

DONEGAL GROUP INC  
Form 10-Q  
May 05, 2009

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

(Mark One)

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

**For the quarterly period ended March 31, 2009**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_.**

**Commission file number 0-15341  
Donegal Group Inc.**

(Exact name of registrant as specified in its charter)

Delaware

23-2424711

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification No.)

1195 River Road, P.O. Box 302, Marietta, PA

17547-0302

(Address of principal executive offices)

(Zip code)

(717) 426-1931

(Registrant's telephone number, including area code)

Not applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No   
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated  Accelerated filer

Smaller reporting

filer o

Non-accelerated filer o  
(Do not check if a smaller reporting  
company)

company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 19,904,993 shares of Class A Common Stock, par value \$0.01 per share, and 5,576,775 shares of Class B Common Stock, par value \$0.01 per share, outstanding on April 30, 2009.

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**Part I. Financial Information****Item 1. Financial Statements.****Donegal Group Inc. and Subsidiaries  
Consolidated Balance Sheets**

	<b>March 31, 2009</b>	<b>December 31, 2008</b>
	(Unaudited)	
<b>Assets</b>		
Investments		
Fixed maturities		
Held to maturity, at amortized cost	\$ 90,023,099	\$ 99,878,156
Available for sale, at fair value	485,222,058	445,815,749
Equity securities, available for sale, at fair value	7,905,397	5,894,975
Investments in affiliates	8,707,368	8,594,177
Short-term investments, at cost, which approximates fair value	47,760,204	71,952,469
Total investments	639,618,126	632,135,526
Cash	2,290,662	1,830,954
Accrued investment income	6,563,440	6,655,506
Premiums receivable	56,803,877	55,337,270
Reinsurance receivable	83,104,381	79,952,971
Deferred policy acquisition costs	29,625,997	29,541,281
Deferred tax asset, net	8,664,927	10,994,644
Prepaid reinsurance premiums	52,089,959	51,436,487
Property and equipment, net	6,999,015	6,686,684
Accounts receivable securities		862,790
Federal income taxes recoverable	2,537,288	2,590,928
Other	2,081,318	2,083,995
Total assets	\$ 890,378,990	\$ 880,109,036
<b>Liabilities and Stockholders Equity</b>		
<b>Liabilities</b>		
Losses and loss expenses	\$ 249,158,100	\$ 239,809,276
Unearned premiums	229,320,987	229,013,929
Accrued expenses	11,761,785	14,149,754
Reinsurance balances payable	2,490,760	1,566,816
Cash dividends declared to stockholders		2,602,104
Subordinated debentures	15,465,000	15,465,000
Accounts payable securities	7,261,762	1,820,574
Due to affiliate	1,154,581	3,148,057
Drafts payable	834,410	876,210
Due to Sheboygan policyholders	2,556,258	6,843,454
Other	2,025,601	1,229,997

Total liabilities	522,029,244	516,525,171
<b>Stockholders Equity</b>		
Preferred stock, \$1.00 par value, authorized 2,000,000 shares; none issued		
Class A common stock, \$.01 par value, authorized 30,000,000 shares, issued 20,510,199 and 20,494,764 shares and outstanding 19,881,500 and 19,869,065 shares	205,102	204,948
Class B common stock, \$.01 par value, authorized 10,000,000 shares, issued 5,649,240 shares and outstanding 5,576,775 shares	56,492	56,492
Additional paid-in capital	163,461,351	163,136,938
Accumulated other comprehensive income	6,052,455	1,713,836
Retained earnings	207,322,810	207,182,253
Treasury stock	(8,748,464)	(8,710,602)
Total stockholders equity	368,349,746	363,583,865
Total liabilities and stockholders equity	\$ 890,378,990	\$ 880,109,036

See accompanying notes to consolidated financial statements.

**Donegal Group Inc. and Subsidiaries**  
**Consolidated Statements of Income**  
(Unaudited)

	<b>Three Months Ended March</b>	
	<b>31,</b>	
	<b>2009</b>	<b>2008</b>
<b>Revenues:</b>		
Net premiums earned	\$ 88,349,543	\$ 82,007,766
Investment income, net of investment expenses	5,357,589	5,691,741
Net realized investment gains	258,855	695,356
Lease income	221,621	244,113
Installment payment fees	1,299,756	1,153,127
<b>Total revenues</b>	<b>95,487,364</b>	<b>89,792,103</b>
<b>Expenses:</b>		
Net losses and loss expenses	65,949,165	53,785,061
Amortization of deferred policy acquisition costs	14,733,000	13,719,000
Other underwriting expenses	12,676,632	12,403,152
Policyholder dividends	243,529	270,438
Interest	1,204,778	612,476
Other expenses	468,005	499,226
<b>Total expenses</b>	<b>95,275,109</b>	<b>81,289,353</b>
Income before income tax expense	212,255	8,502,750
Income tax expense	42,451	1,943,667
Net income	\$ 169,804	\$ 6,559,083
Earnings per common share:		
Class A common stock basic	\$ 0.01	\$ 0.26
Class A common stock diluted	\$ 0.01	\$ 0.26
Class B common stock basic and diluted	\$ 0.01	\$ 0.24

