which vary with, and are primarily related to the production of new and renewal business, are deferred. For interest-sensitive life and annuity products, these costs are amortized in relation to the present value of expected gross profits on the policies arising principally from investment, mortality and expense margins in accordance with SFAS No. 97, "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments". For other life and health products, these costs are amortized in proportion to premium revenue using the same assumptions used in estimating the liabilities for future policy benefits in accordance with SFAS No. 60, "Accounting and Reporting by Insurance Enterprises."

The determination of expected gross profits for interest-sensitive products is an inherently uncertain process that relies on assumptions including projected interest rates, the persistency of the policies issued as well as anticipated benefits, commissions and expenses. It is possible

that the actual profits from the business may vary materially from the assumptions used in the determination and amortization of deferred acquisition costs. Deferred policy acquisition costs are written off to the extent that it is determined that future policy premiums and investment income or gross profits would not be adequate to cover related losses and expenses.

Present value of future profits and other intangibles

Business combinations accounted for as a purchase result in the allocation of the purchase consideration to the fair values of the assets and liabilities acquired, including the present value of future profits, establishing such fair values as the new accounting basis. The present value of future profits is based on an estimate of the cash flows of the in force business acquired, discounted to reflect the present value of those cash flows. The discount rate selected depends upon the general market conditions at the time of the acquisition and the inherent risk in the transaction. Purchase consideration in excess of the fair value of net assets acquired, including the present value of future profits and other identified intangibles, for a specific acquisition, is allocated to goodwill. Allocation of purchase price is performed in the period in which the purchase is consummated. Adjustments, if any, in subsequent periods relate to resolution of pre-acquisition contingencies and refinements made to estimates of fair value in connection with the preliminary allocation.

Amortization of present value of future profits is based upon the pattern of the projected cash flows of the in-force business acquired, over weighted average lives ranging from six to forty years. Other identified intangibles are amortized over their estimated lives.

On a periodic basis, management reviews the unamortized balances of present value of future profits, goodwill and other identified intangibles to determine whether events or circumstances indicate the carrying value of such assets is not recoverable, in which case an impairment charge would be recognized. Management believes that no impairments of present value of future profits, goodwill or other identified intangibles existed as of December 31, 2004.

Investment valuation Fair value of investments is based upon quoted market prices, where available, or on values obtained from independent pricing services. For certain mortgage and asset-backed securities, the determination of fair value is based primarily upon the amount and timing of expected future cash flows of the security. Estimates of these cash flows are based upon current economic conditions, past credit loss experience and other circumstances.

We regularly evaluate the amortized cost of our investments compared to the fair value of those investments. Impairments of securities generally are recognized when a decline in fair value below the amortized cost basis is considered to be other-than-temporary. Generally,

we consider a decline in fair value to be other-than-temporary when the fair value of an individual security is below amortized cost for an extended period and we do not believe that recovery in fair value is probable. Impairment losses for certain mortgage and asset-backed securities are recognized when an adverse change in the amount or timing of estimated cash flows occurs, unless the adverse change is solely a result of changes in estimated market interest rates and we intend to hold the security until maturity. The cost basis for securities determined to be impaired are reduced to their fair value, with the excess of the cost basis over the fair value recognized as a realized investment loss.

Income taxes We use the liability method to account for deferred income taxes. Under the liability method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date of a change in tax rates.

We establish valuation allowances on our deferred tax assets for amounts that we determine will not be recoverable based upon our analysis of projected taxable income and our ability to implement prudent and feasible tax planning strategies. Increases in these valuation allowances are recognized as deferred tax expense. Subsequent determinations that portions of the valuation allowances are no longer necessary are reflected as deferred tax benefits. To the extent that valuation allowances were established in conjunction with acquisitions, changes in those allowances are first applied to increasing or decreasing the goodwill (but not below zero) or other intangibles related to the acquisition and then applied as an increase or decrease in income tax expense.

SIGNIFICANT TRANSACTIONS – ACQUISITIONS

Acquisition of Heritage Health Systems, Inc. On May 28, 2004, we acquired Heritage, a privately owned managed care company that operates Medicare Advantage plans in Houston and Beaumont Texas, for \$98 million in cash plus transaction costs of \$1.6 million. The acquisition was financed with \$66.5 million of net proceeds derived from the amendment of our credit facility and \$33.1 million of cash on hand. As of the date of acquisition, Heritage had approximately 16,000 Medicare members and annualized revenues of approximately \$140 million. Operating results generated by Heritage prior to the

date of acquisition are not included in our consolidated financial statements.

Acquisition of Pyramid Life On March 31, 2003, we acquired all of the outstanding common stock of Pyramid Life Insurance Company (“Pyramid Life”). Pyramid Life specializes in selling health and life insurance products to the senior market, including Medicare Supplement and Select, long term care, life insurance, and annuities. With this acquisition, we acquired a \$120 million block of in-force business, as well as a career sales force that is skilled in selling senior market insurance products. Pyramid Life markets its products in 30 states through a career agency sales force of over 1,000 agents operating out of 39 Senior Solutions® Sales Centers. Following a transition period that took approximately ten months, the Pyramid Life business was fully transitioned into our existing operations. Operating results generated by Pyramid Life prior to the date of acquisition are not included in our consolidated financial statements.

Recapture of Reinsurance Ceded Effective April 1, 2003, we entered into agreements to recapture approximately \$48 million of Medicare Supplement business that had previously been reinsured to Transamerica Occidental Life Insurance Company, Reinsurance Division (“Transamerica”) under two quota share contracts. No ceding allowance was paid in the recapture and we currently retain 100% of the risks on the \$48 million of Medicare Supplement business. There was no gain or loss reported on these recapture agreements.

Acquisition of Nationwide Block of Business In November 2002 we entered into an agreement with Nationwide Life Insurance Company (“Nationwide”) to acquire, through a 100% quota share reinsurance agreement, Nationwide’s individual Medicare Supplement policies. Approximately \$22 million of annualized premium was in force at the date of acquisition.

Acquisition of Ameriplus On August 1, 2003, we acquired 100% of the outstanding common stock of Ameriplus Preferred Care, Inc. (“Ameriplus”). Ameriplus is engaged in the business of creating and maintaining a network of hospitals for the purpose of providing discounts to our Medicare Select policyholders. Ameriplus’ network is utilized in connection with Medicare Select policies written by our subsidiaries and can be offered to non-affiliated parties as well. Ameriplus receives network fees when premiums for these Medicare Select policies are collected.

Acquisition of Guarantee Reserve Marketing Organization Effective July 1, 2003, we entered into an agreement with Swiss Re and its newly acquired subsidiary, Guarantee Reserve Life Insurance Company (“Guarantee

Reserve”), to acquire Guarantee Reserve’s marketing organization, including all rights to do business with its field force. The primary product sold by this marketing organization is low face amount whole life insurance, primarily for seniors. Beginning July 1, 2003, the Guarantee Reserve field force continued to write this business in Guarantee Reserve, with us administering all new business and assuming 50% of the risk through a quota share reinsurance arrangement. New business has been written by our subsidiaries with 50% of the risk ceded to Swiss Re beginning in the second quarter of 2004 as the products were approved for sale in each state.

Results of Operations – Consolidated Overview

The following table reflects income from each of our segments⁽¹⁾ and contains a reconciliation to reported net income:

For the year ended December 31, (In thousands)	2002	2003	2004
Senior Market Health Insurance ⁽¹⁾	\$ 8,564	\$ 27,734	\$ 35,407
Senior Managed Care – Medicare Advantage ⁽¹⁾	–	–	10,136
Specialty Health Insurance ⁽¹⁾	25,603	24,435	26,316
Life Insurance/Annuities ⁽¹⁾	14,207	11,981	13,370
Senior Administrative Services ⁽¹⁾	7,632	11,018	13,090
Corporate ⁽¹⁾	(6,893)	(10,746)	(12,498)
Realized gains (losses)	(5,083)	2,057	10,647
Income before income taxes ⁽¹⁾	44,030	66,479	96,468
Income taxes, excluding capital gains	15,682	23,325	28,871
Income taxes on capital gains (losses)	(1,779)	720	3,726
Income tax benefit on early extinguishment of debt	–	(618)	–
Total income taxes	13,903	23,427	32,597
Net income	\$30,127	\$ 43,052	\$ 63,871
Per Share Data (Diluted):			
Net income	\$ 0.56	\$ 0.78	\$ 1.13

⁽¹⁾We evaluate the results of operations of our segments based on income before realized gains and income taxes. Management believes that realized gains and losses are not indicative of overall operating trends. This differs from generally accepted accounting principles, which includes the effect of realized gains in the determination of net income. The schedule above reconciles our segment income to net income in accordance with generally accepted accounting principles.

Years ended December 31, 2004 and 2003 Net income for 2004 increased 48% to \$63.9 million, or \$1.13 per share, compared to \$43.1 million, or \$0.78 per share in 2003. During 2004, we recognized realized gains, net of tax, of \$6.9 million, or \$0.12 per share, compared to realized gains, net of tax, of \$1.3 million, or \$0.02 per share in 2003. The realized gains in 2004 were generated at Penncorp Life (Canada) as a result of the sale of investments to fund the dividend of approximately \$19.6 million paid to the parent company during the first quarter of 2004 and the tax payments made during the first quarter of 2004 relating to 2003 taxable income. See “Liquidity

and Capital Resources – Obligations of the Parent Company to Affiliates” for additional information regarding the dividend. Additionally, during the third quarter of 2004, we took the opportunity to realize investment gains as interest rates dropped during the year to make efficient use of our tax capital loss carryforwards. We believe that further opportunity for generating realized investment gains is limited. Our overall effective tax rate was 33.8% for 2004 and 35.2% for 2003.

Our Senior Market Health Insurance segment results improved by \$77 million, or 28%, to \$35.4 million in 2004 compared to 2003, primarily as a result of the Pyramid Life business being included for a full year in 2004 compared to nine months in 2003 and increased retention of the Medicare Supplement business. We have increased our retention to 100% for all Medicare Supplement business sold beginning January 1, 2004.

Our Senior Managed Care – Medicare Advantage segment includes the results of Heritage and our other initiatives in Medicare managed care, including our Medicare Advantage private fee for service plans, for the seven months since acquisition or inception.

Our Specialty Health Insurance segment results improved by \$1.9 million, or 8%, to \$26.3 million in 2004 compared to 2003, primarily as a result of improvement in loss ratios, as well as the strengthening of the Canadian dollar, relative to the U.S. dollar.

Results for our Life Insurance/Annuities segment improved by \$1.4 million, or 12%, to \$13.4 million in 2004 compared to 2003, primarily as a result of an increase in business and more favorable morbidity.

Our Senior Administrative Services segment income improved by \$2.1 million, or 19%, compared to 2003. This improvement was primarily a result of the growth in premiums managed.

The loss from our Corporate segment increased by \$1.8 million, or 16%, compared to the 2003. The increase was due to higher interest cost as a result of an increase in the amount of the debt outstanding during the year, relating to the amendment of our credit facility in connection with our acquisition of Heritage, offset in part, by a reduction in the weighted average interest rates, as compared to the same period of 2003.

Years Ended December 31, 2003 and 2002 Net income for 2003 increased 43%, to \$43.1 million, or \$0.78 per share, compared to \$30.1 million, or \$0.56 per share in 2002. During 2003, we recognized realized gains, net of tax of \$1.3 million, or \$0.02 per share, compared to realized losses, net of tax of \$3.3 million, or \$0.06 per share in 2002. The losses in 2002 were primarily a result of the recognition of an impairment of our WorldCom holdings. In connection with the acquisition of Pyramid Life on March 31, 2003, we refinanced our credit facility. As a result of the repayment of our existing debt, we were required to write off the unamortized portion of the fees

we incurred for that debt. This resulted in a pre-tax, non-cash charge of \$1.8 million (the “financing charge”), which is included in the operating loss of the Corporate segment. Our overall effective tax rate was 35.2% for 2003 as compared to 31.6% for 2002. Our 2002 results benefited from the release of a portion of a tax valuation reserve that added \$0.03 per share. Excluding the release of the tax valuation allowance, the effective tax rate was 35.2% in 2002.

Our Senior Market Health Insurance segment results increased by \$19.2 million, or 224%, to \$27.7 million in 2003 compared to 2002, primarily due to the addition of the Pyramid Life business since its acquisition on March 31, 2003 and growth and increased retention of the Medicare Supplement business. We had increased our retention, on average, to 75% for all Medicare Supplement business sold beginning January 1, 2003, from 50% in 2002.

Our Specialty Health Insurance segment results decreased by \$1.2 million, or 5%, to \$24.4 million in 2003 compared to 2002, primarily as a result of an increase in loss ratios, offset by strengthening of the Canadian dollar.

Results for our Life Insurance/Annuities segment declined by \$2.2 million, or 16%, to \$12.0 million in 2003 compared to 2002, primarily as a result of less favorable mortality.

Our Senior Administrative Services segment income improved by \$3.4 million, or 44%, compared to 2002. This improvement was primarily a result of the growth in premiums managed and the scheduled reduction in the amortization of intangible assets.

The loss from our Corporate segment increased by \$3.9 million, or 56%, compared to 2002, due primarily to the charge associated with the refinancing of our debt and the increase in financing costs and other parent company expenses. In connection with the acquisition of Pyramid Life, we refinanced our debt. The early extinguishment of the existing debt resulted in the immediate amortization of the related capitalized loan origination fees, resulting in a pre-tax expense of approximately \$1.8 million. The increase in financing cost was due to an increase in the amount of the debt outstanding during the year, offset in part, by a reduction in the weighted average interest rates for the year, compared to 2002.

SEGMENT RESULTS – SENIOR MARKET HEALTH INSURANCE

<i>For the year ended December 31, (In thousands)</i>	2002	2003	2004
Premiums:			
Direct and assumed	\$ 394,047	\$ 511,272	\$ 576,345
Ceded	(289,121)	(243,215)	(221,022)
Net premiums	104,926	268,057	355,323
Net investment income	1,853	3,341	4,167
Other income	123	221	859
Total revenue	106,902	271,619	360,349
Policyholder benefits	73,482	184,493	246,019
Change in deferred acquisition costs	(10,201)	(21,914)	(32,878)
Amortization of intangible assets	112	1,823	1,973
Commissions and general expenses, net of allowances	34,945	79,483	109,828
Total benefits, claims and other deductions	98,338	243,885	324,942
Segment income	\$ 8,564	\$ 27,734	\$ 35,407

Years ended December 31, 2004 and 2003 Our Senior Market Health Insurance segment results improved by \$77 million, or 28%, to \$35.4 million in 2004 compared to 2003, primarily as a result of the inclusion of the results of operations of the Pyramid Life business for a full year in 2004 compared to only nine months in 2003 and increased retention of the Medicare Supplement business. We have increased our retention to 100% for all Medicare Supplement business sold beginning January 1, 2004.

Revenues. Net premiums for the Senior Market Health Insurance segment increased by \$87.3 million, or 33%, compared to 2003. Approximately \$28.2 million, or 11%, relates to additional premiums from the Pyramid Life business as a result of the inclusion of the results of operations of the Pyramid Life business for a full year in 2004 compared to only nine months in 2003. \$59.1 million, or 22%, is due to growth and increased retention of the Medicare Supplement business.

Net investment income increased by approximately \$0.8 million, or 25%, compared to 2003. The increase is due primarily to growth in invested assets due to growth in business.

Benefits, Claims and Expenses. Policyholder benefits, including the change in reserves, increased by \$61.5 million, or 33%, during 2004 compared to 2003, primarily as a result of the increased retention of the Medicare Supplement business noted above, the effect of a full year of the Pyramid Life operations and a modest increase in loss ratios. Overall loss ratios for the segment increased to 69.2% in 2004 compared to 68.8% in 2003, which accounted for \$1.3 million of the increase in benefits. The additional quarter of the Pyramid Life business contributed \$19.6 million and the growth and increased

retention rate added the balance of \$40.6 million to the increase.

The change in deferred acquisition costs was \$11.0 million more in 2004, compared to the amount in 2003. \$3.7 million of this change is due to the Pyramid Life business being included for a full year in 2004 compared to nine months in 2003. The balance of \$7.3 million is a result of growth and the increased retention of the Medicare Supplement business.

The amortization of intangibles relates primarily to intangibles relating to the acquisition of Pyramid Life.

Commissions and general expenses increased by \$30.3 million, or 38%, in 2004 compared to 2003. \$7.8 million of this increase is due to the inclusion of an additional quarter of the results of operations of the Pyramid Life business and the balance of \$22.5 million is due to higher net commission expense due to the growth and increased retention of the Medicare Supplement business. The following table details the components of commission and other operating expenses:

<i>For the year ended December 31, (In thousands)</i>	2003	2004
Commissions	\$ 78,014	\$ 84,977
Other operating costs	61,236	72,269
Reinsurance allowances	(59,767)	(47,418)
Commissions and general expenses, net of allowances	\$ 79,483	\$109,828

The ratio of commissions to gross premiums decreased to 14.7% during 2004, from 15.3% in 2003, as a result of the growth in the in force renewal premium from better persistency and rate increases. Other operating costs as a percentage of gross premiums increased to 12.5% during 2004 from 12.0% in 2003. Commission and expense allowances received from reinsurers as a percentage of the premiums ceded also decreased to 21.5% during 2004 from 24.6% in 2003, primarily due to the reduction in new business ceded and the affects of normal lower commission allowances on an aging base of renewal ceded business.

Years ended December 31, 2003 and 2002 Our Senior Market Health Insurance segment results increased by \$19.2 million, or 224%, to \$27.7 million in 2003 compared to 2002, primarily due to the inclusion of the results of operations of the Pyramid Life business since its acquisition on March 31, 2003 and growth and increased retention of the Medicare Supplement business. We had increased our retention, on average, to 75% for all Medicare Supplement business sold beginning January 1, 2003, from 50% in 2002.

Revenues. Net premiums for the Senior Market Health Insurance segment increased by \$163.1 million, or 156%, compared to 2002. Approximately \$77.1 million, or 47% of the increase, related to additional premiums from the Pyramid Life business since its acquisition. \$86.0 million, or 53% of the increase, is due to growth and increased retention of the Medicare Supplement business.

Net investment income increased by approximately \$1.5 million, or 80%, compared to 2003. The increase is due primarily to growth in invested assets due to growth in business.

Benefits, Claims and Expenses. Policyholder benefits, including the change in reserves, increased by \$111.0 million, or 151%, during 2003 compared to 2002, primarily as a result of increased retention of the Medicare Supplement business noted above and the inclusion of the results of operations of the Pyramid Life business, since its acquisition. This was partially offset by a decrease in loss ratios. Overall loss ratios for the segment decreased to 68.8% in 2003 compared to 70.0% in 2002, which decreased benefits by \$1.1 million. The additional Pyramid Life business contributed \$51.8 million of additional benefits expense and growth in business and the increased retention rate added the balance of \$60.3 million to the increase.

The change in deferred acquisition costs was \$11.7 million more in 2003, compared to the amount in 2002. \$7.5 million of this change was due to the addition of Pyramid Life business, since its acquisition. The balance of \$4.2 million was a result of growth and the increased retention of the Medicare Supplement business.

The amortization of intangibles relates primarily to intangibles relating to the acquisition of Pyramid Life.

Commissions and general expenses increased by \$44.5 million, or 127%, in 2003 compared to 2002. \$24.2 million of this increase is due to the additional Pyramid business, since its acquisition on March 31, 2003 and the balance of \$20.3 million is due to higher net commission expense due to the growth and increased

retention of the Medicare Supplement business. The following table details the components of commission and other operating expenses:

<i>For the year ended December 31, (In thousands)</i>	2002	2003
Commissions	\$ 66,400	\$ 78,014
Other operating costs	49,717	61,236
Reinsurance allowances	(81,172)	(59,767)
Commissions and general expenses, net of allowances	<u>\$ 34,945</u>	<u>\$ 79,483</u>

The ratio of commissions to gross premiums decreased to 15.3% during 2003, from 16.9% in 2002, as a result of the growth in the in force renewal premium from better persistency and rate increases. Other operating costs as a percentage of gross premiums decreased to 12.0% during 2003 from 12.6% in 2002. Commission and expense allowances received from reinsurers as a percentage of the premiums ceded also decreased to 24.6% during 2003 from 28.1% in 2002, primarily due to the reduction in new business ceded, the recapture of the Transamerica treaties, and the effects of normal lower commission allowances on an aging base of renewal ceded business.

SEGMENT RESULTS – SENIOR MANAGED CARE – MEDICARE ADVANTAGE

<i>For the year ended December 31, (In thousands)</i>	2002	2003	2004 ⁽²⁾
Net premiums	\$–	\$–	\$93,011
Net and other investment income	–	–	517
Total revenue	–	–	93,528
Medical expenses	–	–	66,449
Amortization of intangible assets	–	–	1,901
Commissions and general expenses	–	–	15,042
Total benefits, claims and other deductions	–	–	83,392
Segment income	–	–	10,136
Depreciation, amortization and interest	–	–	2,104
Earnings before interest, taxes, depreciation and amortization (“EBITDA”) ⁽¹⁾	<u>\$–</u>	<u>\$–</u>	<u>\$12,240</u>

⁽¹⁾ In addition to segment income, we also evaluate the results of our Medicare Advantage segment based on earnings before interest, taxes, depreciation and amortization (“EBITDA”). EBITDA is a common alternative measure of performance used by investors, financial analysts and rating agencies. It is also a measure that is included in the fixed charge ratio required by the covenants for our outstanding bank debt. Accordingly, these groups use EBITDA, along with other measures, to estimate the value of a company and evaluate the Company’s ability to meet its debt service requirements. While we consider EBITDA to be an important measure of comparative operating performance, it should not be construed as an alternative to segment income or cash flows from operating activities (as determined in accordance with generally accepted accounting principles).

⁽²⁾ Includes results for the seven months since acquisition or inception.

Our Senior Managed Care – Medicare Advantage segment includes the operations of Heritage and our other initiatives in Medicare managed care, including our Medicare Advantage private fee-for-service plans. Heritage generates its revenues and profits from three sources. First, Heritage owns an interest in SelectCare, a health plan that offers coverage to Medicare beneficiaries under a contract with CMS. Next, Heritage operates three separate Management Service Organizations (“MSO’s”) that manage the business of SelectCare and two affiliated Independent Physician Associations (“IPA’s”). Lastly, Heritage participates in the profits derived from these IPA’s. The components of the revenues and results within the segment are as follows:

<i>For the year ended December 31, 2004⁽¹⁾</i> <i>(In thousands)</i>	Revenues	Segment Income
Health Plan	\$ 90,497	\$ 3,722
Affiliated IPA’s	58,517	5,619
MSO’s and Corporate	15,843	1,124
Private Fee-for Service	3,333	(329)
Eliminations	(74,662)	–
Total	\$ 93,528	\$10,136

(1)Includes results for the seven months since acquisition or inception.

Intrasegment revenues are reported on a gross basis in each of the above components of the Medicare Advantage segment. These intrasegment revenues are eliminated in the consolidation for the segment totals. The eliminations include premiums received by the IPA’s from the Health Plan amounting to \$59.1 million and management fees received by the MSO’s from the Health Plan and the IPA’s amounting to \$15.6 million for the seven months since its acquisition.

Heritage operates a health plan through SelectCare, a provider sponsored organization (“PSO”). SelectCare is a Medicare Advantage coordinated care plan operating in Beaumont and Houston, Texas, which had 16,100 members as of May 28, 2004 (the date of acquisition) and receives its premiums primarily from CMS. SelectCare makes capitated risk payments to four IPA’s or medical groups in the Houston and Beaumont regions, two of which are affiliated IPA’s. In addition, SelectCare retains the risk for certain other types of care, primarily out of area emergency and transplants. As of December 31, 2004, SelectCare had approximately 18,800 members enrolled. For the seven months since its acquisition, SelectCare had revenues of \$90.5 million and had a medical loss ratio of 83.3%.

Heritage participates in the profits from the two affiliated IPA’s that receive capitated payments from SelectCare. As of December 31, 2004, the affiliated IPA’s managed the care for approximately 14,200 SelectCare members. For the seven months since its acquisition, Heritage earned \$5.6 million on \$58.5 million in fees received from SelectCare.

Heritage owns three MSO’s that provide comprehensive management services to SelectCare and its affiliated IPA’s as part of long-term management agreements. Services provided include strategic planning, provider network services, marketing, finance and accounting, enrollment, claims processing, information systems, utilization review, credentialing and quality management. For the seven months since its acquisition, these MSO’s earned \$1.1 million of income on \$15.8 million of fees collected.

Starting in the month of June, American Progressive, an insurance subsidiary of Universal American, began enrolling members in its private fee for service product, a Medicare Advantage program that allows its member to have more flexibility in the delivery of their health care services than other Medicare Advantage plans. In addition to premium received from CMS, American Progressive receives modest premium payments from the members as well. As of December 31, 2004, American Progressive had 1,405 members enrolled. For the seven months since inception, American Progressive collected \$3.3 million of premium from CMS and the members, and reported a medical loss ratio of 75.4%. In addition, American Progressive expensed approximately \$0.4 million in start-up expenses, primarily during the second quarter of 2004.

SEGMENT RESULTS – SPECIALTY HEALTH INSURANCE

<i>For the year ended December 31,</i> <i>(In thousands)</i>	2002	2003	2004
Premiums:			
Direct and assumed	\$164,034	\$173,746	\$174,343
Ceded	(29,815)	(29,131)	(26,561)
Net premiums	134,219	144,615	147,782
Net investment income	27,737	26,970	26,351
Other income	369	546	516
Total revenue	162,325	172,131	174,649
Policyholder benefits	88,371	97,204	96,836
Change in deferred acquisition costs	(11,838)	(10,553)	(8,292)
Commissions and general expenses, net of allowances	60,189	61,045	59,789
Total benefits, claims and other deductions	136,722	147,696	148,333
Segment income	\$ 25,603	\$ 24,435	\$ 26,316

Years ended December 31, 2004 and 2003 Our Specialty Health Insurance segment results improved by \$1.9 million, or 8%, to \$26.3 million in 2004 compared to 2003, primarily as a result of improvement in loss ratios, as well as the strengthening of the Canadian dollar. The operations of PennCorp Life (Canada), which are included in our Specialty Health segment results, are transacted using the Canadian dollar as the functional currency. The Canadian dollar strengthened relative to the U.S. dollar in 2004. The average conversion rate increased 8%, to

C\$0.7689 per U.S. \$1.00 for 2004, from C\$0.7141 per U.S. \$1.00 for 2003. This strengthening added approximately \$1.0 million of pre-tax income to the Specialty Health segment results for 2004, compared to 2003. See discussion below under the heading “Quantitative and Qualitative Disclosures about Market Risk” for additional information.

Revenues. Net premiums for the Specialty Health Insurance segment increased by \$3.2 million, or 2%, compared to 2003. Approximately, \$1.9 million of the increase relates to additional long term care and major medical premiums from the inclusion of the results of operations of Pyramid Life business for a full year in 2004 compared to only nine months in 2003. The balance of the increase is due to rate increases, offset by a reduction in long term care premium as a result of our decision to discontinue marketing that product, beginning in late 2003. Canadian business accounted for approximately 40% of the net premiums of this segment in 2004 and 38% of the net premiums in 2003, the increase attributed to the stronger Canadian dollar.

Net investment income decreased by approximately \$0.6 million, or 2%, compared to 2003. The decrease is due primarily to a combination of lower yields and a decrease in invested assets, due to the dividend paid by Penncorp Life (Canada) to our parent holding company in early 2004.

Benefits, Claims and Expenses. Policyholder benefits, including the change in reserves, decreased by \$0.4 million, or less than 1%, during 2004 compared to 2003, primarily as a result of improved loss ratios. Overall loss ratios for the segment declined to 65.5% in 2004 compared to 67.2% in 2003. During 2004 we recorded a non-recurring reduction in reserves in the amount of U.S. \$1.3 million (C\$1.8 million) which was identified during a review in connection with a conversion of the actuarial system used to determine reserves on our Canadian policies. Additionally, during 2004, we increased reserves on the runoff block of Florida home healthcare business by \$1.4 million as a result of an actuarial study performed on this block.

The increase in deferred acquisition costs was \$2.3 million less in 2004, compared to the increase in 2003. This is a result of a lower level of new business being written relative to the amortization of amounts previously capitalized.

Commissions and general expenses decreased by \$1.3 million, or 2%, in 2004 compared to 2003. Approximately \$0.6 million of the decrease relates to reductions in general expenses and the balance relates to lower commission expense as a result of the reduction in new business sold.

Years ended December 31, 2003 and 2002 Our Specialty Health Insurance segment results decreased by \$1.2 million, or 5%, to \$24.4 million in 2003 compared to 2002, primarily as a result of an increase in loss ratios, offset by strengthening of the Canadian dollar. The operations of Penncorp Life (Canada), which are included in our Specialty Health segment results, are transacted using the Canadian dollar as the functional currency. The Canadian dollar strengthened relative to the U.S. dollar in 2003. The average conversion rate increased 12%, to C\$0.7141 per U.S. \$1.00 for 2003, from C\$0.6370 per U.S. \$1.00 for 2002. This strengthening added approximately \$1.5 million of pre-tax income to the Specialty Health segment results for 2003, compared to 2002. See discussion below under the heading “Quantitative and Qualitative Disclosures about Market Risk” for additional information.

Revenues. Net premiums for the Specialty Health Insurance segment increased by \$10.4 million, or 8%, compared to 2002. Approximately, \$6.7 million of the increase was related to premiums from the Pyramid Life business since its acquisition. The remainder of the increase was primarily due to rate increases. Canadian business accounted for approximately 38% of the net premiums of this segment in 2003 and 43% of the net premiums in 2002.

Net investment income decreased by approximately \$0.8 million, or 3%, compared to 2002. The decrease was due primarily to lower yields on invested assets.

Benefits, Claims and Expenses. Policyholder benefits, including the change in reserves, increased by \$8.8 million, or 10%, during 2003 compared to 2002. Approximately \$6.4 million of the increase was related to benefits from the Pyramid Life business since its acquisition. The balance was primarily a result of higher loss ratios. Overall loss ratios for the segment increased to 67.2% in 2003 compared to 65.8% in 2002. The increase in deferred acquisition costs was \$1.3 million less in 2003, compared to the increase in 2002. This was the result of lower levels of new business being written relative to the amortization of amounts previously capitalized.

Commissions and general expenses increased by \$0.9 million, or 1%, in 2003 compared to 2002. The increase was due primarily to the additional Pyramid Life business, since its acquisition.

SEGMENT RESULTS – LIFE INSURANCE/ ANNUITIES

For the year ended December 31,
(In thousands)

	2002	2003	2004
Premiums:			
Direct and assumed	\$36,091	\$ 43,933	\$ 61,543
Ceded	(7,342)	(7,793)	(11,506)
Net premiums	28,749	36,140	50,037
Net investment income	27,865	30,742	34,207
Other income	203	208	279
Total revenue	56,817	67,090	84,523
Policyholder benefits	20,572	26,411	34,844
Interest credited to policyholders	10,964	14,900	18,617
Change in deferred acquisition costs	(5,844)	(18,637)	(24,337)
Amortization of intangible assets	-	817	925
Commissions and general expenses, net of allowances	16,918	31,618	41,104
Total benefits, claims and other deductions	42,610	55,109	71,153
Segment income	\$14,207	\$ 11,981	\$ 13,370

Years ended December 31, 2004 and 2003 Results for our Life Insurance/Annuities segment improved by \$1.4 million, or 12%, to \$13.4 million in 2004 compared to 2003, primarily as a result of an increase in business and more favorable morbidity.

Revenues. Net premiums for the segment increased by \$13.9 million, or 39%, compared to 2003. Approximately, \$7.1 million of the increase relates to the net business produced by the former Guarantee Reserve field force acquired in mid 2003. Approximately \$2.5 million of the increase relates to additional premiums from the Pyramid Life business as a result of inclusion of the results of operations of the Pyramid business for a full year in 2004 compared to only nine months in 2003. The balance relates to increased sales of our senior life product and an increase in policy fees on our interest sensitive life and annuity business as a result of the growth in the level of deposits for those products. Ceded premiums increased by approximately \$2.3 million as a result of the Guarantee Reserve business. During 2003, prior to receiving approval to write the business through the insurance subsidiaries of Universal American, 50% of the business was assumed from Swiss Re. As we received the regulatory approvals, we wrote the business through our insurance subsidiaries and ceded 50% back to Swiss Re. The balance of the increase in the ceded premiums relates to the increase in our senior life business.

Our agents sold \$72.0 million of fixed annuities during 2004 and \$120.7 million in 2003. Annuity deposits are not considered premiums for reporting in accordance with generally accepted accounting principles. The reduction in annuity sales was the result of lower interest crediting rates on policy account balances and a decrease in

minimum guaranteed crediting rates on our policies from the rates existing in 2003.

Net investment income increased by approximately \$3.5 million, or 11%, compared to 2003. Approximately \$4.9 million relates to the increase in policyholder account balances as a result of the additional deposits received as noted above. This was offset by a decline in yields on the portfolio.

Benefits, Claims and Expenses. Policyholder benefits, including the change in reserves, increased by \$8.4 million, or 32%, during 2004 compared to 2003, consistent with the increase in premiums. Claims benefits incurred for the segment declined in 2004 compared to 2003, as a result of more favorable mortality. Interest credited increased by \$3.7 million, due to the increase in policyholder account balances as a result of continued annuity sales, offset by a reduction in credited rates. In addition, during the fourth quarter of 2004, we recorded approximately \$0.3 million in additional benefits on certain replacement annuity policies that we determined contained inappropriate disclosure information to the insured. There is no additional liability to these policyholders.

The increase in deferred acquisition costs was approximately \$5.7 million more in 2004, compared to the increase in 2003. This is directly related to the increase in commissions and other acquisition costs related to the new life and annuity business produced during the year. The amortization of intangible assets relates to the present value of the future profits of the life business acquired with Pyramid Life. Commissions and general expenses increased by \$9.5 million, or 30%, in 2004 compared to 2003, consistent with the increase in premium.

Years ended December 31, 2003 and 2002 Results for our Life Insurance/Annuities segment declined by \$2.2 million, or 16%, to \$12.0 million in 2003 compared to 2002, primarily as a result of less favorable mortality.

Revenues. Net premiums for the segment increased by \$7.4 million, or 26%, compared to 2002. Approximately \$3.6 million of the increase was related to additional premiums from the Pyramid business since its acquisition on March 31, 2003. Approximately, \$1.7 million of the increase was related to the net business produced by the former Guarantee Reserve field force acquired in mid 2003. The balance was related to increased sales of our senior life product and an increase in policy fees on our interest sensitive life and annuity business as a result of the growth in the level of deposits for those products. Ceded premiums increased by approximately \$0.5 million as a result of the increase in our senior life business.

Our agents sold \$120.7 million of fixed annuities during 2003 and \$46.1 million in 2002. Annuity deposits are not considered premiums for reporting in accordance with generally accepted accounting principles.

Net investment income increased by approximately \$2.9 million, or 10%, compared to 2002. Approximately \$4.3 million was related to the increase in policyholder account balances as a result of the additional deposits received as noted above. This was offset by a decline in yields.

Benefits, Claims and Expenses. Policyholder benefits, including the change in reserves, increased by \$5.8 million, or 28%, during 2003 compared to 2002, consistent with the increase in premiums. Approximately \$3.7 million of the increase relates to benefits from the Pyramid Life business since its acquisition. The balance was primarily a result of less favorable mortality in 2003 compared to 2002. Interest credited increased by \$3.9 million, due to the increase in policyholder account balances as a result of the continued sales and the Pyramid Life business added since its acquisition on March 31, 2003.

The increase in deferred acquisition costs was approximately \$12.8 million more in 2003, compared to the increase in 2002. This was directly related to the increase in commissions and other acquisition costs related to the new life and annuity business produced during the year. The amortization of intangible assets was related to the present value of the future profits of the life business acquired with Pyramid Life. Commissions and general expenses increased by \$14.7 million, or 87%, in 2003 compared to 2002. Approximately \$5.9 million was related to commissions and expenses relating to the Guarantee Reserve business, approximately \$4.3 million was related to commissions and expenses relating to the annuity business and approximately \$2.1 million of the increase was related to commissions and expenses for the Pyramid Life business since its acquisition.

SEGMENT RESULTS – SENIOR ADMINISTRATIVE SERVICES

<i>For the year ended December 31, (In thousands)</i>	2002	2003	2004
Affiliated Fee Revenue			
Medicare Supplement	\$18,604	\$22,478	\$29,376
Long term care	2,635	2,589	2,752
Life insurance	347	2,480	3,942
Other	1,245	1,797	2,819
Total Affiliated Revenue	22,831	29,344	38,889
Unaffiliated Fee Revenue			
Medicare Supplement	9,022	9,469	8,557
Long term care	8,205	7,065	6,331
Non-insurance products	1,270	1,563	1,552
Other	1,420	1,042	1,330
Total Unaffiliated Revenue	19,917	19,139	17,770
Service fee and other income	42,748	48,483	56,659
Net investment income	470	48	9
Total revenue	43,218	48,531	56,668
Amortization of present value			
of future profits	1,514	370	418
General expenses	34,072	37,143	43,160
Total expenses	35,586	37,513	43,578
Segment income	7,632	11,018	13,090
Depreciation, amortization			
and interest	2,846	2,038	2,199
Earnings before interest, taxes, depreciation and amortization ("EBITDA") ⁽¹⁾	\$10,478	\$13,056	\$15,289

⁽¹⁾In addition to segment income, we also evaluate the results of our Senior Administrative Services segment based on earnings before interest, taxes, depreciation and amortization ("EBITDA"). EBITDA is a common alternative measure of performance used by investors, financial analysts and rating agencies. It is also a measure that is included in the fixed charge ratio required by the covenants for our outstanding bank debt. Accordingly, these groups use EBITDA, along with other measures, to estimate the value of a company and evaluate the Company's ability to meet its debt service requirements. While we consider EBITDA to be an important measure of comparative operating performance, it should not be construed as an alternative to segment income or cash flows from operating activities (as determined in accordance with generally accepted accounting principles).

Included in unaffiliated revenue are fees received to administer certain business of our insurance subsidiaries that is 100% reinsured to an unaffiliated reinsurer, which amounted to \$5.3 million in the year ended December 31, 2004, \$74 million for 2003 and \$6.9 million for 2002. These fees, together with the affiliated revenue, were eliminated in consolidation.

Years ended December 31, 2004 and 2003 Our Senior Administrative Services segment income improved by \$2.1 million, or 19%, compared to 2003. This improvement was primarily a result of the growth in premiums managed. EBITDA for this segment increased \$2.2 million, or 17%, compared to 2003.

Service fee revenue increased by \$8.2 million, or 17%, compared to 2003. Affiliated service fee revenue increased by \$9.5 million compared to 2003 as a result of the increase in Medicare Supplement/Select business in force at our insurance subsidiaries, including Pyramid, for which CHCS Services began providing service effective January 1, 2004, and fees from the administration of the life insurance products sold by the Guarantee Reserve marketing organization that was acquired in July 2003. Unaffiliated service fee revenue decreased by approximately \$1.4 million primarily due to the reduction in the fees from the underwriting work we performed for the consortium that is offering long term care to employees of the federal government and their families. The initial enrollment period for this program, for which we performed underwriting, began in the third quarter of 2002 and ended during the first quarter of 2003. General expenses for the segment increased by \$6.0 million, or 16%, due primarily to the increase in business.

Years Ended December 31, 2003 and 2002 Our Senior Administrative Services segment income improved by \$3.4 million, or 44%, compared to 2002. This improvement was primarily a result of the growth in premiums managed and the scheduled reduction in the amortization of intangible assets. EBITDA for this segment increased \$2.6 million, or 25%, compared to 2002.

Service fee revenue increased by \$5.7 million, or 13%, compared to 2002. Affiliated service fee revenue increased by \$6.5 million compared to 2002 as a result of the increase in Medicare Supplement/Select business in force at our insurance subsidiaries, as well as the fees from the administration of the life insurance products sold by the recently acquired Guarantee Reserve marketing organization. Unaffiliated service fee revenue decreased by approximately \$0.8 million primarily due to the reduction in the fees from the underwriting work we performed for the consortium that is offering long term care to employees of the federal government and their families. The initial enrollment period for this program, for which we performed underwriting, began in the third quarter of 2002 and ended during the first quarter of 2003.

General expenses for the segment increased by \$3.1 million, or 9%, primarily due to the increase in business and the cost of bringing new clients on line.

The amortization of intangible assets relates primarily to the acquisition of CHCS Services, Inc. (formerly American Insurance Administration Group, Inc., "AIAG"). Approximately \$7.7 million of the present value of future profits ("PVFP") was established when AIAG was acquired in January 2000. It is being amortized in proportion to the expected profits from the contracts in force on the date of acquisition. During 2003, the amortization of PVFP was approximately \$0.4 million compared to \$1.5 million in 2002.

SEGMENT RESULTS – CORPORATE

The following table presents the primary components comprising the loss from the segment:

<i>For the year ended December 31, (In thousands)</i>	2002	2003	2004
Interest	\$3,095	\$ 4,894	\$ 7,903
Early extinguishment of debt	-	1,766	-
Amortization of capitalized loan origination fees	539	492	727
Stock-based compensation expense	641	367	92
Other parent company expenses, net	2,618	3,227	3,776
Segment loss	\$6,893	\$10,746	\$12,498

Years Ended December 31, 2004 and 2003 The loss from our Corporate segment increased by \$1.8 million, or 16%, compared to 2003. The increase was due to higher interest cost as a result of an increase in the amount of the debt outstanding during the year, relating to the amendment of our credit facility in connection with our acquisition of Heritage, offset in part, by a reduction in the weighted average interest rates, as compared to the same period of 2003. Our combined outstanding debt was \$176.1 million at December 31, 2004 compared to \$113.2 million at December 31, 2003. The weighted average interest rate on our loan payable decreased to 4.06% in 2004 from 4.5% in 2003. The weighted average interest rate on our other long term debt increased slightly to 6.3% for 2004 from 5.9% for 2003. See "Liquidity and Capital Resources" for additional information regarding our loan payable and other long term debt. As noted below, in 2003, we reported a \$1.8 million charge relating to the early extinguishment of debt that was incurred during the first quarter of 2003 that did not recur in 2004. Other parent company expenses increased as a result of additional expenses from an increase in corporate governance related activities, as well as management bonuses.

Certain of the companies acquired in July 1999 had post-retirement benefit plans in place prior to their acquisition and Universal American maintained the liability for the expected cost of such plans. In October 2000, participants were notified of the termination of the plans in accordance with their terms. The liability will continue to be reduced as, and to the extent, it becomes certain that we will incur no liabilities for the plans as a result of the termination. During the fourth quarter of 2004, \$0.6 million of the liability was released and during the fourth quarter of 2003, \$0.4 million of the liability was released. Future projected releases of the liability are anticipated to be \$1.9 million in 2005, \$0.7 million in 2006, and \$0.1 million in 2007.

Years Ended December 31, 2003 and 2002 The loss from our Corporate segment increased by \$3.9 million, or 56%, compared to 2002, due primarily to the charge associated with the refinancing of our debt and the increase in financing costs and other parent company expenses. In connection with the acquisition of Pyramid Life, we refinanced our debt. The early extinguishment of the existing debt resulted in the immediate amortization of the related capitalized loan origination fees, resulting in a pre-tax expense of approximately \$1.8 million. The increase in financing cost was due to an increase in the amount of the

debt outstanding during the year, offset in part, by a reduction in the weighted average interest rates for the year, compared to 2002. We issued \$60.0 million of trust preferred securities during 2003, of which \$21.0 million was used to pay down the new term loan. Our combined outstanding debt was \$113.2 million at December 31, 2003 compared to \$65.8 million at December 31, 2002. The weighted average interest rate on our long term debt decreased to 4.5% in 2003 from 5.4% in 2002. Other parent company expenses increased as a result of additional expenses from an increase in acquisition related activities.

Contractual Obligations and Commercial Commitments

Our contractual obligations as of December 31, 2004, are shown below.

Contractual Obligations (In thousands)	Total	Less than 1 Year	Payments Due by Period		
			1-3 Years	3-5 Years	More than 5 Years
Long Term Debt Obligations ⁽¹⁾ :					
Trust preferred securities ⁽²⁾	\$221,486	\$5,150	\$10,306	\$10,329	\$195,701
Loan payable ⁽³⁾	118,386	9,564	18,444	90,378	—
Capital Lease Obligations	—	—	—	—	—
Operating Lease Obligations	19,281	2,526	5,192	4,276	7,287
Purchase Obligations ⁽⁴⁾	42,868	9,498	19,195	13,800	375
Policy Related Liabilities ⁽⁵⁾					
Policyholder account balances	702,532	47,857	87,963	78,553	488,159
Reserves for future policy benefits	1,083,436	59,099	111,096	102,259	810,982
Policy and contract claims	102,435	76,568	24,119	1,630	118
Other Long-Term Liabilities	—	—	—	—	—
Total	\$2,290,424	\$210,262	\$276,315	\$301,225	\$1,502,622

(1) These obligations include contractual interest and reflect scheduled maturities for contractual obligations existing as of December 31, 2004 and do not include any obligations arising as a result of our shelf registration.

(2) Trust preferred securities all have scheduled maturities of 30 years from the date of issue, however they are all callable by us after five years. For the purpose of this schedule, we have assumed that the securities will be redeemed at their scheduled maturities, not the call date. Accordingly, the obligation for repayment of principal relating to these is included in the more than 5 Years column. The trust preferred securities all have floating rate coupons, except for \$15 million which has a fixed rate through its no call period and then converts to a floating rate. Additionally, we have entered into separate swap agreements whereby we pay fixed rates on \$35 million of the trust preferred securities through the no call period. We did not project future changes in the base interest rates. For the purpose of this schedule, we applied the base rate in effect at December 31, 2004 to all future periods. Additionally, we assumed that, upon the expiration of the swap agreements and the fixed rate, the rate for the respective trust preferred securities adjusted to a variable rate using the current base rate.

(3) Includes scheduled amortization through final maturity in 2009. The loan payable is floating rate debt. We did not project future changes in the base interest rates. For the purpose of this schedule, we applied the rate in effect at December 31, 2004 to all future periods.

(4) Includes minimum obligations on our data center outsourcing contract, as well as payments required under our outsourced administration service contract for our HMO product (See Outsourcing Arrangements above). Our actual monthly payments are affected by the amount of service provided under the contract and the HMO product's premium levels in force and currently exceed the minimums stated in the contracts. Therefore our actual payments will exceed the amounts presented in the above schedule based upon future usage and premium amounts.

(5) The obligations on policy related liabilities represent those payments we expect to make on death, disability and health insurance claims and policy surrenders. These projected values contain assumptions for future policy persistency, mortality and morbidity comparable with our historical experience. The distribution of payments for policy and contract claims includes assumptions as to the timing of policyholders reporting claims for prior periods and the amounts of those claims. Actual amounts and timing of both future policy benefits and policy and contract claims may differ significantly from the estimates above. We anticipate that the liabilities for policyholder account balances and reserves for future policy benefits totaling \$1.8 billion, along with future net premiums, investment income and recoveries from our reinsurers, will be sufficient to fund future policy benefit payments. In addition, we anticipate that the policy and contract claims liability totaling \$ 102.4 million, along with recoveries from our reinsurers, will be sufficient to fund these claim liability payments.

LIQUIDITY AND CAPITAL RESOURCES

Our capital is used primarily to support the retained risks and growth of our insurance company subsidiaries and health plan and to support our parent company as an insurance holding company. In addition, we use capital to fund our growth through acquisitions of other companies, blocks of insurance or administrative service business.

We require cash at our parent company to meet our obligations under our credit facility and our outstanding debenture held by our subsidiary, Pennsylvania Life. In January 2002, our parent company issued a debenture to Pennsylvania Life in conjunction with the transfer of the business of Pennsylvania Life's Canadian Branch to Penncorp Life (Canada). The outstanding balance on the debenture was \$34 million at December 31, 2004. We anticipate funding the repayment of the debenture from dividends of Penncorp Life (Canada). We also require cash to pay the operating expenses necessary to function as a holding company (applicable insurance department regulations require us to bear our own expenses), and to meet the costs of being a public company.

We believe that our current cash position, the availability of our \$15.0 million revolving credit facility, the expected cash flows of our administrative service company and management service organizations (acquired in the acquisition of Heritage) and the surplus note interest payments from American Exchange (as explained below) can support our parent company obligations for the foreseeable future. However, there can be no assurance as to our actual future cash flows or to the continued availability of dividends from our insurance company subsidiaries.

Credit Facility, as Amended in May 2004 In connection with the acquisition of Pyramid Life, we obtained an \$80 million credit facility (the "Credit Agreement") on March 31, 2003 to repay our then existing loan and provide funds for the acquisition of Pyramid Life. The Credit Agreement consisted of a \$65 million term loan which was drawn to fund the acquisition and a \$15 million revolving loan facility. The Credit Agreement initially called for interest at the London Interbank Offering Rate ("LIBOR") for one, two or three months, at the option of the Company, plus 300 basis points. Effective March 31, 2004, the spread over LIBOR was reduced to 275 basis points in accordance with the terms of the Credit Agreement. Principal repayments were scheduled over a five-year period with a final maturity date of March 31, 2008. We incurred loan origination fees of approximately \$2.1 million, which were capitalized and are being amortized on a straight-line basis over the life of the Credit Agreement.