**Consolidated Statements of Comprehensive Income**  
(Unaudited)

**Three Months Ended March**  
**31,**  
**2009**                      **2008**

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Net income	\$ 169,804	\$ 6,559,083
Other comprehensive income (loss), net of tax		
Unrealized income (loss) on securities:		
Unrealized holding income (loss) during the period, net of income tax (benefit)	4,506,875	(3,047,590)
Reclassification adjustment, net of income tax	(168,256)	(451,981)
Other comprehensive income (loss)	4,338,619	(3,499,571)
Comprehensive income	\$ 4,508,423	\$ 3,059,512

See accompanying notes to consolidated financial statements.

**Donegal Group Inc. and Subsidiaries**  
**Consolidated Statement of Stockholders' Equity**  
(Unaudited)  
**Three Months Ended March 31, 2009**

	Class A Shares	Class B Shares	Class A Amount	Class B Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Retained Earnings	Treasury Stock	Total Stockholders' Equity
December 31, 2008	20,494,764	5,649,240	\$204,948	\$56,492	\$163,136,938	\$1,713,836	\$207,182,253	\$(8,710,602)	\$363,713,825
of common stock									
compensation plans)	15,435		154		296,788				
ne							169,804		
dividends							(1,622)		
stock options					27,625		(27,625)		
use of treasury stock								(37,862)	
comprehensive income						4,338,619			4,338,619
March 31, 2009	20,510,199	5,649,240	\$205,102	\$56,492	\$163,461,351	\$6,052,455	\$207,322,810	\$(8,748,464)	\$368,134,734

See accompanying notes to consolidated financial statements.

**Donegal Group Inc. and Subsidiaries**  
**Consolidated Statements of Cash Flows**  
(Unaudited)

	<b>Three Months Ended March 31,</b>	
	<b>2009</b>	<b>2008</b>
<b>Cash Flows from Operating Activities:</b>		
Net income	\$ 169,804	\$ 6,559,083
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	668,878	599,320
Net realized investment gains	(258,855)	(695,356)
Changes in assets and liabilities:		
Losses and loss expenses	9,348,824	2,541,098
Unearned premiums	307,058	19,931,400
Premiums receivable	(1,466,607)	(4,894,650)
Deferred acquisition costs	(84,716)	(2,728,561)
Deferred income taxes	(6,463)	(322,787)
Reinsurance receivable	(3,151,410)	2,026,243
Prepaid reinsurance premiums	(653,472)	(2,264,309)
Accrued investment income	92,066	349,244
Due to affiliate	(1,993,476)	(1,249,335)
Reinsurance balances payable	923,944	(666,338)
Current income taxes	53,640	1,309,376
Accrued expenses	(2,387,969)	(2,056,526)
Other, net	756,503	1,220,694
Net adjustments	2,147,945	13,099,513
Net cash provided by operating activities	2,317,749	19,658,596
<b>Cash Flows from Investing Activities:</b>		
Purchases of fixed maturities:		
Available for sale	(41,986,797)	(87,231,024)
Purchases of equity securities, available for sale	(7,598,470)	(503,765)
Maturity of fixed maturities:		
Held to maturity	9,694,049	20,021,499
Available for sale	12,204,191	14,969,487
Sales of fixed maturities:		
Available for sale	2,431,991	13,063,738
Sales of equity securities, available for sale	6,419,877	3,254,419
Payments to Sheboygan policyholders	(4,287,196)	
Net decrease (increase) in investment in affiliates	(14,250)	18,426
Net purchase of property and equipment	(569,055)	(416,755)
Net sale of short-term investments	24,192,265	18,257,658
Net cash provided by (used in) investing activities	486,605	(18,566,317)



**Cash Flows from Financing Activities:**

Cash dividends paid	(2,603,726)	(2,211,780)
Issuance of common stock	296,942	1,664,661
Purchase of treasury stock	(37,862)	(1,508,121)
Tax benefit on exercise of stock options		624,933
Net cash used in financing activities	(2,344,646)	(1,430,307)
Net increase (decrease) in cash	459,708	(338,028)
Cash at beginning of period	1,830,954	4,289,365
Cash at end of period	\$ 2,290,662	\$ 3,951,337
Cash paid during period Interest	\$ 277,857	\$ 695,745
Net cash paid during period Taxes	\$	\$ 425,000

See accompanying notes to consolidated financial statements.