In connection with the acquisition of Heritage on May 28, 2004, the Company amended the Credit Agreement by increasing the facility to \$120 million from \$80 million (the "Amended Credit Agreement"), including an increase in the term loan portion to \$105 million from \$36.4 million (the balance outstanding at May 28,

2004) and maintaining the \$15 million revolving loan facility. None of the revolving loan facility has been drawn as of December 31, 2004. Under the Amended Credit Agreement, the spread over LIBOR was reduced to 225 basis points. Effective January 1, 2005, the interest rate on the term loan is 4.8%. Principal repayments are scheduled at \$5.3 million per year over a five-year period with a final payment of \$80.1 million due upon maturity on March 31, 2009. The Company incurred additional loan origination fees of approximately \$2.1 million, which were capitalized and are being amortized on a straight-line basis over the life of the Amended Credit Agreement along with the continued amortization of the origination fees incurred in connection with the Credit Agreement. The Company pays an annual commitment fee of 50 basis points on the unutilized revolving loan facility.

The obligations of the Company under the Amended Credit Facility are guaranteed by our subsidiaries, WorldNet Services Corp., CHCS Services Inc., CHCS Inc., Quincy Coverage Corporation, Universal American Financial Services, Inc., Heritage, HHS-HPN Network, Inc., Heritage Health Systems of Texas, Inc., PSO Management of Texas, LLC, HHS Texas Management, Inc. and HHS Texas Management LP (collectively the "Guarantors") and secured by substantially all of the assets of each of the Guarantors. In addition, as security for the performance by the Company of its obligations under the Amended Credit Facility, the Company, WorldNet Services Corp., CHCS Services Inc., Heritage and HHS Texas Management, Inc., have each pledged and assigned substantially all of their respective securities (but not more than 65% of the issued and outstanding shares of voting stock of any foreign subsidiary), all of their respective limited liability company and partnership interests, all of their respective rights, title and interest under any service or management contract entered into between or among any of their respective subsidiaries and all proceeds of any and all of the foregoing.

The Amended Credit Facility requires the Company and its subsidiaries to meet certain financial tests, including a minimum fixed charge coverage ratio, a minimum risk based capital test and a minimum consolidated net worth test. The Amended Credit Facility also contains covenants, which among other things, limit the incurrence of additional indebtedness, dividends, capital expenditures, transactions with affiliates, asset sales, acquisitions, mergers, prepayments of other indebtedness, liens and encumbrances and other matters customarily restricted in such agreements.

The Amended Credit Facility contains customary events of default, including, among other things, payment defaults, breach of representations and warranties, covenant defaults, cross-acceleration, cross-defaults to certain other indebtedness, certain events of bankruptcy and insolvency and judgment defaults.

Due to the variable interest rate for this Credit Agreement, the Company would be subject to higher interest costs if short-term interest rates rise.

We made regularly scheduled principal payments of \$5.7 million and paid \$3.1 million in interest in connection with our credit facilities during the year ended December 31, 2004. During 2003, we made regularly scheduled principal payments of \$8.7 million and paid \$2.7 million in interest in connection with our credit facilities.

The following table shows the schedule of principal payments (in thousands) remaining on our Amended Credit Agreement, with the final payment in March 2009:

2005	\$ 5,250
2006	5,250
2007	5,250
2008	5,250
2009	80,063
	<u>\$101,063</u>

2003 Refinancing of Debt In January 2003, we made a scheduled principal payment of \$2.8 million on our then current credit facility, and in March, 2003 made an addi-

tional principal payment of \$5.0 million from a portion of the proceeds from the issuance of Trust Preferred securities. These payments reduced the outstanding balance on our then current credit facility to \$42.9 million, which was repaid on March 31, 2003 from the proceeds of the Credit Agreement obtained in connection with the acquisition of Pyramid Life. The early extinguishment of the then existing debt resulted in the immediate amortization of the related capitalized loan origination fees, resulting in a pre-tax expense of approximately \$1.8 million.

Other Long Term Debt We formed statutory business trusts, which exist for the exclusive purpose of issuing trust preferred securities representing undivided beneficial interests in the assets of the trust, investing the gross proceeds of the trust preferred securities in junior subordinated deferrable interest debentures of our parent holding company (the "Junior Subordinated Debt") and engaging in only those activities necessary or incidental thereto. In accordance with the adoption of FIN 46R, we have deconsolidated the trusts.

Separate subsidiary trusts of our parent holding company (the "Trusts") have issued a combined \$75.0 million in thirty year trust preferred securities (the "Capital Securities") as of December 31, 2004, as detailed in the following table:

Maturity Date	Amount Issued <i>(In thousands)</i>	Term	Spread Over LIBOR <i>(Basis points)</i>	Rate as of December 31, 2004
December 2032	\$15,000	Fixed/Floating	400 ⁽¹⁾	6.7%
March 2033	10,000	Floating	400	6.1%
May 2033	15,000	Floating	420	6.6%
May 2033	15,000	Fixed/Floating	410 ⁽²⁾	7.4%
October 2033	20,000	Fixed/Floating	395 ⁽³⁾	7.0%
	<u>\$75,000</u>			

⁽¹⁾ Effective September, 2003, we entered into a swap agreement whereby it will pay a fixed rate of 6.7% in exchange for a floating rate of LIBOR plus 400 basis points. The swap contract expires in December 2007.

⁽²⁾ The rate on this issue is fixed at 7.4% for the first five years, after which it is converted to a floating rate equal to LIBOR plus 410 basis points.

⁽³⁾ Effective April 29, 2004, we entered into a swap agreement whereby it will pay a fixed rate of 6.98% in exchange for a floating rate of LIBOR plus 395 basis points. The swap contract expires in October 2008.

The Trusts have the right to call the Capital Securities at par after five years from the date of issuance. The proceeds from the sale of the Capital Securities, together with proceeds from the sale by the Trusts of their common securities to our parent holding company, were invested in thirty-year floating rate Junior Subordinated Debt of our parent holding company. From the proceeds of the trust preferred securities, \$26.0 million was used to pay down debt during 2003. The balance of the proceeds has been used, in part to fund acquisitions, to provide capital to our insurance subsidiaries to support growth and to be held for general corporate purposes.

The Capital Securities represent an undivided beneficial interest in the Trusts' assets, which consist solely of the Junior Subordinated Debt. Holders of the Capital Securi-

ties have no voting rights. Our parent holding company owns all of the common securities of the Trusts. Holders of both the Capital Securities and the Junior Subordinated Debt are entitled to receive cumulative cash distributions accruing from the date of issuance, and payable quarterly in arrears at a floating rate equal to the three-month LIBOR plus a spread. The floating rate resets quarterly and is limited to a maximum of 12.5% during the first sixty months. Due to the variable interest rate for these securities, we may be subject to higher interest costs if short-term interest rates rise. The Capital Securities are subject to mandatory redemption upon repayment of the Junior Subordinated Debt at maturity or upon earlier redemption. The Junior Subordinated Debt is unsecured and ranks junior and subordinate in right of payment to all present and

future senior debt of our parent holding company and is effectively subordinated to all existing and future obligations of the Company's subsidiaries. Our parent holding company has the right to redeem the Junior Subordinated Debt after five years from the date of issuance.

Our parent holding company has the right at any time, and from time to time, to defer payments of interest on the Junior Subordinated Debt for a period not exceeding 20 consecutive quarters up to each debenture's maturity date. During any such period, interest will continue to accrue and our parent holding company may not declare or pay any cash dividends or distributions on, or purchase, our common stock nor make any principal, interest or premium payments on or repurchase any debt securities that rank equally with or junior to the Junior Subordinated Debt. Our parent holding company has the right at any time to dissolve the Trusts and cause the Junior Subordinated Debt to be distributed to the holders of the Capital Securities. We have guaranteed, on a subordinated basis, all of the Trusts' obligations under the Capital Securities including payment of the redemption price and any accumulated and unpaid distributions to the extent of available funds and upon dissolution, winding up or liquidation but only to the extent the Trusts have funds available to make such payments. The Capital Securities have not been and will not be registered under the Securities Act of 1933, as amended (the "Securities Act"), and will only be offered and sold under an applicable exemption from registration requirements under the Securities Act.

We paid \$4.7 million in interest in connection with the Junior Subordinated Debt during the year ended December 31, 2004, and paid \$2.1 million during 2003.

Lease Obligations We are obligated under certain lease arrangements for our executive and administrative offices in New York, Florida, Indiana, Tennessee, Texas, and Ontario, Canada. Rent expense was \$2.6 million for the year ended December 31, 2004, \$1.9 million for 2003 and \$1.7 million for 2002. Annual minimum rental commitments, subject to escalation, under non-cancelable operating leases (in thousands) are as follows:

2005	\$ 2,526
2006	2,605
2007	2,588
2008	2,328
2009 and thereafter	9,236
Totals	\$19,283

In addition to the above, Pennsylvania Life and Penncorp Life (Canada) are the named lessees on 71 properties occupied by Career Agents for use as field offices. The Career Agents reimburse Pennsylvania Life and Penncorp Life (Canada) the actual rent for these field offices. The total annual rent paid by the Company and reimbursed by the Career Agents for these field offices during 2004 was approximately \$1.1 million.

Shelf Registration On November 3, 2004, we filed a universal shelf registration statement on Form S-3 with the U.S. Securities and Exchange Commission ("SEC"), pursuant to which we may issue common stock, warrants and debt securities from time to time, up to an aggregate offering of \$140 million. The registration statement also covers five million shares of common stock that may be offered for sale by Capital Z Financial Services Fund II, L.P. ("Capital Z"), our largest shareholder. In the event that Capital Z sells all of the five million shares, Capital Z would still own 20.3 million shares or approximately 37% of our outstanding common stock, before giving effect to any issuance of shares by us pursuant to the shelf registration. The shelf registration statement was declared effective in December, 2004.

The shelf registration statement enables us to raise funds from the offering of any individual security covered by the shelf registration statement, as well as any combination thereof, through one or more methods of distribution, subject to market conditions and our capital needs. The terms of any offering pursuant to this shelf will be established at the time of the offering. We plan to use the proceeds from any future offering under the registration statement for general corporate purposes, including, but not limited to, working capital, capital expenditures, investments in subsidiaries, acquisitions and refinancing of debt. A more detailed description of the use of proceeds will be included in any specific offering of securities in the prospectus supplement relating to the offering. A copy of the shelf registration statement as filed with the SEC on Form S-3 may be obtained at the SEC's website at www.sec.gov, or through the Investor Relations section of the Universal American website at www.uafc.com.

Obligations of the Parent Company to Affiliates In January 2002, our parent company issued an \$18.5 million, 8.5% debenture to Pennsylvania Life in connection with the transfer of the business of Pennsylvania Life's Canadian Branch to Penncorp Life (Canada). The debenture is scheduled to be repaid in full during 2005. Our parent company repaid principal of \$4.5 million in 2002, \$7.1 million in 2003 and \$3.5 million in 2004, reducing the outstanding balance to \$3.4 million. Our parent holding company paid \$0.5 million in interest on these debentures during 2004, \$1.0 million in 2003 and \$1.5 million in 2002. The interest on these debentures is eliminated in consolidation. Dividends from Penncorp Life (Canada)

funded the interest and principal paid on the debenture to date and it is anticipated that they will fund all future payments made on this debenture.

Sources of Liquidity to the Parent Company We anticipate funding the obligations of the parent company and the capital required to grow our business from the four distinct and uncorrelated sources of cash flow within the organization as follows:

- the expected cash flows of our senior administrative services company,
- the expected cash flows of our senior managed care company (acquired in the acquisition of Heritage),
- dividend payments received from Penncorp Life (Canada), and
- surplus note principal and interest payments from American Exchange.

In addition, we maintain a large cash position and have access to our unutilized \$15.0 million revolving credit facility. However, there can be no assurance as to our actual future cash flows or to the continued availability of dividends from our insurance company subsidiaries.

Senior Administrative Services Company. Liquidity for our senior administrative services subsidiary is measured by its ability to pay operating expenses and pay dividends to our parent company. The primary source of liquidity is fees collected from clients. We believe that the sources of cash for our senior administrative services company exceed scheduled uses of cash and results in amounts available to dividend to our parent holding company. We measure the ability of the senior administrative services company to pay dividends based on its earnings before interest, taxes, depreciation and amortization (“EBITDA”). EBITDA for our Senior Administrative Services segment was \$15.3 million for the year ended December 31, 2004, and was \$13.1 million for 2003 and \$10.5 million for 2002.

Senior Managed Care Company. Liquidity for our managed care company is measured by its ability to pay operating expenses and pay dividends to our parent company. The primary source of liquidity is management fees for administration of SelectCare and services provided to the IPA's. Dividend payments by SelectCare to Heritage are subject to the approval of the insurance regulatory authorities of the state of Texas, SelectCare's state of domicile. SelectCare is not able to pay dividends during 2005 without prior approval. We believe that the sources of cash to our managed care holding company exceed scheduled uses of cash which will result in funds available to dividend to our parent holding company. We measure the ability of the senior managed care holding company to pay dividends based on its EBITDA. EBITDA for our senior managed care holding company was \$12.2 million for the seven months since its acquisition on May 28, 2004.

Penncorp Life (Canada) Dividends. Penncorp Life (Canada) is a Canadian insurance company. Canadian law provides that a life insurer may pay a dividend after such dividend declaration has been approved by its board of directors and upon at least 10 days prior notification to the Superintendent of Financial Institutions. Such a dividend is limited to retained net income (based on Canadian GAAP) for the preceding two years, plus net income earned for the current year. In considering approval of a dividend, the board of directors must consider whether the payment of such dividend would be in contravention of the Insurance Companies Act of Canada. During the first quarter of 2004, Penncorp Life (Canada) paid dividends of C\$26.7 million (approximately US\$20.0 million) to Universal American, relating to 2003 net income. The amount of the dividend was larger than normal due to a benefit received by Penncorp Life (Canada) from an actuarial experience study that allowed Penncorp Life (Canada) to reduce its policy benefit reserves at December 31, 2003 on a Canadian GAAP basis. The actuarial experience study did not have an impact on Penncorp Life (Canada)'s policy benefit reserves on a U.S. GAAP basis. During the remainder of 2004, Penncorp Life (Canada) paid dividends totaling C\$7.2 million (US\$5.6 million) relating to net income for 2004. Penncorp Life (Canada) paid dividends to Universal American totaling C\$11.2 million (US\$8.1 million) during 2003 and C\$9.3 million (US\$5.9 million) during 2002. We anticipate that Penncorp Life (Canada) will be able to pay dividends equal to its net income earned during 2005, less \$2.5 million.

Insurance Subsidiaries – Surplus Note, Dividends and Capital Contributions. Cash generated by our insurance company subsidiaries will be made available to our holding company, principally through periodic payments of principal and interest on the surplus note owed to our holding company by our subsidiary, American Exchange Life. As of December 31, 2004, the principal amount of the surplus note was \$48.5 million. The note bears interest to our parent holding company at LIBOR plus 325 basis points. We anticipate that the surplus note will be primarily serviced by dividends from Pennsylvania Life, a wholly owned subsidiary of American Exchange, and by tax-sharing payments among the insurance companies that are wholly owned by American Exchange and file a consolidated Federal income tax return. American Exchange made principal payments totaling \$11.6 million during the year ended December 31, 2004. No principal payments were made during 2003. During 2002, the surplus note was reduced by \$10.0 million in the form of a capital contribution to American Exchange by our holding company. American Exchange paid interest on the surplus note of \$2.4 million during the year ended December 31, 2004, \$2.8 million in 2003, and \$3.8 million in 2002.

Our parent holding company made capital contributions to American Exchange amounting to \$178 million

during 2004. In March 2004, Pennsylvania Life declared and paid a dividend in the amount of \$10.6 million to American Exchange. American Exchange made capital contributions of \$12.0 million to Union Bankers, \$8.2 million to American Pioneer and \$7.0 million to American Progressive during the year ended December 31, 2004.

During the year ended December 31, 2003, no dividends were declared or paid by the U.S. insurance company subsidiaries to American Exchange. During 2003, American Exchange received capital contributions from its parent totaling \$35.5 million. American Exchange made capital contributions of \$27.0 million to Pennsylvania Life, primarily relating to the acquisition of Pyramid Life, \$2.5 million to American Pioneer, \$2.5 million to American Progressive and \$3.5 million to Union Bankers. Pennsylvania Life contributed \$1.0 million to Pyramid Life in 2003.

During 2002, Pennsylvania Life paid dividends amounting to \$3.0 million to American Exchange. Universal American contributed 100% of the common stock of American Pioneer and American Progressive to American Exchange during 2002. American Exchange also received capital contributions from its parent totaling \$4.2 million during the year. American Exchange made capital contributions of \$3.0 million to American Pioneer and \$1.2 million to American Progressive during 2002.

Dividend payments by our U.S. insurance companies to our holding company or to intermediate subsidiaries are limited by, or subject to the approval of the insurance regulatory authorities of each insurance company's state of domicile. Such dividend requirements and approval processes vary significantly from state to state. Pennsylvania Life is able to pay ordinary dividends of up to \$6.3 million to American Exchange during 2005, without prior approval. Pyramid Life is able to pay ordinary dividends of up to \$2.5 million to Pennsylvania Life (its direct parent) with prior notice to the Kansas Insurance Department and Marquette would be able to pay ordinary dividends of up to \$0.3 million to Constitution (its direct parent) without the prior approval from the Texas Insurance Department during 2005. American Exchange, American Pioneer, American Progressive, Constitution and Union Bankers had negative earned surplus at December 31, 2004 and are not able to pay dividends in 2005 without special approval.

Insurance Subsidiaries – Liquidity Liquidity for our insurance company subsidiaries is measured by their ability to pay scheduled contractual benefits, pay operating expenses, fund investment commitments, and pay dividends to their parent company. The principal sources of cash for our insurance operations include scheduled and unscheduled principal and interest payments on investments, premium payments, annuity deposits, and the sale or maturity of investments. Both the sources and uses of cash are reasonably predictable and we believe that these

sources of cash for our insurance company subsidiaries exceed scheduled uses of cash.

Liquidity is also affected by unscheduled benefit payments including benefits under accident and health insurance policies, death benefits and interest-sensitive policy surrenders and withdrawals.

Our accident and health insurance policies generally provide for fixed-benefit amounts and, in the case of Medicare Supplement policies, for supplemental payments to Medicare provider rates. Some of these benefits are subject to medical-cost inflation and we have the capability to file for premium rate increases to mitigate rising medical costs. Our health insurance business is widely dispersed in the United States and Canada, which mitigates the risk of unexpected increases in claim payments due to epidemics and events of a catastrophic nature. These accident and health policies are not interest-sensitive and therefore are not subject to unexpected policyholder redemptions due to investment yield changes.

Some of our life insurance and annuity policies are interest-sensitive in nature. The amount of surrenders and withdrawals is affected by a variety of factors such as credited interest rates for similar products, general economic conditions and events in the industry that affect policyholders' confidence. Although the contractual terms of substantially all of our in force life insurance policies and annuities give the holders the right to surrender the policies and annuities, we impose penalties for early surrenders. As of December 31, 2004 we held reserves that exceeded the underlying cash surrender values of our net retained in force life insurance and annuities by \$34.3 million. Our insurance subsidiaries, in our view, have not experienced any material changes in surrender and withdrawal activity in recent years.

Changes in interest rates may affect the incidence of policy surrenders and withdrawals. In addition to the potential impact on liquidity, unanticipated surrenders and withdrawals in a changed interest rate environment could adversely affect earnings if we were required to sell investments at reduced values in order to meet liquidity demands. We manage our asset and liability portfolios in order to minimize the adverse earnings impact of changing market rates. We have segregated a portion of our investment portfolio in order to match liabilities that are sensitive to interest rate movements with fixed income securities containing similar characteristics to the related liabilities, most notably the expected duration and required interest spread. We believe that this asset/liability management process adequately covers the expected payment of benefits related to these liabilities.

As of December 31, 2004, our insurance company subsidiaries held cash and cash equivalents totaling \$1294 million, as well as fixed maturity securities that could readily be converted to cash with carrying values (and fair values) of \$1.2 billion.

The net yields on our cash and invested assets decreased to 4.9% for the year ended December 31, 2004, from 5.3% for 2002 and 6.4% for 2003. A portion of these securities are held to support the liabilities for policyholder account balances, which liabilities are subject to periodic adjustments to their credited interest rates. The credited interest rates of the interest-sensitive policyholder account balances are determined by us based upon factors such as portfolio rates of return and prevailing market rates and typically follow the pattern of yields on the assets supporting these liabilities.

Our insurance subsidiaries are required to maintain minimum amounts of statutory capital and surplus as required by regulatory authorities. However, substantially more than the statutory minimum amounts are needed to meet statutory and administrative requirements of adequate capital and surplus to support the current level of our insurance subsidiaries' operations. Each of our insurance subsidiaries' statutory capital and surplus exceeds its respective minimum statutory requirement at levels we believe are sufficient to support their current levels of operation. Additionally, the National Association of Insurance Commissioners ("NAIC") imposes regulatory risk-based capital ("RBC") requirements on life insurance enterprises. At December 31, 2004, all of our insurance subsidiaries maintained ratios of total adjusted capital to RBC in excess of the "authorized control level". The combined statutory capital and surplus, including asset valuation reserve, of our U.S. insurance subsidiaries totaled \$127.9 million at December 31, 2004 and \$117.1 million at December 31, 2003. Statutory net income for the year ended December 31, 2004 was \$5.4 million, which included after tax net realized gains of \$0.9 million, and for the year ended December 31, 2003 was \$6.0 million, which included after tax net realized losses of \$0.3 million. The net statutory loss for the year ended December 31, 2002 was \$9.1 million, which included after tax net realized losses of \$16.8 million.

Penncorp Life (Canada) reports to Canadian regulatory authorities based upon Canadian statutory accounting principles that vary in some respects from U.S. statutory accounting principles. Penncorp Life (Canada)'s net assets based upon Canadian statutory accounting principles were C\$574 million (US\$47.8 million) as of December 31, 2004 and were C\$82.9 million (US\$63.5 million) as of December 31, 2003. Net income based on Canadian generally accepted accounting principles was C\$8.4 million (US\$6.5 million) for the year ended December 31, 2004, C\$34.4 million (US\$24.6 million) for 2003 and C\$12.8 million (US\$8.2 million) for 2002. Penncorp Life (Canada) maintained a Minimum Continuing Capital and Surplus Requirement Ratio ("MCCSR") in excess of the minimum requirement at December 31, 2004.

Investments Our investment policy is to balance the portfolio duration to achieve investment returns consistent with the preservation of capital and maintenance of liquidity adequate to meet payment of policy benefits and claims. We invest in assets permitted under the insurance laws of the various states in which we operate. Such laws generally prescribe the nature, quality of and limitations on various types of investments that may be made. We do not currently have investments in partnerships, special purpose entities, real estate, commodity contracts, or other derivative securities. We currently engage the services of three investment advisors under the direction of the management of our insurance company subsidiaries and in accordance with guidelines adopted by the Investment Committees of their respective boards of directors. Conning Asset Management Company manages the portfolio of all of our United States subsidiaries, except for the portfolio of Pyramid Life, and certain floating rate portfolios, which are managed by Hyperion Capital. MFC Global Investment Management manages our Canadian portfolio. We invest primarily in fixed maturity securities of the U.S. Government and its agencies and in corporate fixed maturity securities with investment grade ratings of "BBB-" (Standard & Poor's Corporation), "Baa3" (Moody's Investor Service) or higher. Our current policy is not to invest in derivative programs or other hybrid securities, except for GNMA's, FNMA's and investment grade corporate collateralized mortgage obligations.

As of December 31, 2004, 99.4% of our fixed maturity investments had investment grade ratings from Standard & Poor's Corporation or Moody's Investor Service. There were no non-income producing fixed maturities as of December 31, 2004. During the year ended December 31, 2004, we did not write down the value of any fixed maturity securities. We wrote down the value of certain fixed maturity securities, considered to have been subject to an other-than-temporary decline in value, by \$1.3 million during 2003, and by \$10.6 million during 2002 (primarily as a result of the impairment of our World Com holdings). In each case, these write-downs represent our estimate of other than temporary declines in value and were included in net realized gains (losses) on investments in our consolidated statements of operations.

As of December 31, 2004, our insurance company subsidiaries held cash and cash equivalents totaling \$129.4 million, as well as fixed maturity securities that could readily be converted to cash with carrying values (and fair values) of \$1.2 billion.

FEDERAL INCOME TAXATION OF THE COMPANY

We file a consolidated return for Federal income tax purposes that includes all of the non-life insurance company subsidiaries, including Heritage. American Progressive was included in the consolidated return through March 31, 2002 and American Pioneer was included through June 30, 2002. American Exchange and its subsidiaries and Penncorp Life (Canada) are not currently included. American Exchange and its subsidiaries, including American Progressive since April 1, 2002 and American Pioneer since July 1, 2002, filed a separate consolidated Federal return. Penncorp Life (Canada) files a separate return with the Canada Revenue Agency.

As of December 31, 2004 we (exclusive of American Exchange and its subsidiaries and Penncorp Life (Canada)) had net operating tax loss carryforwards of approximately \$7.9 million (including \$6.9 million from Heritage) that expire in 2015 and 2024 and capital loss carryforwards of \$1.3 million that expire in 2007. As of December 31, 2004, we also had an Alternative Minimum Tax ("AMT") credit carryforward for Federal income tax purposes of approximately \$0.5 million that can be carried forward indefinitely. As a result of our acquisitions of CHCS and Heritage, use of most of our loss carryforwards is subject to annual limitations.

As of December 31, 2004, American Exchange and its subsidiaries had net operating loss carryforwards, most of which relate to the companies acquired in 1999 (and were incurred prior to their acquisition by us), of approximately \$6.9 million that expire between 2009 and 2017. At December 31, 2004, American Exchange and its subsidiaries also had capital loss carryforwards of \$7.9 million that expire in 2007. As of December 31, 2004, American Exchange and its subsidiaries also had an AMT credit carryforward for Federal income tax purposes of approximately \$0.7 million that can be carried forward indefinitely. As a result of the change in the ownership of the companies acquired in 1999, use of most of these loss carryforwards is subject to annual limitations.

At December 31, 2004 and 2003, the Company carried valuation allowances of \$3.8 million and \$0.6 million, respectively, with respect to its deferred tax assets. The Company establishes a valuation allowance based upon an analysis of projected taxable income and its ability to implement prudent and feasible tax planning strategies. As a result of uncertainty regarding the ability to generate taxable capital gains, the Company established a valuation allowance in the amount of \$3.2 million for its capital loss carryforwards during 2004 that was recorded as a deferred income tax expense. Additionally, the Company released \$3.8 million relating to a portion of reserve amounts established for pre-acquisition tax years of certain life insurance subsidiaries that were being examined by the Internal Revenue Service. At December 31, 2003, the valuation allowance for certain of the life tax operat-

ing loss carryforwards no longer was considered necessary. The amount of the valuation allowance released during 2003 was \$4.5 million and was recorded as a deferred income tax benefit. In 2003, the Company established a reserve for pre-acquisition tax years of certain life insurance subsidiaries that were being examined by the Internal Revenue Service. As a result of the increased profitability of the Administrative Services segment, valuation allowances for certain of the non-life tax loss carryforwards no longer were considered necessary as of December 31, 2003. The amount of the valuation allowance released during 2003 was \$0.1 million and was also recorded as a deferred income tax benefit. Management believes it is more likely than not that the Company will realize the value of the recorded net deferred tax assets.

Our U.S. insurance company subsidiaries, other than Peninsular Life Insurance Company, are taxed as life insurance companies as provided in the Internal Revenue Code. The Omnibus Budget Reconciliation Act of 1990 amended the Internal Revenue Code to require a portion of the expenses incurred in selling insurance products to be capitalized and amortized over a period of years, as opposed to an immediate deduction in the year incurred. Instead of measuring actual selling expenses, the amount capitalized for tax purposes is based on a percentage of premiums. In general, the capitalized amounts are subject to amortization over a ten-year period. Since this change only affects the timing of the deductions, it does not, assuming stability of rates, affect the provisions for taxes reflected in our financial statements prepared in accordance with GAAP. However, by deferring deductions, the change has the effect of increasing our current tax expense and reducing statutory surplus. There was no material increase in our current income tax provision for any of the three years in the period ended December 31, 2004 due to the existence of our insurance company subsidiaries' net operating loss carryforwards.

The Jobs Creation Tax Act of 2004 contains a provision that places a two year moratorium on the imposition of tax on distributions from Policyholder Surplus Accounts ("PSA"). Additionally, the ordering rules were changed to allow for the first dollar of any distribution to reduce the PSA. Any distribution during 2005 and 2006 from an insurance company that has a PSA will be treated as a distribution from its PSA account. However, the distribution will not be subject to federal income tax. As of December 31, 2004, we had \$20.2 million of PSA balances and have accrued \$7.1 million in deferred tax liabilities corresponding to those balances. The Jobs Creation Tax Act of 2004 provides the mechanism to eliminate this potential tax without the imposition of any tax payment. However, the transactions required to trigger the elimination of the potential tax would require pre-approval of the Insurance Departments of the respective companies. There can be no assurance that we will receive such approvals.

EFFECTS OF RECENTLY ISSUED AND PENDING ACCOUNTING PRONOUNCEMENTS

There was no material impact on our consolidated financial condition or results of operations as a result of our adoption of the recently issued accounting pronouncements. We do not anticipate any material impact from the future adoption of the pending accounting pronouncements, other than the adoption of Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123R"). SFAS 123R requires all companies to recognize compensation costs for share-based payments to employees based on the grant-date fair value of the award for financial statements for reporting periods beginning after June 15, 2005. Refer to Consolidated Financial Statements Note 2 – Recent and Pending Accounting Pronouncements.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

In general, market risk relates to changes in the value of financial instruments that arise from adverse movements in interest rates, equity prices and foreign exchange rates. We are exposed principally to changes in interest rates that affect the market prices of our fixed income securities as well as the cost of our variable rate debt. Additionally, we are exposed to changes in the Canadian dollar that affects the translation of the financial position and the results of operations of our Canadian subsidiary from Canadian dollars to U.S. dollars.

Investment Interest Rate Sensitivity Our profitability could be affected if we were required to liquidate fixed income securities during periods of rising and/or volatile interest rates. However, we attempt to mitigate our exposure to adverse interest rate movements through a combination of active portfolio management and by staggering the maturities of our fixed income investments to assure sufficient liquidity to meet our obligations and to address reinvestment risk considerations. Our insurance liabilities generally arise over relatively long periods of time, which typically permits ample time to prepare for their settlement.

Certain classes of mortgage-backed securities are subject to significant prepayment risk due to the fact that in periods of declining interest rates, individuals may refinance higher rate mortgages to take advantage of the lower rates then available. We monitor and adjust our investment portfolio mix to mitigate this risk.

We regularly conduct various analyses to gauge the financial impact of changes in interest rate on our financial condition. The ranges selected in these analyses reflect our assessment as being reasonably possible over the succeeding twelve-month period. The magnitude of changes modeled in the accompanying analyses should not be construed as a prediction of future economic events, but rather, be treated as a simple illustration of the potential impact of such events on our financial results.

The sensitivity analysis of interest rate risk assumes an instantaneous shift in a parallel fashion across the yield curve, with scenarios of interest rates increasing and decreasing 100 and 200 basis points from their levels as of December 31, 2004, and with all other variables held constant. A 100 basis point increase in market interest rates would result in a pre-tax decrease in the market value of our fixed income investments of \$70.6 million and a 200 basis point increase in market interest rates would result in \$138.6 million decrease. Similarly, a 100 basis point decrease in market interest rates would result in a pre-tax increase in the market value of our fixed income investments of \$77.4 million and a 200 basis point decrease in market interest rates would result in a \$160.2 million increase.

Debt We pay interest on our term loan and a portion of our trust preferred securities based on the London Inter Bank Offering Rate ("LIBOR") for one, two or three months. Due to the variable interest rate, the Company would be subject to higher interest costs if short-term interest rates rise. We have attempted to mitigate our exposure to adverse interest rate movements by fixing the rate on \$15.0 million of the trust preferred securities for a five year period through the contractual terms of the security at inception and an additional \$35.0 million through the use of interest rate swaps.

We regularly conduct various analyses to gauge the financial impact of changes in interest rate on our financial condition. The ranges selected in these analyses reflect our assessment as being reasonably possible over the succeeding twelve-month period. The magnitude of changes modeled in the accompanying analyses should not be construed as a prediction of future economic events, but rather, be treated as a simple illustration of the potential impact of such events on our financial results.

The sensitivity analysis of interest rate risk assumes scenarios increases or decreases in LIBOR of 100 and 200 basis points from their levels as of December 31, 2004, and with all other variables held constant. The following table summarizes the impact of changes in LIBOR, based on the weighted average balance outstanding and the weighted average interest rates for the nine months ended December 31, 2004.

Description of Floating Rate Debt (in millions)	Weighted Average Interest Rate	Weighted Average Balance Outstanding	Effect of Change in LIBOR on Pre-tax Income for the year ended December 31, 2004			
			200 Basis Point Decrease	100 Basis Point Decrease	100 Basis Point Increase	200 Basis Point Increase
Loan Payable	4.06%	\$75.8	\$1.5	\$0.8	\$(0.8)	\$(1.5)
Other long term debt	5.69%	\$25.0	0.5	0.3	(0.3)	(0.5)
Total			\$2.0	\$1.1	\$(1.1)	\$(2.0)

As noted above, we have fixed the interest rate on \$50 million of our \$176 million of total debt outstanding, leaving \$125 million of the debt exposed to rising interest rates. As of December 31, 2004 we had approximately \$181 million of cash and cash equivalents and \$55 million in short duration floating rate investment securities. We anticipate that the net investment income on this \$236 million will be positively impacted by rising interest rates and will mitigate the negative impact of rising interest rates on our debt.

Currency Exchange Rate Sensitivity Portions of our operations are transacted using the Canadian dollar as the functional currency. As of and for the year ended December 31, 2004, approximately 12% of our assets, 9% of our revenues, excluding realized gains, and 16% of our income before realized gains and taxes were derived from our Canadian operations. As of and for the year ended December 31, 2003, approximately 13% of our assets, 12% of our revenues, excluding realized gains, and 21% of our income before realized gains and taxes were derived from our Canadian operations. Accordingly, our earnings and shareholder's equity are affected by fluctuations in the value of the U.S. dollar as compared to the Canadian dollar. Although this risk is somewhat mitigated by the fact that both the assets and liabilities for our foreign operations are denominated in Canadian dollars, we are still subject to translation gains and losses.

We periodically conduct various analyses to gauge the financial impact of changes in the foreign currency exchange rate on our financial condition. The ranges selected in these analyses reflect our assessment of what is reasonably possible over the succeeding twelve-month period.

A 10% strengthening of the U.S. dollar relative to the Canadian dollar, as compared to the actual average exchange rate for the year ended December 31, 2004, would have resulted in a decrease in our income before realized gains and taxes of approximately \$1.2 million for the year ended December 31, 2004 and a decrease in our shareholders' equity of approximately \$4.9 million at December 31, 2004. A 10% weakening of the U.S. dollar relative to the Canadian dollar would have resulted in an increase in our income before realized gains and taxes of approximately \$1.5 million for the year ended December 31, 2004 and an increase in shareholders' equity of approximately \$6.0 million at December 31, 2004. Our sensitivity analysis of the effects of changes in foreign currency exchange rates does not factor in any potential change in sales levels, local prices or any other variables.

The magnitude of changes reflected in the above analysis regarding interest rates and foreign currency exchange rates should, in no manner, be construed as a prediction of future economic events, but rather as a simple illustration of the potential impact of such events on our financial results.

CONSOLIDATED BALANCE SHEETS

Universal American Financial Corp. and Subsidiaries

December 31, (in thousands)	2004	2003
ASSETS		
Investments (Notes 2 and 6):		
Fixed maturities available for sale, at fair value (amortized cost: 2004, \$1,109,678; 2003, \$1,081,954)	\$1,170,822	\$1,141,392
Equity securities, at fair value (cost: 2004, \$749; 2003, \$1,481)	755	1,507
Policy loans	24,318	25,502
Other invested assets	1,187	1,583
Total investments	1,197,082	1,169,984
Cash and cash equivalents	181,257	116,524
Accrued investment income	13,151	14,476
Deferred policy acquisition costs (Notes 2 and 12)	208,281	143,711
Amounts due from reinsurers (Note 13)	212,501	219,182
Due and unpaid premiums	6,474	7,433
Deferred income tax asset (Note 7)	-	15,757
Present value of future profits and other amortizing intangible assets	60,804	44,047
Goodwill and other indefinite lived intangible assets (Notes 2 and 4)	75,180	13,117
Income taxes receivable	865	-
Other assets	61,493	36,717
Total assets	\$2,017,088	\$1,780,948
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES		
Policyholder account balances (Note 2)	\$ 478,373	\$ 419,685
Reserves for future policy benefits	762,563	722,466
Policy and contract claims – life	10,802	8,672
Policy and contract claims – health (Note 11)	91,288	100,232
Loan payable (Note 14)	101,063	38,172
Other long term debt (Note 15)	75,000	75,000
Amounts due to reinsurers	6,023	6,779
Income taxes payable	-	12,489
Deferred income tax liability (Note 7)	5,206	-
Other liabilities	67,349	51,715
Total liabilities	1,597,667	1,435,210
Commitments and contingencies (Note 17)		
STOCKHOLDERS' EQUITY (Note 8)		
Common stock (Authorized: 100 million shares, issued: 2004, 55.3 million shares; 2003, 54.1 million shares)	553	541
Additional paid-in capital	172,525	164,355
Accumulated other comprehensive income (Notes 8 and 21)	40,983	39,774
Retained earnings	206,329	142,458
Less: Treasury stock (2004, 0.1 million shares; 2003, 0.2 million shares)	(969)	(1,390)
Total stockholders' equity	419,421	345,738
Total liabilities and stockholders' equity	\$2,017,088	\$1,780,948

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF OPERATIONS

Universal American Financial Corp. and Subsidiaries

	2004	2003	2002
<i>For the Year Ended December 31, 2004</i>			
<i>(In thousands, per share amounts in dollars)</i>			
REVENUES:			
Direct premium and policyholder fees earned	\$ 858,921	\$ 700,415	\$ 586,686
Reinsurance premiums assumed	35,682	27,042	5,075
Reinsurance premiums ceded	(249,419)	(280,489)	(325,184)
Net premiums and policyholder fees earned (Note 13)	645,184	446,968	266,577
Net investment income (Note 6)	65,191	61,075	57,716
Net realized gains (losses) on investments (Note 6)	10,647	2,057	(5,083)
Fee and other income	14,323	12,648	12,313
Total revenues	735,345	522,748	331,523
BENEFITS, CLAIMS AND EXPENSES:			
Claims and other benefits	421,710	292,211	168,526
Net increase in reserves for future policy benefits	21,275	14,423	12,880
Interest credited to policyholders	18,617	14,900	10,963
Increase in deferred acquisition costs (Note 12)	(65,507)	(51,104)	(27,850)
Amortization of intangible assets (Note 4)	5,232	3,023	1,642
Commissions	142,412	135,937	115,074
Commission and expense allowances on reinsurance ceded	(50,463)	(69,712)	(94,689)
Interest expense	7,903	4,894	3,095
Early extinguishment of debt (Note 14)	-	1,766	-
Other operating costs and expenses	137,698	109,931	97,852
Total benefits, claims and other deductions	638,877	456,269	287,493
Income before taxes	96,468	66,479	44,030
Income tax expense	32,597	23,427	13,903
Net income	\$ 63,871	\$ 43,052	\$ 30,127
Earnings per common share (Notes 2 and 20):			
Basic	\$ 1.17	\$ 0.80	\$ 0.57
Diluted	\$ 1.13	\$ 0.78	\$ 0.56

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME

Universal American Financial Corp. and Subsidiaries

	Common Stock	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Retained Earnings	Treasury Stock	Total
<i>For the Three Years Ended December 31, 2004</i>						
<i>(In thousands)</i>						
Balance, January 1, 2002	\$528	\$155,746	\$ 5,603	\$ 69,279	\$ (386)	\$230,770
Net income	–	–	–	30,127	–	30,127
Other comprehensive income (Note 21)	–	–	24,284	–	–	24,284
Comprehensive income	–	–	–	–	–	54,411
Issuance of common stock (Note 8)	4	1,016	–	–	–	1,020
Stock-based compensation (Note 9)	–	1,412	–	–	–	1,412
Repayments of loans to officers (Note 8)	–	10	–	–	–	10
Treasury shares purchased, at cost (Note 8)	–	–	–	–	(1,520)	(1,520)
Treasury shares reissued (Note 8)	–	80	–	–	586	666
Balance, December 31, 2002	532	158,264	29,887	99,406	\$(1,320)	286,769
Net income	–	–	–	43,052	–	43,052
Other comprehensive income (Note 21)	–	–	9,887	–	–	9,887
Comprehensive income	–	–	–	–	–	52,939
Issuance of common stock (Note 8)	9	4,077	–	–	–	4,086
Stock-based compensation (Note 9)	–	1,343	–	–	–	1,343
Repayments of loans to officers (Note 8)	–	653	–	–	–	653
Treasury shares purchased, at cost (Note 8)	–	–	–	–	(1,113)	(1,113)
Treasury shares reissued (Note 8)	–	18	–	–	1,043	1,061
Balance, December 31, 2003	541	164,355	39,774	142,458	(1,390)	345,738
Net income	–	–	–	63,871	–	63,871
Other comprehensive income (Note 21)	–	–	1,209	–	–	1,209
Comprehensive income	–	–	–	–	–	65,080
Issuance of common stock (Note 8)	12	4,779	–	–	–	4,791
Stock-based compensation (Note 9)	–	3,010	–	–	–	3,010
Repayments of loans to officers (Note 8)	–	126	–	–	–	126
Treasury shares purchased, at cost (Note 8)	–	–	–	–	(325)	(325)
Treasury shares reissued (Note 8)	–	255	–	–	746	1,001
Balance, December 31, 2004	\$553	\$172,525	\$40,983	\$206,329	\$ (969)	\$419,421

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Universal American Financial Corp. and Subsidiaries

<i>For the Year Ended December 31, 2004</i> <i>(In thousands)</i>	2004	2003	2002
Cash flows from operating activities:			
Net income	\$ 63,871	\$ 43,052	\$ 30,127
Adjustments to reconcile net income to net cash provided by operating activities, net of balances acquired (see Note 3 – Business Combinations):			
Deferred income taxes	22,435	7,839	9,404
Change in reserves for future policy benefits	27,751	17,393	33,780
Change in policy and contract claims	(16,080)	23	9,055
Change in deferred policy acquisition costs	(65,507)	(51,104)	(27,850)
Amortization of present value of future profits and other intangibles	5,232	3,023	1,642
Net accretion of bond discount	(3,724)	(3,299)	(3,716)
Amortization of capitalized loan origination fees	1,193	2,248	539
Change in policy loans	1,184	286	298
Change in accrued investment income	1,325	(1,371)	778
Change in reinsurance balances	5,825	18,327	(7,983)
Realized losses (gains) on investments	(10,647)	(2,057)	5,083
Change in income taxes payable	(13,354)	10,488	(1,143)
Other, net	6,850	(548)	(1,349)
Net cash provided by operating activities	26,354	44,300	48,665
Cash flows from investing activities:			
Proceeds from sale or redemption of fixed maturities	304,886	271,968	266,541
Cost of fixed maturities purchased	(304,803)	(335,629)	(362,141)
Purchase of business, net of cash acquired (Note 3)	(65,961)	(58,940)	–
Other investing activities	(19,803)	(3,852)	(3,734)
Net cash used by investing activities	(85,681)	(126,453)	(99,334)
Cash flows from financing activities:			
Net proceeds from issuance of common stock	4,916	4,741	1,020
Cost of treasury stock purchases	(325)	(1,113)	(1,520)
Change in policyholder account balances	58,688	109,870	34,835
Change in reinsurance on policyholder account balances	(35)	1,028	798
Principal repayment on loan payable	(5,703)	(8,653)	(10,700)
Early extinguishment of debt (Note 14)	–	(68,950)	–
Issuance of new debt (Note 14)	68,594	65,000	–
Cost of new debt issued	(2,075)	–	–
Issuance of trust preferred securities (Note 15)	–	60,000	15,000
Net cash provided by financing activities	124,060	161,923	39,433
Net increase (decrease) in cash and cash equivalents	64,733	79,770	(11,236)
Cash and cash equivalents at beginning of year	116,524	36,754	47,990
Cash and cash equivalents at end of year	\$ 181,257	\$ 116,524	\$ 36,754
Supplemental cash flow information:			
Cash paid for interest	\$ 7,805	\$ 4,804	\$ 2,574
Cash paid for income taxes	\$ 20,464	\$ 3,199	\$ 3,707

See notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Universal American Financial Corp. and Subsidiaries

1. ORGANIZATION AND COMPANY BACKGROUND:

Universal American Financial Corp. was incorporated in the State of New York in 1981 as a life and accident & health insurance holding company. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) and consolidate the accounts of Universal American Financial Corp. (“Universal American”) and its subsidiaries (collectively the “Company”), American Progressive Life & Health Insurance Company of New York (“American Progressive”), American Pioneer Life Insurance Company (“American Pioneer”), American Exchange Life Insurance Company (“American Exchange”), Pennsylvania Life Insurance Company (“Pennsylvania Life”), Peninsular Life Insurance Company (“Peninsular”), Union Bankers Insurance Company (“Union Bankers”), Constitution Life Insurance Company (“Constitution”), Marquette National Life Insurance Company (“Marquette”), Penncorp Life Insurance Company, a Canadian company (“Penncorp Life (Canada)”), The Pyramid Life Insurance Company (“Pyramid Life”), Heritage Health Systems, Inc., including SelectCare of Texas, L.L.C. (collectively “Heritage”), and CHCS Services, Inc. (“CHCS”).

Pyramid Life was acquired on March 31, 2003 and Heritage was acquired on May 28, 2004. Operating results for these entities prior to the date of their respective acquisitions are not included in Universal American’s consolidated results of operations.

Collectively, the insurance company subsidiaries are licensed to sell life and accident & health insurance and annuities in all fifty states, the District of Columbia, Puerto Rico and all the provinces of Canada. The principal insurance products currently sold by the Company are Medicare Supplement and Select, fixed benefit accident and sickness disability insurance, senior life insurance and fixed annuities. The Company distributes these products through independent general agents and its career agency systems. The independent general agents sell for American Pioneer, American Progressive, Constitution and Union Bankers while the career agents focus on sales for Pennsylvania Life, Pyramid Life and Penncorp Life (Canada). Heritage operates Medicare Advantage plans in Houston and Beaumont Texas, and our Medicare Advantage private fee-for-service plan in the northeastern portion of the United States. CHCS, the Company’s administrative services company, acts as a service provider for both affiliated and unaffiliated insurance companies for senior market insurance and non-insurance programs.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

A. Basis of Presentation: The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”). For the insurance subsidiaries, GAAP differs from statutory accounting practices prescribed or permitted by regulatory authorities. The accompanying consolidated financial statements include the accounts of Universal American and its wholly-owned subsidiaries, including the operations of acquired companies from the date of their acquisition. All material inter-company transactions and balances have been eliminated. The significant accounting policies followed by Universal American and subsidiaries that materially affect financial reporting are summarized below.

B. Use of Estimates: The preparation of our financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the amounts of assets and liabilities and disclosures of assets and liabilities reported by us at the date of the financial statements and the revenues and expenses reported during the reporting period. As additional information becomes available or actual amounts become determinable, the recorded estimates may be revised and reflected in operating results. Actual results could differ from those estimates. In our judgment, the accounts involving estimates and assumptions that are most critical to the preparation of our financial statements are future policy benefits and claim liabilities, deferred policy acquisition costs, goodwill, present value of future profits and other intangibles, the valuation of certain investments and income taxes. There have been no changes in our critical accounting policies during the current year.

C. Investments: The Company follows Statement of Financial Accounting Standards (“SFAS”) No. 115, “Accounting for Certain Debt and Equity Securities” (“SFAS 115”). SFAS 115 requires that debt and equity securities be classified into one of three categories and accounted for as follows: Debt securities that the Company has the positive intent and the ability to hold to maturity are classified as “held to maturity” and reported at amortized cost. Debt and equity securities that are held for current resale are classified as “trading securities” and reported at fair value, with unrealized gains and losses included in earnings. Debt and equity securities not classified as held to maturity or as trading securities are classified as “available for sale” and reported at fair value.

Unrealized gains and losses on available for sale securities are excluded from earnings and reported as accumulated other comprehensive income, net of tax and deferred policy acquisition cost adjustments.

As of December 31, 2004 and 2003, all fixed maturity securities were classified as available for sale and were carried at fair value, with the unrealized gain or loss, net of tax and deferred policy acquisition cost adjustments, included in accumulated other comprehensive income. Equity securities are carried at current fair value. Policy loans are stated at the unpaid principal balance. Short-term investments are carried at cost, which approximates fair value. Other invested assets include mortgage loans and collateral loans. The collateral loans are carried at their underlying collateral value, the cash surrender value of life insurance. Mortgage loans are carried at the unpaid principal balance.

The fair value of investments is based upon quoted market prices, where available, or on values obtained from independent pricing services. For certain mortgage and asset-backed securities, the determination of fair value is based primarily upon the amount and timing of expected future cash flows of the security. Estimates of these cash flows are based on current economic conditions, past credit loss experience and other factors.

The Company regularly evaluates the amortized cost of its investments compared to the fair value of those investments. Impairments of securities are generally recognized when a decline in fair value below the amortized cost basis is considered to be other-than-temporary. Impairment losses for certain mortgage and asset-backed securities are recognized when an adverse change in the amount or timing of estimated cash flows occurs, unless the adverse change is solely a result of changes in estimated market interest rates. The cost basis for securities determined to be impaired are reduced to their fair value, with the excess of the cost basis over the fair value recognized as a realized investment loss.

Realized investment gains and losses on the sale of securities are based on the specific identification method.

Investment income is generally recorded when earned. Premiums and discounts arising from the purchase of certain mortgage and asset-backed securities are amortized into investment income over the estimated remaining term of the securities, adjusted for anticipated prepayments. The prospective method is used to account for the impact on investment income of changes in the estimated future cash for these securities. Premiums and discounts on other fixed maturity securities are amortized using the interest method over the remaining term of the security.

D. Deferred Policy Acquisition Costs: The cost of acquiring new business, principally commissions and certain expenses of the agency, policy issuance and underwriting departments, all of which vary with, and are primarily related to the production of new and renewal

business, have been deferred. These costs are being amortized in relation to the present value of expected gross profits on the policies arising principally from investment, mortality and expense margins in accordance with SFAS No. 97, "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments," ("SFAS 97") for interest sensitive life and annuity products and in proportion to premium revenue using the same assumptions used in estimating the liabilities for future policy benefits in accordance with SFAS No. 60, "Accounting and Reporting by Insurance Enterprises," ("SFAS 60") for non-interest sensitive life and all accident & health products. Deferred policy acquisition costs are written off to the extent that it is determined that future policy premiums and investment income or gross profits would not be adequate to cover related losses and expenses.

The Company has several reinsurance arrangements in place on its life and accident & health insurance risks (see Note 12 – Deferred Acquisition Costs). Amounts capitalized for deferred acquisition costs are reported net of the related commissions and expense allowances received from the reinsurer on these costs.

E. Present Value of Future Profits and Goodwill: Business combinations accounted for as a purchase result in the allocation of the purchase consideration to the fair values of the assets and liabilities acquired, including the present value of future profits, establishing such fair values as the new accounting basis. The present value of future profits is based on an estimate of the cash flows of the in force business acquired, discounted to reflect the present value of those cash flows. The discount rate selected depends upon the general market conditions at the time of the acquisition and the inherent risk in the transaction. Purchase consideration in excess of the fair value of net assets acquired, including the present value of future profits and other identified intangibles, for a specific acquisition, is allocated to goodwill. Allocation of purchase price is performed in the period in which the purchase is consummated. Adjustments, if any, in subsequent periods relate to resolution of pre-acquisition contingencies and refinements made to estimates of fair value in connection with the preliminary allocation.

Amortization of present value of future profits is based upon the pattern of the projected cash flows of the in-force business acquired, over weighted average lives ranging from six to forty years. Other identified intangibles are amortized over their estimated lives.

At least annually, management reviews the unamortized balances of present value of future profits, goodwill and other identified intangibles to determine whether events or circumstances indicate the carrying value of such assets is not recoverable, in which case an impairment charge would be recognized. Management believes that no impairments of present value of future profits,

goodwill or other identified intangibles existed as of December 31, 2004.

F. Recognition of Revenues, Contract Benefits and Expenses for Investment and Universal Life Type Policies:

Revenues for universal life-type policies and investment products consist of mortality charges for the cost of insurance and surrender charges assessed against policyholder account balances during the period. Amounts received for investment and universal life type products are not reflected as premium revenue; rather such amounts are accounted for as deposits, with the related liability included in policyholder account balances. Benefit claims incurred in excess of policyholder account balances are expensed. The liability for policyholder account balances for universal life-type policies and investment products under SFAS 97 are determined following a “retrospective deposit” method. The retrospective deposit method establishes a liability for policy benefits at an amount determined by the account or contract balance that accrues to the benefit of the policyholder, which consists principally of policy account values before any applicable surrender charges. The base rates on the annuity products currently marketed by us range from 3% to 3.6%. We offer sales inducements in the form of first year only bonus interest rates, which range from 1% to 4%, on certain of our annuity products. Including the bonus interest rates, our current credited rates on our annuity products range from 3% to 7.3%. Our currently marketed annuity products have minimum guaranteed interest rates ranging from 1.5% to 3%. For Universal Life products, current credited rates range from 4% to 6%, which represent the minimum guaranteed rates. There is no first year only bonus interest on our Universal Life policies.

G. Recognition of Premium Revenues and Policy Benefits for Accident & Health Insurance Products:

Premiums are recorded when due and recognized as revenue over the period to which the premiums relate. Benefits and expenses associated with earned premiums are recognized as the related premiums are earned so as to result in recognition of profits over the life of the policies. This association is accomplished by recording a provision for future policy benefits and amortizing deferred policy acquisition costs. The liability for future policy benefits for accident & health policies consists of active life reserves and the estimated present value of the remaining ultimate net cost of incurred claims. Active life reserves include unearned premiums and additional reserves. The additional reserves are computed on the net level premium method using assumptions for future investment yield, mortality and morbidity experience. The assumptions are based on past experience. Claim reserves are established for future payments not yet due on incurred claims, primarily relating to individual disability and long term care insurance and group long-term disability insur-

ance products. These reserves are initially established based on past experience, continuously reviewed and updated with any related adjustments recorded to current operations. Claim liabilities represent policy benefits due but unpaid and primarily relate to individual health insurance products.

H. Recognition of Premium Revenues and Policy Benefits for Traditional Life and Annuity Products:

Premiums from traditional life and annuity policies with life contingencies generally are recognized as revenue when due. Benefits and expenses are matched with such revenue so as to result in the recognition of profits over the life of the contracts. This matching is accomplished by recording a provision for future policy benefits and the deferral and subsequent amortization of policy acquisition costs.

I. Recognition of Premium Revenues and Policy Benefits for Medicare Advantage Policies:

Premiums received pursuant to Medicare Advantage contracts with the Federal government’s Centers for Medicare & Medicaid Services (“CMS”) for Medicare enrollees are recorded as revenue in the month in which members are entitled to receive service. Premiums collected in advance are deferred. Accounts receivable from CMS and healthplan members for coordinating physician services and inpatient, outpatient and ancillary care are included in other assets and are recorded net of estimated bad debts. Policies and contract claims include actual claims reported but not paid and estimates of health care services incurred but not reported. The estimated claims incurred but not reported are based on historical data, current enrollment, health service utilization statistics and other related information. Although considerable variability is inherent in such estimates, management believes that the liability is adequate. Changes in assumptions for medical costs caused by changes in actual experience could cause these estimates to change in the near term.

J. Recognition of Administrative Service Revenue:

Fees for administrative services generally are recognized over the period for which the Company is obligated to provide service.

K. Income Taxes:

The Company uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates

is recognized in income in the period that includes the enactment date of a change in tax rates.

The Company establishes valuation allowances on its deferred tax assets for amounts that it determines will not be recoverable based upon an analysis of projected taxable income and its ability to implement prudent and feasible tax planning strategies. Increases in the valuation allowances are recognized as deferred tax expense. Subsequent determinations that portions of the valuation allowances are no longer necessary are reflected as deferred tax benefits. To the extent that valuation allowances were established in conjunction with acquisitions, changes in those allowances are first applied to goodwill (but not below zero) or other intangibles related to the acquisition and then are applied to income tax expense.

L. Reinsurance: Amounts recoverable under reinsurance contracts are included in total assets as amounts due from reinsurers rather than net against the related policy asset or liability. The cost of reinsurance related to long-duration contracts is accounted for over the life of the underlying reinsured policies using assumptions consistent with those used to account for the underlying policies.

M. Foreign Currency Translation: The financial statement accounts of the Company's Canadian operations, which are denominated in Canadian dollars, are translated into U.S. dollars as follows: (i) assets and liabilities are translated at the rates of exchange as of the balance sheet dates and the related unrealized translation adjustments are included as a component of accumulated other comprehensive income, and (ii) revenues, expenses and cash flows are translated using a weighted average of exchange rates for each period presented.

N. Derivative Instruments – Cash Flow Hedge: The Company uses derivative instruments, interest rate swaps, to hedge risk arising from interest rate volatility ("cash-flow" hedge). These cash-flow hedges are recognized on the balance sheet at their fair value, based on independent pricing sources. The fair value of the cash-flow hedges are reported as assets or liabilities in other assets or other liabilities. On the date the interest rate swap contract is entered into, the Company designates it as a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability. Changes in the fair value of the interest rate swap that is designated and qualifies as a cash-flow hedge are recorded in accumulated other comprehensive income and are reclassified into earnings when the variability of the cash flow hedged item impacts earnings. Gains and losses on derivative contracts that are reclassified into earnings are included in the line items in which the hedged item is recorded.

At the inception of the contract, the Company formally documents all relationships between the hedging instrument and the hedged item, as well as its risk-management objective and strategy for undertaking each hedge transaction. The Company also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivative used in hedging transactions are highly effective in offsetting changes in the cash flows of the hedged items.

O. Earnings Per Common Share: Basic earning per share ("EPS") excludes dilution and is computed by dividing net income by the weighted average number of shares outstanding for the period. Diluted EPS gives the dilutive effect of the stock options outstanding during the year. There were 109,250 and 2,000 stock options excluded from the computation of diluted EPS at December 31, 2004 and December 31, 2003, respectively because they were anti-dilutive.

P. Stock Based Compensation: The Company has elected to follow Accounting Principles Board ("APB") Opinion No. 25. "Accounting for Stock Issued to Employees" ("APB 25") and related interpretations in accounting for its employee and director stock options. Accordingly, no expense is recognized for those options issued with an exercise price at or above market on the date of the award. For options issued to employees with an exercise price that is less than market on the date of grant the Company recognizes an expense for the difference between the exercise price and the value of the options on the date of grant. The Company follows SFAS No. 123 "Accounting for Stock Based Compensation," ("SFAS 123") for determining the fair value of options issued to agents and others. The fair value of options awarded to agents and others are expensed over the vesting period of each award.

Q. Cash Flow Information: Cash and cash equivalents include cash on deposit, money market funds, and short term investments that had an original maturity of three months or less from the time of purchase.

R. Adoption of New Accounting Pronouncements: In January 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities," an interpretation of Accounting Research Bulletin No. 51, which requires an entity to assess its interests in a variable interest entity to determine whether to consolidate that entity. A variable interest entity ("VIE") is an entity in which the equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated support from other parties or the equity investors do not have the characteristics of a controlling financial

interest. FIN 46 requires that a VIE be consolidated by its primary beneficiary, which is the party that will absorb a majority of the entity's expected losses if they occur, receive a majority of the entity's expected residual returns if they occur, or both.

The provisions of FIN 46 were effective immediately for VIEs created after January 31, 2003 and for VIEs for which the Company obtains an interest after that date. For any VIEs acquired prior to February 1, 2003, the provisions of the interpretation of FIN 46, as amended by FASB Staff Position No. 46-6, are effective for the quarter ending December 31, 2003. An interpretation of FIN 46 was issued in December 2003, which allowed the Company to defer the effective date for consolidation of VIEs to the first reporting period that ends after March 15, 2004. Adoption of the provisions of the interpretation FIN 46 did not have a material impact on the consolidated financial condition or results of operations.

In December 2003, the FASB issued a revised version of FIN 46 ("FIN 46R"), which incorporates a number of modifications and changes made to the original version. FIN 46R replaces the previously issued FIN 46 and, subject to certain special provisions, is effective no later than the end of the first reporting period that ends after December 15, 2003 for entities considered to be special-purpose entities and no later than the end of the first reporting period that ends after March 15, 2004 for all other VIEs. Although early adoption was permitted, the Company adopted FIN 46R in the first quarter of 2004. The adoption of FIN 46R resulted in the deconsolidation of the VIEs that issued mandatorily redeemable preferred securities of a subsidiary trust ("trust preferred securities"). The sole assets of the VIEs are junior subordinated debentures issued by the Company with repayment terms identical to the trust preferred securities. Previously, the trust preferred securities were reported as a separate liability on the Company's balance sheet as "company obligated mandatorily redeemable preferred securities of subsidiary trusts holding solely junior subordinated debentures." The dividends on the trust preferred securities were reported as interest expense. As a result of the deconsolidation, the liability for the junior subordinated debentures issued by the Company to the subsidiary trusts are reported as a separate liability in the Company's balance sheet as "other long term debt." See Note 15 – Other Long Term Debt for a description of the trust preferred securities.

In July 2003, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants issued a final Statement of Position 03-1, "Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts" ("SOP 03-1"). SOP 03-1 addresses a wide variety of topics, however, the primary provision that applies to the Company relates to capitalizing sales inducements that meet specified criteria and amortizing such amounts over the life of the contracts using the same methodology as used for amortizing deferred acquisition costs. The Company adopted SOP 03-1 effective January 1, 2004.

The Company currently offers enhanced or bonus crediting rates to contract-holders on certain of its individual annuity products. The Company's policy in this regard was to defer only the portion of the bonus interest amount that was offset by a corresponding reduction in the sales commission to the agent. Effective January 1, 2004, all bonus interest was deferred and amortized. The adoption of SOP 03-1 did not have a material impact on the consolidated financial position or results of operations of the Company.

On December 31, 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure" ("SFAS 148"). This standard amends SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123") to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. This standard also requires prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company has applied the disclosure provisions of SFAS 148 as of December 31, 2003, as required and presented below.

As permitted by SFAS 123, the Company measured its stock-based compensation for employees and directors using the intrinsic value approach under APB 25. Accordingly, the Company did not recognize compensation expense upon the issuance of its stock options because the option terms were fixed and the exercise price equaled the market price of the underlying common stock on the grant date. The Company does not intend to adopt the fair value method of accounting for stock-based compensation provisions of SFAS 123 for its employees or directors. The Company complied with the provisions of SFAS 123 by providing pro forma disclosures of net income and related per share data giving consideration to the fair value method provisions of SFAS 123. For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period.

The following table illustrates the effect on net income and earnings per share if the fair value based method had been applied during each period presented.

For the year ended December 31, (In thousands, except per share amounts)	2004	2003	2002
Reported net income	\$63,871	\$43,052	\$30,127
Add back: Stock-based compensation expense included in reported net income, net of tax	589	1,527	1,536
Less: Stock based compensation expense determined under fair value based method for all awards, net of tax	(2,126)	(2,895)	(2,623)
Pro forma net income	\$62,334	\$41,684	\$29,040
Net income per share:			
Basic, as reported	\$ 1.17	\$ 0.80	\$ 0.57
Basic, pro forma	\$ 1.14	\$ 0.78	\$ 0.55
Diluted, as reported	\$ 1.13	\$ 0.78	\$ 0.56
Diluted, pro forma	\$ 1.10	\$ 0.76	\$ 0.54

Pro forma compensation expense reflected for prior periods is not indicative of future compensation expense that would be recorded by the Company if it were to adopt the fair value based recognition provisions of SFAS 123 for stock based compensation for its employees and directors. Future expense may vary based upon factors such as the number of awards granted by the Company and the then-current fair market value of such awards.

The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model with the following range of assumptions:

Risk free interest rates	3.12% – 6.68%
Dividend yields	0.0%
Expected volatility	40.00% – 48.64%
Expected lives of options (in years)	0 – 9.0

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options. Detailed information for activity in the Company's stock plans can be found in Note 9 – Stock-Based Compensation.

S. Pending Accounting Pronouncements: In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123R"), which replaces

SFAS 123 and supercedes APB Opinion No. 25, "Accounting for Stock Issued to Employees". SFAS 123R requires all companies to recognize compensation costs for share-based payments to employees based on the grant-date fair value of the award for financial statements for reporting periods beginning after June 15, 2005. The pro forma disclosures previously permitted under SFAS 123 will no longer be an alternative to financial statement recognition. The transition methods include prospective and retrospective adoption options. The prospective method requires that compensation expense be recorded for all unvested stock-based awards including those granted prior to adoption of the fair value recognition provisions of SFAS 123, at the beginning of the first quarter of adoption of SFAS 123R, while the retrospective methods would record compensation expense for all unvested stock-based awards beginning with the first period restated. The Company will adopt SFAS 123R in the third quarter of fiscal 2005 using the prospective method.

As permitted by SFAS 123, the Company currently accounts for share-based payments to employees using Opinion 25's intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options. Accordingly, the adoption of SFAS 123(R)'s fair value method will have a significant impact on our result of operations, although it will have no impact on our overall financial position. The impact of adoption of SFAS 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, had we adopted SFAS 123(R) in prior periods, the impact of that standard would have approximated the impact of SFAS 123 as described in the above disclosure of pro forma net income and earnings per share. SFAS 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. While the company cannot estimate what those amounts will be in the future (because they depend on, among other things, when employees exercise stock options), the amount of operating cash flows recognized in prior periods for such excess tax deductions were \$2.3 million, \$0.1 million, and \$0.1 million in 2004, 2003 and 2002, respectively.

In March 2004, the Emerging Issues Task Force ("EITF") reached a final consensus on Issue 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" ("EITF 03-1"). EITF 03-1 adopts a three-step impairment model for securities within its scope. The three-step model must be applied on a security-by-security basis as follows:

Step 1: Determine whether an investment is impaired. An investment is impaired if the fair value of the investment is less than its amortized cost basis.

Step 2: Evaluate whether an impairment is other-than-temporary. For debt securities that cannot be contractually prepaid or otherwise settled in such a way that the investor would not recover substantially all of its cost, an impairment is deemed other-than-temporary if the investor does not have the ability and intent to hold the investment until a forecasted market price recovery or it is probable that the investor will be unable to collect all amounts due according to the contractual terms of the debt security.

Step 3: If the impairment is other-than-temporary, recognize an impairment loss equal to the difference between the investment's cost basis and its fair value.

Subsequent to an other-than-temporary impairment loss, a debt security should be accounted for in accordance with Statement of Position ("SOP") 03-3, "Accounting for Loans and Certain Debt Securities Acquired in a Transfer." EITF 03-1 does not replace the impairment guidance for investments accounted for under EITF Issue 99-20, "Recognition of Interest Income and Impairments on Purchased and Retained Beneficial Interests in Securitized Financial Assets" ("EITF 99-20"), however, investors will be required to determine if a security is other-than-temporarily impaired under EITF 03-1 if the security is determined not to be impaired under EITF 99-20. The disclosure provisions of EITF 03-1 adopted by the Company effective December 31, 2003 and included in Note 6 – Investments of the consolidated financial statements included in the Company's 2003 Annual Report on Form 10-K will prospectively include securities subject to EITF 99-20.

In September 2004, the FASB staff issued clarifying guidance for comment in FASB Staff Position ("FSP") EITF Issue 03-1-a, "Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1, 'The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,'" (FSP 03-1-a) and subsequently voted to delay the implementation of the impairment measurement and recognition guidance contained in paragraphs 10 – 20 of EITF 03-1 in order to reconsider certain aspects of the consensus as well as the implementation guidance included in FSP 03-1-a. The disclosure guidance including quantitative and qualitative information regarding investments in an unrealized loss position remain effective and are included in Note 6.

The ultimate impact the adoption of EITF 03-1 will have on the Company's consolidated financial condition and results of operations is still unknown. Depending on the nature of the ultimate guidance, adoption of the standard could potentially result in the recognition of unrealized losses, including those declines in value that are attributable to interest rate movements, as other-than-temporary impairments, except those deemed to be minor in nature. As of December 31, 2004, the Company had \$2.7 million of total gross unrealized losses. The amount of impairments to be recognized, if any, will depend on

the final standard, market conditions and management's intent and ability to hold securities with unrealized losses at the time of the impairment evaluation.

T. Reclassifications: Certain reclassifications have been made to prior years' financial statements to conform to current period presentation.

3. BUSINESS COMBINATIONS:

Acquisition of Heritage Health Systems, Inc. On May 28, 2004, the Company acquired 100% of the outstanding common stock of Heritage, a privately owned managed care company that operates Medicare Advantage plans in Houston and Beaumont Texas, for \$98 million in cash plus transaction costs of \$1.6 million. Heritage generates its revenues and profits from three sources. First, Heritage owns an interest in SelectCare of Texas, L.L.C. ("SelectCare"), a health plan that offers coverage to Medicare beneficiaries under a contract with CMS. Next, Heritage operates three separate Management Service Organizations ("MSO's") that manage the business of SelectCare and two affiliated Independent Physician Associations ("IPA's"). Lastly, Heritage participates in the net results derived from these IPA's. The acquisition was financed with \$66.5 million of net proceeds derived from the amendment of the Company's credit facility (See Note 14 – Loan Payable) and \$33.1 million of cash on hand. As of the date of acquisition, Heritage had approximately 16,000 Medicare members and annualized revenues of approximately \$140 million. Operating results generated by Heritage prior to May 28, 2004, the date of acquisition, are not included in the Company's consolidated financial statements.

On the acquisition date, the fair value of net tangible assets of Heritage amounted to \$23.2 million. The excess of the purchase price over the fair value of net tangible assets acquired was \$76.4 million. As of May 28, 2004, the Company performed the initial allocation of the excess to identifiable intangible assets. Based on this initial allocation, approximately \$14.6 million was assigned to amortizing intangible assets, including \$12.1 million (net of deferred income taxes of \$6.5 million), which was assigned to the value of the membership in force and determined to have a weighted average life of 6 years and \$2.2 million (net of deferred taxes of \$1.2 million), which was assigned to the IPA's, and determined to have a weighted average lives of between 6 and 13 years. Approximately \$4.7 million was allocated to non-amortizing intangible assets, including \$4.0 million assigned to the value of trademarks and \$0.7 million assigned to the value of Heritage's licenses. Each of these items was determined to have indefinite lives. The balance of \$57.1 million was assigned to goodwill.

Acquisition of Pyramid Life On March 31, 2003, the Company acquired all of the outstanding common stock of Pyramid Life. In this transaction, the Company acquired a block of in-force business as well as a career sales force skilled in selling senior market insurance products. The purchase price of \$57.5 million and transaction costs of \$2.4 million were financed with \$20.1 million of net proceeds generated from the refinancing of the Company's credit facility and \$39.8 million of cash on hand, including a portion of the proceeds from the issuance of trust preferred securities in December 2002 and March 2003. (See Note 14 – Loan Agreements and Note 15 – Trust Preferred Securities). Operating results generated by Pyramid Life prior to March 31, 2003, the date of acquisition, are not included in the Company's consolidated financial statements. At the time of closing, the fair value of net tangible assets of the acquired company amounted to \$27.6 million. The excess of the purchase price over the fair value of net tangible assets acquired was \$32.3 million. At March 31, 2003, the Company performed the initial allocation of the excess to identifiable intangible assets. Based on this initial allocation, approximately \$13.1 million (net of deferred taxes of \$7.1 million) was assigned to the present value of future profits acquired and determined to have a weighted average life of 7 years. Approximately \$14.3 million (net of deferred taxes of \$7.7 million) was assigned to the distribution channel acquired and determined to have a weighted average life of 30 years. The distribution channel represents the estimated future new sales production from the career distribution established by Pyramid Life. Pyramid Life distributes its products on an exclusive basis through 32 Senior Sales Solution Centers ("SSSC's"). The remaining \$4.9 million was assigned to the value of the trademarks and licenses acquired, which are deemed to have an indefinite life.

The condensed balance sheets of Heritage and Pyramid Life were as follows on their respective dates of acquisition:

<i>(in thousands)</i>	Heritage May 28, 2004	Pyramid Life March 31, 2003
ASSETS		
Cash and Investments	\$ 38,150	\$105,774
PVEP and other amortizing intangibles	22,013	42,263
Goodwill and other non-amortizing intangibles	61,849	4,867
Other	7,160	16,232
Total Assets	\$129,172	\$169,136
LIABILITIES		
Policy related liabilities	\$ 9,265	\$103,978
Other	20,296	5,297
Total Liabilities	29,561	109,275
Equity	99,611	59,861
Total Liabilities and Equity	\$129,172	\$169,136

The consolidated pro forma results of operations, assuming that Pyramid Life and Heritage were purchased on January 1, 2004 and 2003 is as follows:

Year ended December 31, <i>(In thousands)</i>	2004	2003
Total revenue	\$792,933	\$680,829
Income before taxes ⁽¹⁾	\$101,731	\$ 72,833
Net income ⁽¹⁾	\$ 67,293	\$ 46,764
Earnings per common share:		
Basic	\$ 1.23	\$ 0.87
Diluted ⁽¹⁾	\$ 1.19	\$ 0.85

⁽¹⁾ The above pro forma results of operations includes excess amortization of capitalized loan fees of \$1.9 million in 2003 as a result of the assumed refinancing of the existing debt at January 1, 2003. This additional expense reduced net income by \$1.2 million or \$0.02 per diluted share in 2003. The actual amount of excess amortization reported in 2003 was \$1.8 million.

The pro forma results of operations reflect management's best estimate based upon currently available information. The pro forma adjustments are applied to the historical financial statements of Universal American, Pyramid Life and Heritage to account for Pyramid Life and Heritage under the purchase method of accounting. In accordance with SFAS No. 141, "Business Combinations", the total purchase cost was allocated to the assets and liabilities of Pyramid Life and Heritage based on their relative fair values. These allocations are subject to valuations as of the date of the acquisition based upon appraisals and other information at that time. Management has provided its best estimate of the fair values of assets and liabilities for the purpose of this pro forma information. The pro forma information presented above is for disclosure purposes only and is not necessarily indicative of the results of operations that would have occurred if the acquisition had been consummated on the dates assumed, nor is the pro forma information intended to be indicative of Universal American's future results of operations.

Acquisition of Ameriplus On August 1, 2003, the Company acquired 100% of the outstanding common stock of Ameriplus Preferred Care, Inc. ("Ameriplus"). Ameriplus is engaged in the business of creating and maintaining a network of hospitals for the purpose of providing discounts to our Medicare Select policyholders. Ameriplus' network is utilized in connection with Medicare Select policies written by subsidiaries of Universal American and can be offered to non-affiliated parties as well. Ameriplus receives network fees when premiums for these Medicare Select policies are collected.

The total purchase price was \$2.0 million and was paid with cash of \$1.0 million and 147,711 unregistered shares of common stock of Universal American. At the time of the closing, Ameriplus had no material tangible assets. Substantially the entire purchase price was allocated to the estimated value of the future override fees,

with the balance assigned to goodwill. The value of the future fees has a weighted average estimated life of

approximately 5 years. (See Note 4 – Intangible Assets for additional detail).

4. INTANGIBLE ASSETS

The following table shows the Company's acquired intangible assets that continue to be subject to amortization and accumulated amortization expense.

<i>(In thousands)</i>	December 31, 2004		December 31, 2003	
	Value Assigned	Accumulated Amortization	Value Assigned	Accumulated Amortization
Senior Health Insurance:				
Present value of future profits ("PVFP")	\$18,472	\$ 3,628	\$18,472	\$ 2,097
Distribution Channel	22,055	1,287	22,055	551
Life Insurance/Annuity – PVFP	4,127	1,308	4,127	661
Senior Managed Care – Medicare Advantage:				
PVFP	18,554	1,667	–	–
Value of IPA's	3,459	234	–	–
Senior Administrative Services				
PVFP	7,672	7,035	7,672	6,770
Value of future override fees	1,796	172	1,820	20
Total	\$76,135	\$15,331	\$54,146	\$10,099

The following table shows the changes in the present value of future profits and other amortizing intangible assets.

<i>For the year ended December 31,</i> <i>(In thousands)</i>	2004	2003	2002
Balance, beginning of year	\$44,047	\$ 2,987	\$ 3,463
Additions from acquisitions	21,989	44,083	1,166
Amortization, net of interest	(5,232)	(3,023)	(1,642)
Balance, end of year	\$60,804	\$44,047	\$ 2,987

Estimated future net amortization expense (in thousands) is as follows:

2005		\$ 6,464
2006		6,112
2007		5,742
2008		5,248
2009		4,283
Thereafter		32,955
		\$60,804

The carrying amounts of goodwill and intangible assets with indefinite lives are shown below.

<i>December 31,</i> <i>(In thousands)</i>	2004	2003
Senior Market Health Insurance	\$ 8,760	\$ 8,760
Senior Managed Care – Medicare Advantage	62,063	–
Senior Administrative Services	4,357	4,357
Total	\$75,180	\$13,117

5. REINSURANCE TRANSACTIONS

Recapture of Reinsurance Ceded Effective April 1, 2003, American Pioneer entered into agreements to recapture approximately \$48 million of Medicare Supplement business that had previously been reinsured to Transamerica Occidental Life Insurance Company, Reinsurance Division ("Transamerica") under two quota share contracts. In 1996, American Pioneer entered into two reinsurance treaties with Transamerica. Pursuant to the first of these contracts American Pioneer ceded to Transamerica 90% of approximately \$50 million of annualized premium that it had acquired from First National Life Insurance Company ("First National") in 1996. Under the second contract, as subsequently amended, American Pioneer agreed to cede to Transamerica 75% of certain new business from October 1996 through December 31, 1999. As of April 1, 2003, approximately \$27 million remained ceded under the First National treaty and approximately \$16 million remained ceded under the new business treaty.

As part of an effort to exit certain non-core lines of business, Transamerica approached the Company in 2002 to determine our interest in recapturing the two treaties. Under the terms of the recapture agreements, Transamerica transferred approximately \$18 million in cash to American Pioneer to cover the statutory reserves recaptured by American Pioneer. No ceding allowance was paid by American Pioneer in the recapture and American Pioneer currently retains 100% of the risks on the \$48 million of Medicare Supplement business. No gain or loss was recognized on these recapture agreements.

Acquisition of Guarantee Reserve Marketing Organization Effective July 1, 2003, Universal American entered into an agreement with Swiss Re and its newly acquired subsidiary, Guarantee Reserve Life Insurance Company (“Guarantee Reserve”), to acquire Guarantee Reserve’s marketing organization, including all rights to do business with its field force. The primary product sold by this marketing organization is low face amount whole life insurance, primarily for seniors.

Beginning July 1, 2003, the former Guarantee Reserve field force continued to write this business through Guarantee Reserve, with Universal American administering all new business and assuming 50% of the risk through a quota share reinsurance arrangement. Beginning in April 2004, as the products were approved for sale in each state, new business has been written by a Universal American subsidiary, with 50% of the risk ceded to Swiss Re.

6. INVESTMENTS:

The amortized cost and fair value of fixed maturities are as follows:

<i>December 31, 2004</i> <i>(In thousands)</i>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Classification				
U.S. Treasury securities and obligations of U.S. government	\$ 87,552	\$ 718	\$ (327)	\$ 87,943
Corporate debt securities	486,142	27,467	(1,830)	511,779
Foreign debt securities ⁽¹⁾	209,583	28,797	(33)	238,347
Mortgage and asset-backed securities	326,401	6,879	(527)	332,753
	\$1,109,678	\$63,861	\$(2,717)	\$1,170,822
<hr/>				
<i>December 31, 2003</i> <i>(In thousands)</i>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Classification				
U.S. Treasury securities and obligations of U.S. government	\$ 74,187	\$ 695	\$ (219)	\$ 74,663
Corporate debt securities	544,744	36,892	(4,988)	576,648
Foreign debt securities ⁽¹⁾	218,011	19,041	(118)	236,934
Mortgage and asset-backed securities	245,012	8,711	(576)	253,147
	\$1,081,954	\$65,339	\$(5,901)	\$1,141,392

⁽¹⁾ Primarily Canadian dollar denominated bonds supporting our Canadian insurance reserves.

The amortized cost and fair value of fixed maturities at December 31, 2004 by contractual maturity are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

<i>(In thousands)</i>	Amortized Cost	Fair Value
Due in 1 year or less	\$ 34,890	\$ 35,118
Due after 1 year through 5 years	197,124	208,709
Due after 5 years through 10 years	306,431	326,983
Due after 10 years	244,832	267,259
Mortgage and asset-backed securities	326,401	332,753
	\$1,109,678	\$1,170,822

The fair value and unrealized loss as of December 31, 2004 for fixed maturity and equity securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are shown below.

<i>(In thousands)</i>	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Classification						
U.S. Treasury securities and obligations of U.S. government	\$ 44,558	\$327	\$ -	\$ -	\$ 44,558	\$ 327
Corporate debt securities	15,787	188	45,718	1,643	61,505	1,831
Foreign debt securities ⁽¹⁾	1,018	5	972	27	1,990	32
Mortgage and asset-backed securities	67,092	369	3,493	158	70,585	527
Total fixed maturities	128,455	889	50,183	1,828	178,638	2,717
Equity securities	1	1	-	-	1	1
Total	\$128,456	\$890	\$50,183	\$1,828	\$178,639	\$2,718

⁽¹⁾ Primarily Canadian dollar denominated bonds supporting our Canadian insurance reserves.

There were no fixed maturities as of December 31, 2004, with a fair value less than 87% of the security's amortized cost. As of December 31, 2004, fixed maturities represented more than 99% of the Company's unrealized loss amount, which was comprised of 84 different securities.

The majority of the securities in an unrealized loss position for less than twelve months are depressed due to the rise in long-term interest rates. This group of securities was comprised of 61 securities. Approximately 99%, of the less than twelve months total unrealized loss amount was comprised of securities with fair value that is greater than 90% of amortized cost.

The group of securities depressed for twelve months or more was comprised of 23 securities. This group consists primarily of corporate securities purchased at a premium and had a total amortized cost of \$52 million. The market value for the group was approximately 97% of the amortized cost and 104% of the par value for these securities. There was only one security with a market value less than 90% of amortized cost with an unrealized loss of less than \$0.1 million. A description of the events contributing to the security's unrealized loss position and the factors considered in determining that recording an other-than-temporary impairment was not warranted are outlined below.

As part of the Company's ongoing security monitoring process by a committee of investment and accounting professionals, the Company has reviewed its investment portfolio and concluded that there were no additional other-than-temporary impairments as of December 31, 2004 and 2003. Due to the issuers' continued satisfaction of the securities' obligations in accordance with their contractual terms and the expectation that they will continue to do so, management's intent and ability to hold these securities, as well as the evaluation of the fundamentals of the issuers' financial condition and other objective evidence (including evaluation of the underlying collateral of a security), the Company believes that the prices of the securities in the sectors identified above were temporarily depressed.

The evaluation for other-than-temporary impairments is a quantitative and qualitative process, which is subject to risks and uncertainties in the determination of whether declines in the fair value of investments are other-than-temporary. The risks and uncertainties include changes in general economic conditions, the issuer's financial condition or near term recovery prospects and the effects of changes in interest rates.

Gross unrealized gains and gross unrealized losses of equity securities as of December 31, are as follows:

<i>(In thousands)</i>	2004	2003
Gross unrealized gains	\$7	\$34
Gross unrealized losses	(1)	(8)
Net unrealized gains	\$6	\$26

The components of the change in unrealized gains and losses included in the consolidated statements of stockholders' equity are as follows:

<i>For the year ended December 31, (In thousands)</i>	2004	2003	2002
Change in net unrealized gains (losses):			
Fixed maturities	\$ 1,706	\$8,542	\$38,522
Equity securities	(20)	42	124
Foreign currency	2,329	9,090	679
Fair value of cash flow swap	636	196	-
Adjustment relating to deferred policy acquisition costs	(2,791)	(2,665)	(1,958)
Change in net unrealized gains before income tax	1,860	15,205	37,367
Income tax (expense)	(651)	(5,318)	(13,083)
Change in net unrealized gains	<u>\$ 1,209</u>	<u>\$9,887</u>	<u>\$24,284</u>

The details of net investment income are as follows:

<i>For the year ended December 31, (In thousands)</i>	2004	2003	2002
Investment Income:			
Fixed maturities	\$62,342	\$59,528	\$54,553
Cash and cash equivalents	2,155	882	1,044
Equity securities	34	93	197
Other	967	744	1,279
Policy loans	1,678	1,652	1,697
Mortgage loans	19	62	134
Gross investment income	67,195	62,961	58,904
Investment expenses	(2,004)	(1,886)	(1,188)
Net investment income	<u>\$65,191</u>	<u>\$61,075</u>	<u>\$57,716</u>

There were no non-income producing fixed maturity securities for the years ended December 31, 2004, 2003 or 2002.

Gross realized gains and gross realized losses included in the consolidated statements of operations are as follows:

<i>For the year ended December 31, (In thousands)</i>	2004	2003	2002
Realized gains:			
Fixed maturities	\$12,400	\$ 3,497	\$10,435
Equity securities and other invested assets	32	476	72
Total realized gains	12,432	3,973	10,507
Realized losses:			
Fixed maturities	(1,344)	(1,811)	(14,914)
Equity securities and other invested assets	(441)	(105)	(676)
Total realized losses	(1,785)	(1,916)	(15,590)
Net realized gains (losses)	<u>\$10,647</u>	<u>\$ 2,057</u>	<u>\$ (5,083)</u>

The Company did not write down the value of any fixed maturity securities during 2004. The Company wrote down the value of certain fixed maturity securities by \$1.3 million during 2003, and \$10.6 million during

2002, primarily as a result of the impairment of our WorldCom bonds. The WorldCom bonds were disposed of in the third quarter of 2002 at a price approximating their carrying value after the other-than-temporary decline was recognized. These write downs represent management's estimate of other-than-temporary declines in value and were included in net realized gains (losses) on investments.

At December 31, 2004 and 2003, the Company held unrated or less-than-investment grade corporate debt securities as follows:

December 31, (In thousands)	2004	2003
Carrying value (estimated fair value)	\$7,003	\$8,361
Percentage of total assets	0.3%	0.5%

The holdings of less-than-investment grade securities are diversified and the largest investment in any one such security was \$3.0 million at December 31, 2004, and \$3.1 million at December 31, 2003, which was less than 0.2% of total assets each year.

Included in fixed maturities at December 31, 2004 and 2003 were securities with carrying values of \$41.8 million and \$44.1 million, respectively, held by various states as security for the policyholders of the Company within such states.

7. INCOME TAXES:

The parent holding company files a consolidated return for federal income tax purposes that includes all of the non-life insurance company subsidiaries, including Heritage. American Progressive was included in the consolidated return through March 31, 2002 and American Pioneer was included through June 30, 2002. American Exchange and its subsidiaries and Penncorp Life (Canada) are not currently included. American Exchange and its subsidiaries, including American Progressive since April 1, 2002 and American Pioneer since July 1, 2002, file a separate consolidated federal income tax return. Penncorp Life (Canada) files a separate return with Revenue Canada.

Income before taxes by geographic distribution is as follows:

For the year ended December 31, (In thousands)	2004	2003	2002
United States	\$77,457	\$51,597	\$30,290
Canada	19,011	14,882	13,740
Total income before taxes	\$96,468	\$66,479	\$44,030

The Company's federal and state income tax expense (benefit) is as follows:

For the year ended December 31, (In thousands)	2004	2003	2002
Current – United States	\$ (825)	\$ 303	\$ 208
Current – Canada	3,173	15,285	4,291
Sub total current	2,348	15,588	4,499
Deferred – United States	27,148	17,821	8,268
Deferred – Canada	3,101	(9,982)	1,136
Sub total deferred	30,249	7,839	9,404
Total tax expense	\$32,597	\$23,427	\$13,903

A reconciliation of the "expected" tax expense at 35% with the Company's actual tax expense applicable to operating income before taxes reported in the Consolidated Statements of Operations is as follows:

For the year ended December 31, (In thousands)	2004	2003	2002
Expected tax expense	\$33,764	\$23,268	\$15,410
Change in valuation allowance	3,163	(4,507)	(1,694)
Reserve for prior year taxes of acquired entities	(3,805)	4,439	–
Other	(525)	227	187
Actual tax expense	\$32,597	\$23,427	\$13,903

In addition to federal and state income tax, the Company is subject to state premium taxes, which taxes are included in other operating costs and expenses in the accompanying statements of operations.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying value of assets and liabilities for financial reporting purposes and the amount used for income tax purposes. The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are as follows:

December 31, (In thousands)	2004	2003
Deferred tax assets:		
Reserves for future policy benefits	\$ 43,733	\$ 36,180
Deferred policy acquisition costs	(6,998)	5,309
Loss carryforwards	5,218	5,851
Asset valuation differences	4,403	6,462
Deferred revenues	1,113	998
Tax credit carryforwards	1,234	320
Other	(2,444)	(4,083)
Total gross deferred tax assets	46,259	51,037
Less valuation allowance	(3,756)	(593)
Net deferred tax assets	42,503	50,444
Deferred tax liabilities:		
Present value of future profits	(25,641)	(13,270)
Unrealized gains on investments	(22,068)	(21,417)
Total gross deferred tax liabilities	(47,709)	(34,687)
Net deferred tax (liability) asset	\$ (5,206)	\$ 15,757

At December 31, 2004, the Company (exclusive of American Exchange and its subsidiaries and PennCorp Life) had net operating loss carryforwards of approximately \$7.9 million (including \$6.9 million from Heritage) that expire in 2015 and 2024 and capital loss carryforwards of \$1.3 million that expire in 2007. At December 31, 2004, the Company also had an Alternative Minimum Tax (AMT) credit carryforward for federal income tax purposes of approximately \$0.5 million that can be carried forward indefinitely. At December 31, 2004, American Exchange and its subsidiaries had net operating loss carryforwards, most of which relate to the companies acquired in 1999 (and were incurred prior to their acquisition), of approximately \$6.9 million that expire between 2009 and 2017. At December 31, 2004, American Exchange and its subsidiaries also had capital loss carryforwards of \$7.9 million that expire in 2007 and an AMT credit carryforward for federal income tax purposes of approximately \$0.7 million that can be carried forward indefinitely. As a result of changes in ownership of the Company in July 1999, the use of most of the loss carryforwards of the Company are subject to annual limitations.

At December 31, 2004 and 2003, the Company carried valuation allowances of \$3.8 million and \$0.6 million, respectively, with respect to its deferred tax assets. The Company establishes a valuation allowance based upon an analysis of projected taxable income and its ability to implement prudent and feasible tax planning strategies. As a result of uncertainty regarding the ability to generate taxable capital gains to utilize capital loss carryforwards, the Company established a valuation allowance in the amount of \$3.2 million during 2004 that was recorded as a deferred income tax expense. Additionally, the Company released \$3.8 million relating to a portion of reserve amounts established for pre-acquisition tax years of certain life insurance subsidiaries that were being examined by the Internal Revenue Service. At December 31, 2003, the valuation allowance on certain of the life tax loss carryforwards no longer was considered necessary. The amount of the valuation allowance released during 2003 was \$4.5 million and was recorded as a deferred income tax benefit. In 2003, the Company established a reserve for pre-acquisition tax

years of certain life insurance subsidiaries that were being examined by the Internal Revenue Service. As a result of the increased profitability of the Administrative Services segment, valuation allowances on certain of the non-life tax loss carryforwards no longer were considered necessary as of December 31, 2003. The amount of the valuation allowance released during 2003 was \$0.1 million and was also recorded as a deferred income tax benefit. Management believes it is more likely than not that the Company will realize the recorded value of its net deferred tax assets.

8. STOCKHOLDERS' EQUITY

Preferred Stock The Company has 2.0 million authorized shares of preferred stock with no such shares issued or outstanding at December 31, 2004 or 2003.

Common Stock The par value of common stock is \$.01 per share with 100 million shares authorized for issuance. The shareholders approved a proposal to amend the Company's Restated Certificate of Incorporation to increase the number of authorized shares of common stock, par value \$0.01 per share, from 80 million shares to 100 million shares at the Annual Meeting on May 26, 2004.

Changes in the number of shares of common stock issued were as follows:

Years ended December 31,	2004	2003	2002
Common stock issued, beginning of year	54,111,923	53,184,381	52,799,899
Stock options exercised	1,190,018	389,412	284,748
Stock issued in connection with acquisition	-	147,711	-
Agent stock award	-	41,872	69,484
Stock purchases pursuant to agents' stock purchase and deferred compensation plans	24,151	348,547	30,250
Common stock issued, end of period	55,326,092	54,111,923	53,184,381

Treasury Stock The Board of Directors has approved a plan for the Company to repurchase up to 1.5 million shares of the Company's common stock in the open market. The primary purpose of the plan is to fund employee stock bonuses.

For the year ended December 31, (In thousands, per share amounts in dollars)	2004			2003		
	Shares	Amount	Weighted Average Cost Per Share	Shares	Amount	Weighted Average Cost Per Share
Treasury stock beginning of year	192,863	\$1,390	\$ 7.21	241,076	\$ 1,320	\$5.48
Shares repurchased	30,929	325	10.52	141,718	1,113	7.85
Shares distributed in the form of employee bonuses	(98,851)	(746)	10.12	(189,931)	(1,043)	5.58
Treasury stock, end of period	124,941	\$ 969	\$ 7.75	192,863	\$ 1,390	\$7.21

Through December 31, 2004, the Company had repurchased 791,119 shares at an aggregate cost of \$4.4 million. As of December 31, 2004, 708,881 shares remained available for repurchase under the program. Additional repurchases may be made from time to time at prevailing prices, subject to restrictions on volume and timing.

Additional Paid In Capital In connection with the 1999 acquisition the Company provided loans to certain members of management to purchase shares of common stock. The loans totaled \$1.0 million at inception and were accounted for as a reduction of additional paid in capital in the financial statements. Repayments of these loans amounted to \$0.1 million in 2004 and \$0.7 million in 2003 and are reported as an increase to additional paid in capital. As of December 31, 2004, the outstanding balance of these loans was \$0.1 million.

Accumulated Other Comprehensive Income The components of accumulated other comprehensive income are as follows:

December 31, (In thousands)	2004	2003	2002
Net unrealized appreciation on investments	\$ 61,150	\$ 59,464	\$ 50,880
Deferred acquisition cost adjustment	(7,776)	(4,985)	(2,320)
Foreign currency translation gains (losses)	8,845	6,516	(2,574)
Fair value of cash flow swap	832	196	-
Deferred tax on the above	(22,068)	(21,417)	(16,099)
Accumulated other comprehensive income	<u>\$ 40,983</u>	<u>\$ 39,774</u>	<u>\$ 29,887</u>

9. STOCK BASED COMPENSATION

1998 Incentive Compensation Plan On May 28, 1998, the Company's shareholders approved the 1998 Incentive Compensation Plan (the "1998 ICP"). The 1998 ICP superseded the Company's 1993 Incentive Stock Option Plan. Options previously granted under the Company's Incentive Stock Option Plan will remain outstanding in accordance with their terms and the terms of the respective plans. The 1998 ICP provides for grants of stock options, stock appreciation rights ("SARs"), restricted stock, deferred stock, other stock-related awards, and performance or annual incentive awards that may be settled in cash, stock, or other property ("Awards").

The total number of shares of the Company's Common Stock reserved and available for delivery to participants in connection with Awards under the 1998 ICP is (i) 1.5 million, plus (ii) the number of shares of Common Stock subject to awards under Preexisting Plans that become available (generally due to cancellation or forfeiture) after the effective date of the 1998 ICP, plus (iii) 13% of the number of shares of Common Stock issued or

delivered by the Corporation during the term of the 1998 ICP (excluding any issuance or delivery in connection with Awards, or any other compensation or benefit plan of the Corporation), provided, however, that the total number of shares of Common Stock with respect to which incentive stock options ("ISOs") may be granted shall not exceed 1.5 million. On May 26, 2004, the Company's shareholders approved an amendment to increase the number of shares of common stock authorized for issuance under the 1998 ICP by 2.5 million shares. As of December 31, 2004, a total of 9.8 million shares were eligible for grant under the plan of which 4.9 million shares were reserved for delivery under outstanding options awarded under the 1998 ICP, 2.8 million shares had been issued pursuant to previous awards and 2.1 million shares were reserved for issuance under future Awards at December 31, 2004.

Executive officers, directors, and other officers and employees of the Corporation or any subsidiary, as well as other persons who provide services to the Company or any subsidiary, are eligible to be granted Awards under the 1998 ICP, which is administered by the Board or a Committee established pursuant to the Plan. The Committee, may, in its discretion, accelerate the exercisability, the lapsing of restrictions, or the expiration of deferral or vesting periods of any Award, and such accelerated exercisability, lapse, expiration and vesting shall occur automatically in the case of a "change in control" of the Company, except to the extent otherwise determined by the Committee at the date of grant or thereafter. The Committee has not yet exercised any of its discretions noted above.

Employee Stock Awards In accordance with the 1998 ICP, the Company grants restricted stock to its officers and non-officer employees. These grants vest upon issue. The non-officer grants are expensed and awarded in the same year. The Company granted awards to non-officer employees of 1,661 shares with a fair value of \$15.70 per share during 2004, 5,119 shares with a fair value of \$9.71 per share during 2003 and 7,721 shares with a fair value of \$5.92 per share during 2002. Executive officers are granted restricted stock in connection with the bonuses. This restricted stock vests over four years. The award for 2004 performance has not yet been determined. Executive officers were awarded 79,132 shares with a fair value of \$10.11 per share for 2003 performance and 50,269 shares with a fair value of \$5.57 per share for 2002 performance. The expense for these awards is recognized over the vesting period. For 2002 and prior, other officers were also granted stock awards in connection with their bonuses. These awards vested immediately. Officer grants were accrued for during the year for which they were earned and awarded the following year. The Company granted awards to officers of 130,847 shares with a fair value of \$5.57 per share during 2003 for 2002. The Company rec-

ognized compensation expense of \$0.2 million for the year ended December 31, 2003, and \$1.1 million for 2002.

Agent's Stock Purchase Plan The Company offers shares of its common stock for sale to qualifying agents of the Insurance Subsidiaries pursuant to the Company's Agents Stock Purchase Plan ("ASPP"). Shares are sold at market price and, accordingly, no expense is recognized. Pursuant to the ASPP, agents purchased 5,100 shares at a weighted average price of 10.73 per share in 2004, 183,286 shares at a weighted average price of \$6.20 per share in 2003, and 30,250 shares at a weighted average price of \$6.30 per share in 2002.

Agent's Deferred Compensation Plan The Company also offers shares of Common Stock for sale to its agents

pursuant to the Company's Deferred Compensation Plan for Agents ("DCP"). Under the DCP, agents may elect to defer receipt between 5% and 100% of their first year commission, which deferral will be matched by a contribution by the Company, initially set at 25% of the amount of the deferral, up to a maximum of 5% of the agent's commissions. Both the agent's participation in the DCP and the Company's obligation to match the agent's deferral are subject to the agent satisfying and continuing to satisfy minimum earning, production and persistency standards. Shares are sold under the plan at market price and, accordingly, no expense is recognized, except for the fair value of the shares representing the Company match on the date of the contribution to the DCP. Agents deferred commissions amounting to \$0.3 million in 2004, \$0.1 million in 2003, and \$0.3 million in 2002.

Option Awards A summary of the status of the Company's stock option plans during the three years ended December 31, 2004 and changes during the years ending on those dates is presented below:

<i>(In thousands, per share amounts in dollars)</i>	2004		2003		2002	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding-beginning of year	5,659	\$ 4.17	5,513	\$3.87	4,916	\$3.31
Granted	832	10.69	745	6.28	940	6.64
Exercised	(1,190)	3.99	(389)	3.63	(284)	3.30
Terminated	(121)	7.12	(210)	4.77	(59)	4.21
Outstanding-end of year	5,180	\$ 5.19	5,659	\$4.17	5,513	\$3.87
Options exercisable at end of Year	3,560	\$ 4.46	4,019	\$3.78	3,601	\$3.51

A summary of the weighted average fair value of options granted during the three years ended December 31, 2004 is presented below:

<i>(In thousands, per share amounts in dollars)</i>	2004		2003		2002	
	Options	Weighted-Average Fair Value	Options	Weighted-Average Fair Value	Options	Weighted-Average Fair Value
Above market	173	\$3.10	306	\$1.85	176	\$2.11
At market	659	5.84	439	2.84	629	4.08
Below market	-	-	-	-	135	3.01
Total granted	832	\$5.27	745	\$2.43	940	\$3.55

The following table summarizes information about stock options outstanding at December 31, 2004:

Range of Exercise Prices	Number Outstanding at December 31, 2004	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable at December 31, 2004	Weighted-Average Exercise Price
<i>(In thousands, per share amount in dollars)</i>					
\$ 1.88 – 3.12	754	3.0 years	\$ 2.46	754	\$ 2.46
3.15	1,718	4.6 years	3.15	1,191	3.15
3.25 – 4.79	593	5.4 years	4.03	489	4.04
5.00 – 8.42	1,303	5.9 years	6.53	937	6.64
10.11 – 12.32	812	8.2 years	10.73	189	11.01
\$ 1.88 – 12.32	5,180	5.4 years	\$ 5.19	3,560	\$ 4.46

A summary of the activity relating to the options awarded by the Company for employees, directors and agents is as follows:

<i>(In thousands, per share amounts in dollars)</i>	Employees	Directors	Agents & Others	Total	Range of Exercise Prices
Balance, January 1, 2002	3,598	210	1,108	4,916	
Granted	571	53	316	940	\$ 4.75 – \$ 8.55
Exercised	(131)	(10)	(143)	(284)	\$ 2.00 – \$ 5.31
Terminated	(34)	(11)	(14)	(59)	\$ 2.25 – \$ 6.45
Balance, December 31, 2002	4,004	242	1,267	5,513	
Granted	391	48	306	745	\$ 5.57 – \$10.56
Exercised	(162)	(2)	(225)	(389)	\$ 2.00 – \$ 8.42
Terminated	(122)	(9)	(79)	(210)	\$ 2.62 – \$ 8.42
Balance, December 31, 2003	4,111	279	1,269	5,659	
Granted	610	48	174	832	\$10.11 – \$12.32
Exercised	(420)	(14)	(756)	(1,190)	\$ 1.01 – \$10.11
Terminated	(35)	–	(86)	(121)	\$ 3.15 – \$10.56
Balance, December 31, 2004	4,266	313	601	5,180	

At December 31, 2004, approximately 2.9 million, 0.2 million, and 0.4 million options were exercisable by employees, directors and agents, respectively.

Options Granted to Employees Options are generally granted to eligible employees at a price not less than the market price of the Company's common stock on the date of the grant. Option shares may be exercised subject to the terms prescribed by the individual grant agreement. During 2004, there were approximately 245,000 options issued to management in connection with the management bonus, 25,000 issued for new employees and 340,000 issued to Heritage employees in connection with the acquisition. During 2003, there were 301,000 options issued in connection with the management bonus and 90,000 for new employees. During 2002, there were 377,000 options issued in connection with the management bonus, 176,000 issued for new employees and 18,000 issued to relocated employees. Vested options must be exercised not later than ten years after the date of the grant or following earlier termination of employment. Because these awards are made at a price equal to or greater than market on the date of grant, no compensation cost is recognized for such awards.

On August 1, 1999, the Company issued 2.3 million below market stock options with an exercise price of \$3.15 per share to certain employees and members of management. During 2000, the Company issued an additional 0.2 million below market stock options with an exercise price of \$3.15 per share to certain relocated employees and members of management on July 31, 2000. As of December 31, 2004, the number of these options outstanding decreased to 1.7 million, through employee terminations and exercises. These options are fully vested, except for 0.6 million which will become vested after seven years. These options must be exercised not later than ten years after the date of the grant or following earlier termination of employment. The Company recorded an expense for the difference between the exercise price of \$3.15 per share and the value of the options on the date of grant of \$0.1 million for the year ended December 31, 2004, \$0.4 million for 2003, and \$0.6 million for 2002.

Stock Options Issued to Directors Directors of the Company are eligible for options under the 1998 ICP. The 1998 ICP provides that unless otherwise determined by the Board, each non-employee director would be granted an

option to purchase 4,500 shares of Common Stock upon approval of the 1998 ICP by shareholders or, as to directors thereafter elected, his or her initial election to the Board, and at each annual meeting of shareholders starting in 1999 at which he or she qualifies as a non-employee director. The 1998 ICP also provides that the non-employee directors for American Progressive and Penncorp Life (Canada) would be granted an option to purchase 1,500 shares of Common Stock at each annual meeting. Unless otherwise determined by the Board, such options will have an exercise price equal to 100% of the fair market value per share on the date of grant and will become exercisable in three equal installments after each of the first, second and third anniversaries of the date of grant based on continued service as a director. Because these are made at a price equal to market, no compensation expense is recognized for such awards.

Stock Option and Stock Award Plans for Agents Both career agents and independent general agents are eligible for options under the 1998 ICP. Options are awarded to agents based on production. These options vest in equal installments over a two year period and expire five years from the date of grant. The exercise prices are set at between 110% and 125% of the fair market value of Universal American common stock on the date of the award. During 2004, career agents were awarded a total of approximately 75,000 options and independent general agents were awarded approximately 99,000 options with a weighted average exercise price of \$11.45 per share for 2003 sales performance. During 2003 career agents were awarded a total of approximately 167,000 options and independent general agents were awarded approximately 139,000 options with a weighted average exercise price of \$7.03 per share for 2002 sales performance. During 2002 career agents were awarded a total of approximately 150,000 options and independent general agents were awarded approximately 166,000 options with a weighted average exercise price of \$6.84 per share for 2002 sales performance. The fair values of these options are expensed over the vesting period of each award.

The Company also grants awards of common stock to qualifying Career agents. These shares vest after two years. During 2004, Career agents were awarded stock grants of approximately 36,000 shares with a fair value of \$9.71 per share for 2003 sales performance. During 2003, Career agents were awarded stock grants of approximately 49,000 shares with a fair value of \$5.92 per share for 2002 sales performance. During 2002, Career agents were awarded stock grants of approximately 71,000 shares with a fair value of \$6.63 per share for 2001 sales performance.

Total expense relating to the above plans was \$0.6 million for the year ended December 31, 2004, \$0.9 million for 2003, and \$0.7 million for 2002.

10. STATUTORY FINANCIAL DATA:

The insurance subsidiaries are required to maintain minimum amounts of statutory capital and surplus as required by regulatory authorities. However, substantially more than such minimum amounts are needed to meet statutory and administrative requirements of adequate capital and surplus to support the current level of our insurance subsidiaries' operations. Each of the life insurance subsidiaries' statutory capital and surplus exceeds its respective minimum statutory requirement at levels we believe are sufficient to support their current levels of operation. Additionally, the National Association of Insurance Commissioners ("NAIC") imposes regulatory risk-based capital ("RBC") requirements on life insurance enterprises. At December 31, 2004, all of our life insurance subsidiaries maintained ratios of total adjusted capital to RBC in excess of the "authorized control level". The combined statutory capital and surplus, including asset valuation reserve, of the U.S. life insurance subsidiaries totaled \$127.9 million at December 31, 2004 and \$117.1 million at December 31, 2003. Statutory net income for the year ended December 31, 2004 was \$5.4 million, which included after-tax net realized gains of \$0.9 million, and for the year ended December 31, 2003 was \$6.0 million, which included after-tax net realized losses of \$0.3 million. The net statutory loss for the year ended December 31, 2002 was \$9.1 million, which included after-tax net realized losses of \$16.8 million.

Heritage's insurance subsidiary, SelectCare of Texas is also required to maintain minimum amounts of capital and surplus, as required by regulatory authorities and is also subject to RBC requirements. SelectCare's statutory capital and surplus exceeds its minimum requirement and its RBC is in excess of the "authorized control level." The statutory capital and surplus for SelectCare was \$9.6 million at December 31, 2004 and \$3.8 million at December 31, 2003. Statutory net income for the year ended December 31, 2004 was \$5.5 million and for the year ended December 31, 2003 was \$2.9 million.

Penncorp Life (Canada) reports to Canadian regulatory authorities based upon Canadian statutory accounting principles that vary in some respects from U.S. statutory accounting principles. Penncorp Life (Canada)'s net assets based upon Canadian statutory accounting principles were C\$574 million (US\$47.8 million) as of December 31, 2004 and were C\$82.9 million (US\$63.5 million) as of December 31, 2003. Net income based on Canadian generally accepted accounting principles was C\$8.4 million (US\$6.5 million) for the year ended December 31, 2004, C\$34.4 million (US\$24.6 million) for 2003 and C\$12.8 million (US\$8.2 million) for 2002. Penncorp Life (Canada) maintained a Minimum Continuing Capital and Surplus Requirement Ratio ("MCCSR") in excess of the minimum requirement at December 31, 2004.

11. ACCIDENT AND HEALTH POLICY AND CONTRACT CLAIM LIABILITIES:

Activity in the accident & health policy and contract claim liability is as follows:

For the year ended December 31, (In thousands)	2004	2003	2002
Balance at beginning of year	\$100,232	\$ 88,216	\$ 79,596
Less reinsurance recoverables	(39,014)	(48,925)	(44,685)
Net balance at beginning of year	61,218	39,291	34,911
Balances acquired	9,265	18,744	3,198
Incurred related to:			
Current year	390,814	249,862	138,429
Prior years	(2,141)	(1,949)	(1,506)
Total incurred	388,673	247,913	136,923
Paid related to:			
Current year	348,887	220,602	114,769
Prior years	47,401	25,302	21,074
Total paid	396,288	245,904	135,843
Foreign currency adjustment	630	1,174	102
Net balance at end of year	63,498	61,218	39,291
Plus reinsurance recoverables	27,789	39,014	48,925
Balance at end of year	\$ 91,288	\$100,232	\$ 88,216

In 2004, the Company acquired Heritage. In 2003, the Company acquired Pyramid Life and recaptured a block of Medicare Supplement business previously ceded to Transamerica. In 2002, the Company acquired, through a 100% quota share reinsurance agreement, a block of Medicare Supplement business representing approximately \$20.0 million of annualized premium in force. The balances acquired represent the accident and health claim liabilities acquired in these transactions.

During 2004, the favorable development related primarily to the Medicare supplement business in the Senior Health Insurance Segment. During 2003 and 2002, the favorable development on the accident and health claims reserves resulted from the improvement in claims management processes in the Specialty Health Insurance segment.

12. DEFERRED POLICY ACQUISITION COSTS:

Details with respect to deferred policy acquisition costs (in thousands) are as follows:

For the year ended December 31, (In thousands)	2004	2003	2002
Balance, beginning of year	\$143,711	\$ 92,093	\$ 66,025
Capitalized costs	114,411	88,505	40,550
Adjustment relating to unrealized gains on fixed maturities	(2,791)	(2,665)	(1,958)
Adjustment relating to recapture of reinsurance	-	275	-
Foreign currency adjustment	1,854	2,904	176
Amortization	(48,904)	(37,401)	(12,700)
Balance, end of year	\$208,281	\$143,711	\$ 92,093

The increase in the amount of acquisition costs capitalized during 2003 and the corresponding increase in amortization is directly related to the increase in new business as a result of the acquisitions of Pyramid Life and the Guarantee Reserve marketing organization, the recapture of the Transamerica reinsurance and the increase in retention on new business, as well as the increase in annuities written during the year. The increase in the amount capitalized during 2004 is primarily the result of the full year impact of the above transactions along with an increase in new business in existing companies.

13. REINSURANCE:

In the normal course of business, the Company reinsures portions of certain policies that it underwrites. The Company enters into reinsurance arrangements with unaffiliated reinsurance companies to limit our exposure on individual claims and to limit or eliminate risk on our non-core or underperforming blocks of business. Accordingly, the Company is party to several reinsurance agreements on its life and accident and health insurance risks. The Company's senior market accident and health insurance products are generally reinsured under quota share coinsurance treaties with unaffiliated insurers, while the life insurance risks are reinsured under either quota share coinsurance or yearly-renewable term treaties with unaffiliated insurers. Under quota share coinsurance treaties, the Company pays the reinsurer an agreed upon percentage of all premiums and the reinsurer reimburses the Company that same percentage of any losses. In addition, the reinsurer pays the Company certain allowances to cover commissions, cost of administering the policies and premium taxes. Under yearly-renewable term treaties, the reinsurer receives premiums at an agreed upon rate for its share of the risk on a yearly-renewable term basis. The Company also uses excess of loss reinsurance agreements for certain policies whereby the Company limits its loss in excess of specified thresholds. The Company's quota share coinsurance agreements are generally subject to cancellation on 90 days notice as to future business, but poli-

cies reinsured prior to such cancellation remain reinsured as long as they remain in force.

The Company evaluates the financial condition of its reinsurers and monitors concentrations of credit risk to minimize its exposure to significant losses from reinsurer insolvencies. The Company is obligated to pay claims in the event that any reinsure to whom we have ceded an insured claim fails to meet its obligations under the reinsurance agreement.

The Company has several quota share reinsurance agreements in place with General Re Life Corporation (“General Re”), Hannover Life Re of America (“Hannover”) and Swiss Re Life & Health America (“Swiss Re”), (collectively, the “Reinsurers”), which Reinsurers are rated A or better by A.M. Best. These agreements cover various insurance products, primarily Medicare Supplement, long term care and senior life policies, written or acquired by the Company and contain ceding percentages ranging between 15% and 100%. Effective January 1, 2004, the Company increased its retention on all new Medicare Supplement business to 100%. Therefore, the Company no longer reinsures new Medicare Supplement business. During 2004, we ceded premiums of \$109.0 million to General Re, \$105.3 million to Hannover, and \$7.7 million to Swiss Re, representing 12%, 12% and 1%, respectively, of our total direct and assumed premiums. During 2003, we ceded premiums of \$123.5 million to General Re, \$116.3 million to Hannover and \$4.9 million to Swiss Re, representing 17%, 16% and 1%, respectively, of our total direct and assumed premiums.

Amounts recoverable from all our reinsurers were as follows:

<i>December 31, (In thousands)</i>	2004	2003
Reinsurer		
General Re	\$ 83,696	\$ 95,907
Hannover	68,463	69,544
Swiss Re	14,583	11,099
Other	45,759	42,632
Total	\$212,501	\$219,182

At December 31, 2004, the total amount recoverable from reinsurers included \$208.3 million recoverable on future policy benefits and unpaid claims and \$4.2 million for amounts due from reinsurers on paid claims, commissions and expense allowances net of premiums reinsured. At December 31, 2003, the total amount recoverable from reinsurers included \$215.5 million recoverable on future policy benefits and unpaid claims and \$3.7 million for amounts due from reinsurers on paid claims, commissions

and expense allowances net of premiums reinsured. A summary of reinsurance is presented below:

<i>As of December 31, (In thousands)</i>	2004	2003	2002
Life insurance in force			
Gross amount	\$3,932,446	\$3,757,618	\$3,105,477
Ceded to other companies	(833,452)	(788,761)	(692,132)
Assumed from other companies	138,849	145,028	62,423
Net amount	\$3,237,843	\$3,113,885	\$2,475,768
Percentage of assumed to net	4%	5%	3%
 <i>Year Ended December 31, (In thousands)</i>	 2004	 2003	 2002
Premiums			
Life insurance	\$ 60,450	\$ 44,268	\$ 37,682
Accident and health	798,471	656,147	549,004
Total gross premiums	858,921	700,415	586,686
Ceded to other companies			
Life insurance	(14,766)	(8,142)	(7,656)
Accident and health	(234,653)	(272,347)	(317,528)
Total ceded premiums	(249,419)	(280,489)	(325,184)
Assumed from other companies			
Life insurance	7,376	3,339	1,044
Accident and health	28,306	23,703	4,031
Total assumed premium	35,682	27,042	5,075
Net amount			
Life insurance	53,060	39,465	31,070
Accident and health	592,124	407,503	235,507
Total net premium	\$ 645,184	\$ 446,968	\$ 266,577
Percentage of assumed to net			
Life insurance	14%	8%	3%
Accident and health	5%	6%	2%
Total assumed to total net	6%	6%	2%
Claims recovered	\$ 192,856	\$ 189,626	\$ 224,676

14. LOAN PAYABLE:

Credit Facility, as Amended in May 2004 In connection with the acquisition of Pyramid Life (see Note 3 – Business Combinations), the Company obtained an \$80 million credit facility (the “Credit Agreement”) on March 31, 2003 to repay the then existing loan and provide funds for the acquisition of Pyramid Life. The Credit Agreement consisted of a \$65 million term loan which was drawn to fund the acquisition and a \$15 million revolving loan facility. The Credit Agreement initially called for interest at the London Interbank Offering Rate (“LIBOR”) for one, two or three months, at the option of the Company, plus 300 basis points. Effective March 31, 2004, the spread over

LIBOR was reduced to 275 basis points in accordance with the terms of the Credit Agreement. Principal repayments were scheduled over a five-year period with a final maturity date of March 31, 2008. The Company incurred loan origination fees of approximately \$2.1 million, which were capitalized and are being amortized on a straight-line basis over the life of the Credit Agreement.

In connection with the acquisition of Heritage on May 28, 2004 (see Note 3 – Business Combinations), the Company amended the Credit Agreement by increasing the facility to \$120 million from \$80 million (the “Amended Credit Agreement”), including an increase in the term loan portion to \$105 million from \$36.4 million (the balance outstanding at May 28, 2004) and maintaining the \$15 million revolving loan facility. None of the revolving loan facility has been drawn as of December 31, 2004. Under the Amended Credit Agreement, the spread over LIBOR was reduced to 225 basis points. Effective January 1, 2005, the interest rate on the term loan is 4.8%. Principal repayments are scheduled at \$5.3 million per year over a five-year period with a final payment of \$80.1 million due upon maturity on March 31, 2009. The Company incurred additional loan origination fees of approximately \$2.1 million, which were capitalized and are being amortized on a straight-line basis over the life of the Amended Credit Agreement along with the continued amortization of the origination fees incurred in connection with the Credit Agreement. The Company pays an annual commitment fee of 50 basis points on the unutilized revolving loan facility. The obligations of the Company under the Amended Credit Facility are guaranteed by WorldNet Services Corp., CHCS Services Inc., CHCS Inc., Quincy Coverage Corporation, Universal American Financial Services, Inc., Heritage, HHS-HPN Network, Inc., Heritage Health Systems of Texas, Inc., PSO Management of Texas, LLC, HHS Texas Management, Inc. and HHS Texas Management LP (collectively the “Guarantors”) and secured by substantially all of the assets of each of the Guarantors. In addition, as security for the performance by the Company of its obligations under the Amended Credit Facility, the Company, WorldNet Services Corp., CHCS Services Inc., Heritage and HHS Texas Management, Inc. have each pledged and assigned substantially all of their respective securities (but not more than 65% of the issued and outstanding shares of voting stock of any foreign subsidiary), all of their respective limited liability company and partnership interests, all of their respective rights, title and interest under any service or management contract entered into between or among any of their respective subsidiaries and all proceeds of any and all of the foregoing.

The Amended Credit Facility requires the Company and its subsidiaries to meet certain financial tests, including a minimum fixed charge coverage ratio, a minimum risk based capital test and a minimum consolidated net worth test. The Amended Credit Facility also contains covenants, which among other things, limit the incurrence of additional indebtedness, dividends, capital expenditures, transactions with affiliates, asset sales, acquisitions, mergers, prepayments of other indebtedness, liens and encumbrances and other matters customarily restricted in such agreements.

The Amended Credit Facility contains customary events of default, including, among other things, payment defaults, breach of representations and warranties, covenant defaults, cross-acceleration, cross-defaults to certain other indebtedness, certain events of bankruptcy and insolvency and judgment defaults.

The Company made regularly scheduled principal payments of \$5.7 million and paid \$3.1 million in interest in connection with its credit facilities during the year ended December 31, 2004. During the year ended December 31, 2003, the Company made regularly scheduled principal payments of \$8.7 million and paid \$2.7 million in interest in connection with its credit facilities.

The following table shows the schedule of principal payments (in thousands) remaining on the Amended Credit Agreement, with the final payment in March 2009:

2005	\$ 5,250
2006	5,250
2007	5,250
2008	5,250
2009	80,063
	\$101,063

2003 Refinancing of Debt On March 31, 2003, the Credit Facility issued in 1999 was repaid from the proceeds of the Credit Agreement obtained in connection with the acquisition of Pyramid Life. The early extinguishment of this debt resulted in the immediate amortization of the related capitalized loan origination fees, resulting in a pre-tax expense of approximately \$1.8 million.

The following table sets forth certain summary information with respect to total borrowings of the Company:

(In thousands, except percentages)	As of December 31,		Year Ended December 31,		
	Amount Outstanding	Interest Rate	Maximum Amount Outstanding	Weighted Average Amount Outstanding ^(a)	Average Interest Rate ^(b)
2004	\$101,063	4.29%	\$105,000	\$75,775	4.06%
2003	\$ 38,172	4.14%	\$ 65,000	\$49,889	4.50%
2002	\$ 50,775	5.33%	\$ 61,475	\$55,731	5.44%

(a) The average amounts of borrowings outstanding were computed by determining the arithmetic average of the months' average outstanding in borrowings.

(b) The weighted-average interest rates were determined by dividing interest expense related to total borrowings by the average amounts outstanding of such borrowings.

15. OTHER LONG TERM DEBT:

The Company has formed statutory business trusts, which exist for the exclusive purpose of issuing trust preferred securities representing undivided beneficial interests in the assets of the trust, investing the gross proceeds of the trust preferred securities in junior subordinated deferrable interest debentures of the Company (the

“Junior Subordinated Debt”) and engaging in only those activities necessary or incidental thereto. In accordance with the adoption of FIN 46R, the Company has deconsolidated the trusts. For further discussion of the adoption of FIN 46R, see Note 2 – Recent and Pending Accounting Pronouncements.

Separate subsidiary trusts of the Company (the “Trusts”) have issued a combined \$75.0 million in thirty year trust preferred securities (the “Capital Securities”) as detailed in the following table:

Maturity Date	Amount Issued (In thousands)	Term	Spread Over LIBOR (Basis points)	Rate as of December 31, 2004
December 2032	\$15,000	Fixed/Floating	400 ⁽¹⁾	6.7%
March 2033	10,000	Floating	400	6.1%
May 2033	15,000	Floating	420	6.6%
May 2033	15,000	Fixed/Floating	410 ⁽²⁾	7.4%
October 2033	20,000	Fixed/Floating	395 ⁽³⁾	7.0%
	\$75,000			

(1) Effective September 2003, the Company entered into a swap agreement whereby it will pay a fixed rate of 6.7% in exchange for a floating rate of LIBOR plus 400 basis points. The swap contract expires in December 2007.

(2) The rate on this issue is fixed at 7.4% for the first five years, after which it is converted to a floating rate equal to LIBOR plus 410 basis points.

(3) Effective April 29, 2004, the Company entered into a swap agreement whereby it will pay a fixed rate of 6.98% in exchange for a floating rate of LIBOR plus 395 basis points. The swap contract expires in October 2008.

The Trusts have the right to call the Capital Securities at par after five years from the date of issuance. The proceeds from the sale of the Capital Securities, together with proceeds from the sale by the Trusts of their common securities to the Company, were invested in thirty-year floating rate Junior Subordinated Debt of the Company. From the proceeds of the trust preferred securities, \$26.0 million was used to pay down debt during 2003. The balance of the proceeds has been used, in part to fund acquisitions, to provide capital to the Company's insurance subsidiaries to support growth and to be held for general corporate purposes.

The Capital Securities represent an undivided beneficial interest in the Trusts' assets, which consist solely of the Junior Subordinated Debt. Holders of the Capital Securities have no voting rights. The Company owns all of the common securities of the Trusts. Holders of both the Capital Securities and the Junior Subordinated Debt

are entitled to receive cumulative cash distributions accruing from the date of issuance, and payable quarterly in arrears at a floating rate equal to the three-month LIBOR plus a spread. The floating rate resets quarterly and is limited to a maximum of 12.5% during the first sixty months. Due to the variable interest rate for these securities, the Company would be subject to higher interest costs if short-term interest rates rise. The Capital Securities are subject to mandatory redemption upon repayment of the Junior Subordinated Debt at maturity or upon earlier redemption. The Junior Subordinated Debt is unsecured and ranks junior and subordinate in right of payment to all present and future senior debt of the Company and is effectively subordinated to all existing and future obligations of the Company's subsidiaries. The Company has the right to redeem the Junior Subordinated Debt after five years from the date of issuance.

The Company has the right at any time, and from time to time, to defer payments of interest on the Junior Subordinated Debt for a period not exceeding 20 consecutive quarters up to each debenture's maturity date. During any such period, interest will continue to accrue and the Company may not declare or pay any cash dividends or distributions on, or purchase, the Company's common stock nor make any principal, interest or premium payments on or repurchase any debt securities that rank equally with or junior to the Junior Subordinated Debt. The Company has the right at any time to dissolve the Trusts and cause the Junior Subordinated Debt to be distributed to the holders of the Capital Securities. The Company has guaranteed, on a subordinated basis, all of the Trusts' obligations under the Capital Securities including payment of the redemption price and any accumulated and unpaid distributions to the extent of available funds and upon dissolution, winding up or liquidation but only to the extent the Trusts have funds available to make such payments.

The Company paid \$4.7 million in interest in connection with the Junior Subordinated Debt during the year ended December 31, 2004, and paid \$2.1 million during 2003.

16. DERIVATIVE INSTRUMENTS – CASH FLOW HEDGE

Effective September 4, 2003, the Company entered into a swap agreement whereby it pays a fixed rate of 6.7% on a \$15.0 million notional amount relating to the December 2002 trust preferred securities issuance, in exchange for a floating rate of LIBOR plus 400 basis points, capped at 12.5%. The swap contract expires in December 2007. Effective April 29, 2004, the Company entered into a second swap agreement whereby it pays a fixed rate of 6.98% on a \$20.0 million notional amount relating to the October 2003 trust preferred securities issuance, in exchange for a floating rate of LIBOR plus 395 basis points, capped at 12.45%. The swap contract expires in October 2008. The swaps are designated and qualify as cash flow hedges, and changes in their fair value are recorded in accumulated other comprehensive income. The combined fair value of the swaps was \$0.8 million at December 31, 2004 and \$0.2 million at December 31, 2003 and is included in other assets.

17. COMMITMENTS AND CONTINGENCIES:

Lease Obligations We are obligated under certain lease arrangements for our executive and administrative offices in New York, Florida, Indiana, Tennessee, Texas, and Ontario, Canada. Rent expense was \$2.6 million for the year ended December 31, 2004, \$1.9 million for 2003 and \$1.7 million for 2002. Annual minimum rental commitments, subject to escalation, under non-cancelable operating leases (in thousands) are as follows:

2005	\$ 2,526
2006	2,605
2007	2,588
2008	2,328
2009 and thereafter	9,236
Totals	\$19,283

In addition to the above, Pennsylvania Life and PennCorp Life (Canada) are the named lessees on 71 properties occupied by Career Agents for use as field offices. The Career Agents reimburse Pennsylvania Life and PennCorp Life (Canada) the actual rent for these field offices. The total annual rent paid by the Company and reimbursed by the Career Agents for these field offices during 2004 was approximately \$1.1 million.

Litigation The Company has litigation in the ordinary course of business, including claims for medical, disability and life insurance benefits, and in some cases, seeking punitive damages. Management and counsel believe that after reserves and liability insurance recoveries, none of these will have a material adverse effect on the Company.

18. UNIVERSAL AMERICAN FINANCIAL CORP. 401(K) SAVINGS PLAN:

Effective April 1, 1992, the Company adopted the Universal American Financial Corp. 401(k) Savings Plan ("Savings Plan"). The Savings Plan is a voluntary contributory plan under which employees may elect to defer compensation for federal income tax purposes under Section 401(k) of the Internal Revenue Code of 1986. The employee is entitled to participate in the Savings Plan by contributing through payroll deductions up to 100% of the employee's compensation. The participating employee is not taxed on these contributions until they are distributed. Moreover, the employer's contributions vest at the rate of 25% per plan year, starting at the end of the second year. Amounts credited to employee's accounts under the Savings Plan are invested by the employer-appointed investment committee. Currently, the Company matches 50% of the employee's first 4% of contributions to 2% of the employee's eligible compensation with Company common stock. The Company made matching contributions under the Savings Plan of \$0.6

million in 2004, \$0.4 million in 2003 and \$0.3 million in 2002. Employees are required to hold the employer contribution in Company common stock until vested, at which point the employee has the option to transfer the amount to any of the other investments available under the Savings Plan. The Savings Plan held 565,034 shares of the Company's common stock at December 31, 2004, which represented 47% of total plan assets and 528,722 shares at December 31, 2003, which represented 41% of total plan assets. Generally, a participating employee is entitled to distributions from the Savings Plan upon termination of employment, retirement, death or disability. Savings Plan participants who qualify for distributions may receive a single lump sum, have the assets transferred to another qualified plan or individual retirement account, or receive a series of specified installment payments.

19. DISCLOSURES ABOUT FAIR VALUES OF FINANCIAL INSTRUMENTS:

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

Fixed maturities available for sale: Fair value of fixed maturities is based upon quoted market prices, where available, or on values obtained from independent pricing services. For certain mortgage and asset-backed securities, the determination of fair value is based primarily upon the amount and timing of expected future cash flows of the security. Estimates of these cash flows are

based current economic conditions, past credit loss experience and other circumstances.

Equity securities: For equity securities carried at fair value, based on quoted market price.

Other invested assets: Other invested assets consists of collateralized loans which are carried at the underlying collateral value, cash value of life insurance and mortgage loans which are carried at the aggregate unpaid balance. The determination of fair value for these invested assets is not practical because there is no active trading market for such invested assets and therefore, the carrying value is a reasonable estimate of fair value.

Cash and cash equivalents and policy loans: For cash and cash equivalents and policy loans, the carrying amount is a reasonable estimate of fair value.

Cash flow swap: The cash flow swap is carried at fair value, obtained from a pricing service.

Investment contract liabilities: For annuity and universal life type contracts, the carrying amount is the policyholder account value; estimated fair value equals the policyholder account value less surrender charges.

Loan payable and trust preferred securities: Fair value for the loan payable and trust preferred securities is equal to the carrying amount.

The estimated fair values of the Company's financial instruments are as follows:

December 31, (In thousands)	2004		2003	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Fixed maturities available for sale	\$1,170,822	\$1,170,822	\$1,141,392	\$1,141,392
Equity securities	755	755	1,507	1,507
Policy loans	24,318	24,318	25,502	25,502
Other invested assets	1,187	1,187	1,583	1,583
Cash and cash equivalents	181,257	181,257	116,524	116,524
Cash flow swap	832	832	196	196
Financial liabilities:				
Investment contract liabilities	478,373	444,068	419,685	391,315
Loan payable	101,063	101,063	38,172	38,172
Trust preferred securities	75,000	75,000	75,000	75,000

22. BUSINESS SEGMENT INFORMATION:

The Company's principal business segments are based on product and include: Senior Market Health Insurance, Specialty Health Insurance, Life Insurance/Annuities, Senior Managed Care – Medicare Advantage and Senior Administrative Services. The Company also reports the activities of our holding company in a separate segment. Previously, the Company reported its segments based on distribution channel. The Company's former Senior Market Brokerage and Career Agency segments have been replaced with the three new segments: Senior Market Health Insurance, Life Insurance/Annuity and Specialty Health Insurance. The Senior Managed Care – Medicare Advantage and Administrative Services segments will be unchanged. Management believes that this new segmentation will provide even greater clarity to the results of the Company. Reclassifications have been made to conform prior year amounts to the current year presentation. A description of these segments follows:

Senior Market Health Insurance – This segment consists primarily of our Medicare Supplement business and other senior market health products distributed through our career agency sales force and through our network of independent general agencies.

Specialty Health Insurance – The Specialty Health Insurance segment includes specialty health insurance products, primarily fixed benefit accident and sickness disability insurance sold to the middle income self-employed market in the United States and Canada. This segment also includes certain products that we no longer sell such as long term care and major medical. This segment's products are distributed primarily by our career agents.

Life Insurance/Annuity – This segment includes all of the life insurance and annuity business sold in the United States. This segment's products include senior, traditional and universal life insurance and fixed annuities and are distributed through both independent general agents and our career agency distribution systems.

Senior Managed Care – Medicare Advantage – The Senior Managed Care – Medicare Advantage segment includes

the operations of Heritage and our other initiatives in managed care for seniors. Heritage operates Medicare Advantage plans in Houston and Beaumont Texas, and our Medicare Advantage private fee-for-service plan in the northeastern portion of the United States. Heritage generates its revenues and profits from three sources. First, Heritage owns an interest in SelectCare, a health plan that offers coverage to Medicare beneficiaries under a contract with CMS. Next, Heritage operates three separate Management Service Organizations (“MSO’s”) that manage the business of SelectCare and two affiliated Independent Physician Associations (“IPA’s”). Lastly, Heritage participates in the net results derived from these IPA’s. Heritage’s Medicare Advantage plans are sold by our career agency sales force and directly by employee representatives. Our Medicare Advantage private fee-for-service plans were introduced during the second quarter of 2004 and are sold by independent agents.

Senior Administrative Services – Our senior administrative services subsidiary acts as a third party administrator and service provider of senior market insurance products and geriatric care management for both affiliated and unaffiliated insurance companies. The services provided include policy underwriting and issuance, telephone and face-to-face verification, policyholder services, claims adjudication, case management, care assessment and referral to health care facilities.

Corporate – This segment reflects the activities of Universal American, including debt service, certain senior executive compensation, and compliance with requirements resulting from our status as a public company.

Intersegment revenues and expenses are reported on a gross basis in each of the operating segments but eliminated in the consolidated results. These intersegment revenues and expenses affect the amounts reported on the individual financial statement line items, but are eliminated in consolidation and do not change income before taxes. The significant items eliminated include intersegment revenue and expense relating to services performed by the Senior Administrative Services segment for our other segments and interest on notes payable or receivable between the Corporate segment and the other operating segments.

Financial data by segment, including a reconciliation of segment revenues and segment income (loss) before income taxes to total revenue and net income in accordance with generally accepted accounting principles is as follows:

For the year ended December 31, (In thousands)	2004		2003		2002	
	Revenue	Income (Loss) Before Income Taxes	Revenue	Income (Loss) Before Income Taxes	Revenue	Income (Loss) Before Income Taxes
Senior Market Health Insurance	\$360,349	\$ 35,407	\$271,619	\$ 27,734	\$106,902	\$ 8,564
Specialty Health Insurance	174,649	26,316	172,131	24,435	162,325	25,603
Life Insurance/Annuity	84,523	13,370	67,090	11,981	56,817	14,207
Senior Managed Care – Medicare Advantage	93,528	10,136	–	–	–	–
Senior Administrative Services	56,668	13,090	48,531	11,018	43,218	7,632
Corporate	289	(12,498)	232	(10,746)	857	(6,893)
Intersegment revenues	(44,340)	–	(37,068)	–	(32,197)	–
Adjustments to segment amounts:						
Net realized gains (losses) ⁽¹⁾	10,647	10,647	2,057	2,057	(5,083)	(5,083)
Premium revenue adjustment ⁽²⁾	(968)	–	(1,844)	–	(1,316)	–
Total	\$735,345	\$ 96,468	\$522,748	\$ 66,479	\$331,523	\$44,030

(1) We evaluate the results of operations of our segments based on income before realized gains and losses and income taxes. Management believes that realized gains and losses are not indicative of overall operating trends.

(2) We evaluate the results of our insurance segments based on incurred premium net of the change in unearned premium. The change in unearned premium is reported as part of the net increase in future policy benefits in the consolidated statements of operations. Management believes that including the change in unearned premium in revenue provides more indicative trends for the purpose of evaluating loss ratios.

Identifiable assets by segment are as follows:

As of December 31, (In thousands)	2004	2003
Senior Market Health Insurance	\$ 385,487	\$ 357,753
Specialty Health Insurance	732,680	720,539
Life Insurance/Annuity	723,343	652,673
Senior Managed Care – Medicare Advantage	136,349	–
Senior Administrative Services	19,401	19,321
Corporate	608,722	475,377
Intersegment assets ⁽¹⁾	(588,894)	(444,715)
Total Assets	\$2,017,088	\$1,780,948

(1) Intersegment assets include the elimination of the parent holding company's investment in its subsidiaries as well as the elimination of other intercompany balances.

23. FOREIGN OPERATIONS:

A portion of the Company's operations is conducted in Canada through Penncorp Life (Canada). These assets and liabilities are located in Canada where the insurance risks are written. Revenues, excluding capital gains and losses, of the Company by geographic distribution by country are as follows:

For the year ended December 31, (In thousands)	2004	2003	2002
United States	\$655,724	\$456,631	\$280,871
Canada	68,974	64,060	55,735
Total	\$724,698	\$520,691	\$336,606

Total assets and liabilities of Penncorp Life (Canada), located entirely in Canada, are as follows:

December 31, (In thousands)	2004	2003
Assets	\$233,741	\$236,185
Liabilities	\$188,125	\$175,253

24. CONDENSED QUARTERLY RESULTS OF OPERATIONS (UNAUDITED):

The quarterly results of operations are presented below. Due to the use of weighted average shares outstanding when determining the denominator for earnings per share, the sum of the quarterly per common share amounts may not equal the per common share amounts.

2004 Three Months Ended (In thousands)	March 31,	June 30,	September 30,	December 31,
Total revenue	\$158,538	\$166,507	\$203,721	\$206,579
Total benefits, claims and other expenses	137,353	146,582	174,403	180,539
Income before income taxes	21,185	19,925	29,318	26,040
Income tax expense	7,309	6,874	9,776	8,638
Net income	\$ 13,876	\$ 13,051	\$ 19,542	\$ 17,402
Basic earnings per share	\$ 0.26	\$ 0.24	\$ 0.36	\$ 0.32
Diluted earnings per share	\$ 0.25	\$ 0.23	\$ 0.34	\$ 0.30

2003 Three Months Ended (In thousands)	March 31,	June 30,	September 30,	December 31,
Total revenue	\$ 97,913	\$138,109	\$139,803	\$146,923
Total benefits, claims and other expenses	86,262	121,464	122,106	126,438
Income before income taxes	11,651	16,645	17,697	20,485
Income tax expense	4,103	5,645	6,281	7,398
Net income	\$ 7,548	\$ 11,000	\$ 11,416	\$ 13,087
Basic earnings per share	\$ 0.14	\$ 0.21	\$ 0.21	\$ 0.24
Diluted earnings per share	\$ 0.14	\$ 0.20	\$ 0.21	\$ 0.23

2002 Three Months Ended (In thousands)	March 31,	June 30,	September 30,	December 31,
Total revenue	\$ 82,166	\$ 76,690	\$ 83,956	\$ 88,711
Total benefits, claims and other expenses	70,541	72,217	71,079	73,656
Income before income taxes	11,625	4,473	12,877	15,055
Income tax expense	4,127	1,155	4,558	4,063
Net income	\$ 7,498	\$ 3,318	\$ 8,319	\$ 10,992
Basic earnings per share	\$ 0.14	\$ 0.06	\$ 0.16	\$ 0.21
Diluted earnings per share	\$ 0.14	\$ 0.06	\$ 0.15	\$ 0.20

Significant Fourth Quarter Adjustments During the fourth quarter, the Company performs an annual evaluation of the recoverability of its tax net operating loss carryforwards, based on a projection of future taxable income and other factors. As a result of the continued profitability of the Company's operating segments, valuation

allowances on certain of the Company's tax loss carryforwards were no longer considered necessary. The tax valuation allowance released through deferred tax expense was \$1.6 million, or \$0.03 per diluted share, during the fourth quarter of 2002. There were no significant fourth quarter adjustments during 2003 and 2004.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders of Universal American Financial Corp.:

We have audited the accompanying consolidated balance sheets of Universal American Financial Corp. and subsidiaries as of December 31, 2004 and 2003 and the related consolidated statements of operations, stockholders' equity and comprehensive income, and cash flows for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the

overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Universal American Financial Corp. and subsidiaries at December 31, 2004 and 2003 and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2004, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Universal American Financial Corp.'s internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 11, 2005 expressed an unqualified opinion thereon.

Ernst & Young LLP
New York, New York
March 11, 2005

MANAGEMENT'S ANNUAL REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Management assessed our internal control over financial reporting as of December 31, 2004, the end of our fiscal year. Management based its assessment on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”). Our management believes that the COSO framework is a suitable framework for its evaluation of our internal control over financial reporting because it is free from bias, permits reasonably consistent qualitative and quantitative measurements of our internal controls, is sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of our internal controls are not omitted and is relevant to an evaluation of internal control over financial reporting. Management’s assessment included evaluation of such elements as the design and operating effectiveness of key financial reporting controls, process documentation, accounting policies, and our overall control environment.

Based on our assessment, management has concluded that our internal control over financial reporting was effective as of the end of the fiscal year to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with generally accepted accounting principles. Management has not identified any material weaknesses in our internal control over financial reporting. We reviewed the results of management’s assessment with the Audit Committee of our Board of Directors.

Our independent registered public accounting firm, Ernst & Young LLP, audited management’s assessment and independently assessed the effectiveness of the company’s internal control over financial reporting. Ernst & Young has issued an attestation report on our internal controls that concurs with management’s assessment. Their report immediately follows this report.

Inherent Limitations on Effectiveness of Controls Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal controls over financial reporting will prevent or detect all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. The design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Further, because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within Universal American have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons or by collusion of two or more people. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Projections of any evaluation of controls effectiveness to future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The Board of Directors and Stockholders of
Universal American Financial Corp.:

We have audited management's assessment, included in the accompanying management's annual report on internal control over financial reporting that Universal American Financial Corp. maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Universal American Financial Corp. management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and disposi-

tions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Universal American Financial Corp. maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Universal American Financial Corp. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Universal American Financial Corp. and subsidiaries as of December 31, 2004 and 2003 and the related consolidated statements of operations, stockholders' equity and comprehensive income, and cash flows for each of the three years in the period ended December 31, 2004 and our report dated March 11, 2005 expressed an unqualified opinion thereon.

Ernst & Young LLP
New York, New York
March 11, 2005

MARKET FOR UNIVERSAL AMERICAN'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Market information Our common stock is traded in the over-the-counter market and quoted on the Nasdaq National Market tier of The Nasdaq Stock Market ("Nasdaq") under the symbol "UHCO". The following table sets forth the high and low sales prices for our common stock on the Nasdaq National Market, as reported by Nasdaq for the periods indicated.

Period	Common Stock	
	High	Low
Year Ended December 31, 2003		
First Quarter	\$ 6.06	\$ 5.20
Second Quarter	6.99	5.60
Third Quarter	9.40	5.95
Fourth Quarter	12.45	8.50
Year Ended December 31, 2004		
First Quarter	12.82	9.36
Second Quarter	12.50	10.00
Third Quarter	12.95	10.29
Fourth Quarter	16.01	11.07
Year Ending December 31, 2005		
First Quarter (through March 1, 2005)	16.35	14.16

On March 1, 2005, the closing sale price of our common stock as reported by Nasdaq was \$16.10 per share.

Stockholders As of the close of business on March 1, 2005, there were approximately 1,300 holders of record

of our common stock. We estimate that there are approximately 15,000 beneficial owners of our common stock.

Dividends We have never declared cash dividends on our common stock, and have no present intention to declare any cash dividends in the foreseeable future.

CORPORATE INFORMATION

We make available free of charge on our Internet website (<http://www.uafc.com>) our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to these reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission. Copies of any materials we file with the SEC can be read or copied at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. You can obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC also maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that

file electronically with the SEC. Copies of any materials we have filed electronically with the SEC may be accessed at the SEC's website: <http://www.sec.gov>.

Corporate Headquarters

Universal American Financial Corp.
Six International Drive
Rye Brook, NY 10573-1068
(914) 934-5200

Registrar and Transfer Agent Correspondence concerning your account or address changes should be addressed to:
American Stock Transfer & Trust Co.
59 Maiden Lane, New York, NY 10038
(800) 937-5449

UNIVERSAL AMERICAN FINANCIAL CORP.

OFFICERS

RICHARD A. BARASCH
Chairman and
Chief Executive Officer

GARY W. BRYANT, CPA
Executive Vice President and
Chief Operating Officer

ROBERT A. WAEGELEIN, CPA
Executive Vice President and
Chief Financial Officer

GARY JACOBS
Senior Vice President,
Corporate Development

LISA M. SPIVACK
Senior Vice President and
General Counsel

WILLIAM H. CUSHMAN, CPA
Vice President,
Financial Reporting

DIRECTORS

RICHARD A. BARASCH
Chairman

BRADLEY E. COOPER
Partner,
Capital Z Partners, L.P.

MARK M. HARMELING
Real Estate Investor

BERTRAM HARNETT, ESQ.
President,
Harnett, Lesnick, and Ripps, PA

LINDA LAMEL
Attorney

ERIC LEATHERS
Principal,
Capital Z Partners, L.P.

PATRICK J. McLAUGHLIN
Managing Director,
Emerald Capital Group

ROBERT A. SPASS
Partner,
Capital Z Partners, L.P.

ROBERT F. WRIGHT
President, Robert F.
Wright Associates, Inc.

AMERICAN PIONEER LIFE INSURANCE COMPANY

GARY W. BRYANT, CPA
President and
Chief Executive Officer

MICHAEL A. COLLIFLOWER,
JD, CLU, ChFC, FLMI, AIRC
Senior Vice President,
Legal and Compliance

DONALD M. GRAY,
CPA, CLU, FLMI
Senior Vice President,
Finance and Treasurer

BERNARD BUONANNO
Senior Vice President,
Marketing & Sales

NEIL LUND, FSA, MAAA
Senior Vice President and
Chief Actuary

FREDERICK W. ROOK
Senior Vice President and
Chief Information Officer

DANA ADAMS
Senior Vice President,
Project Management

AMERICAN PROGRESSIVE LIFE & HEALTH INSURANCE COMPANY OF NEW YORK

WILLIAM M. DALY
Senior Vice President,
Marketing

PENNSYLVANIA LIFE INSURANCE COMPANY

WILLIAM E. WEHNER, CLU, FLMI
President

PETER A. ENGLISH
Executive Vice President and
Chief Marketing Officer

PENNCORP LIFE INSURANCE COMPANY (CANADA)

J. PAUL EDMONDSON
President and
Chief Executive Officer

MICHAEL A. HAMILTON
Senior Vice President,
Marketing and Sales

LYNN GRENIER-LEW,
FSA, FCIA, MAAA
Senior Vice President,
Finance

ROSLIND NELLES
Senior Vice President,
Administration

SYLVAIN GOULET,
FSA, FCIA, MAAA
Appointed Actuary,
Eckler Partners, Ltd.

PYRAMID LIFE INSURANCE COMPANY

GLENN PARKER, CLU, ChFC
President

UNION BANKERS INSURANCE COMPANY

KEN HALL
Senior Vice President,
Marketing

CHCS SERVICES, INC.

GARY JACOBS
President

JASON J. ISRAEL
Chief Operating Officer

PATRICK BOUDREAUX
Senior Vice President

MAUREEN LILLIS
Senior Vice President,
Long Term Care

FELISSE OTTEN, A.R.N.P.
Senior Vice President,
Customer Contact

LARRY POPE
Senior Vice President,
Client Relations

LINDA SHOENFELT
Senior Vice President,
Medicare Supplement

LEONARD SHERMAN,
CPA, CLU, FLMI
Senior Vice President and
Chief Financial Officer

HERITAGE HEALTH SYSTEMS, INC.

THEODORE M. CARPENTER, JR.
Chief Executive Officer

STEPHEN C. HOLMAN
Senior Vice President and
Chief Financial Officer

STEPHEN C. ZEGER
Senior Vice President,
Marketing and Sales

RICHARD HARRIS
Senior Vice President,
Health Plan Operations

UNIVERSAL AMERICAN
FINANCIAL CORP.

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