**DONEGAL GROUP INC. AND SUBSIDIARIES**  
**(Unaudited)**  
**Notes to Consolidated Financial Statements**

**1 Organization**

Donegal Mutual Insurance Company ( Donegal Mutual ) organized us as an insurance holding company on August 26, 1986. Our six insurance subsidiaries and Donegal Mutual conduct business as the Donegal Insurance Group. The Donegal Insurance Group writes personal and commercial lines of property and casualty insurance exclusively through a network of independent insurance agents in 18 Mid-Atlantic, Midwest and Southern states. The personal lines products consist primarily of homeowners and private passenger automobile policies. The commercial lines products consist primarily of commercial automobile, commercial multi-peril and workers' compensation policies.

Our insurance subsidiaries are Atlantic States Insurance Company ( Atlantic States ), Southern Insurance Company of Virginia ( Southern ), Le Mars Insurance Company ( Le Mars ), the Peninsula Insurance Group ( Peninsula ) which consists of Peninsula Indemnity Company and The Peninsula Insurance Company, and Sheboygan Falls Insurance Company ( Sheboygan ). We also own approximately 48% of the outstanding stock of Donegal Financial Services Corporation ( DFSC ), a thrift holding company that owns Province Bank FSB. Donegal Mutual owns the remaining approximately 52% of the outstanding stock of DFSC.

At March 31, 2009, Donegal Mutual held approximately 42% of our outstanding Class A common stock and approximately 75% of our outstanding Class B common stock.

Atlantic States and Donegal Mutual are parties to a pooling agreement under which each company places all of its direct written business in the pool and both companies proportionately share the underwriting results of the pool, excluding certain reinsurance assumed by Donegal Mutual from our five other insurance subsidiaries. From July 1, 2000 through February 29, 2008, Atlantic States had a 70% share of the results of the pool, and Donegal Mutual had a 30% share of the results of the pool. Effective March 1, 2008, Donegal Mutual and Atlantic States amended the pooling agreement to increase Atlantic States' share of the results of the pool to 80%. In connection with this amendment to the pooling agreement, Donegal Mutual transferred approximately \$11.9 million in cash and net liabilities to Atlantic States. See Note 4 Reinsurance for more information regarding the pooling agreement.

On March 7, 2007, our board of directors authorized a share repurchase program, pursuant to which we may purchase up to 500,000 shares of our Class A common stock at prices prevailing from time to time in the open market subject to the provisions of Securities and Exchange Commission ( SEC ) Rule 10b-18 and in privately negotiated transactions. We purchased 3,000 and 88,212 shares of our Class A common stock under this program during the three months ended March 31, 2009 and 2008, respectively. We have purchased a total of 483,769 shares of our Class A common stock under this program through March 31, 2009.

In June 2007, Donegal Mutual consummated an affiliation with Sheboygan. As part of the affiliation, Donegal Mutual made a \$3.5 million contribution note investment in Sheboygan. During 2008, Sheboygan's board of directors adopted a plan of conversion to convert to a stock insurance company. Following policyholder and regulatory approval of the plan of conversion, we acquired Sheboygan as of December 1, 2008 for approximately \$12.0 million in cash, including payment of the contribution note and accrued interest to Donegal Mutual. Sheboygan's results of operations have been included in our consolidated results from that date.

On February 23, 2009, our board of directors authorized a share repurchase program, pursuant to which we may purchase up to 300,000 shares of our Class A common stock at prices prevailing from time to time in the open market subject to the provisions of SEC Rule 10b-18 and in privately negotiated transactions. We did not purchase any shares of our Class A common stock under this program during the three months ended March 31, 2009.

## 2 Basis of Presentation

Our financial information for the interim periods included in this Form 10-Q Report is unaudited; however, such information reflects all adjustments, consisting only of normal recurring adjustments that, in the opinion of our management, are necessary for a fair presentation of our financial position, results of operations and cash flows for the interim periods included in this Form 10-Q Report. During the first quarter of 2009, we accrued \$1.4 million related to a contested premium tax case that we are appealing. In accordance with our accounting policy, we recorded \$974,000 of interest and penalties in interest expense and \$426,000 in other underwriting expenses. Our results of operations for the three months ended March 31, 2009 are not necessarily indicative of our results of operations to be expected for the year ending December 31, 2009.

You should read these interim financial statements in conjunction with the financial statements and notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2008. As indicated in Note 22 to our financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2008, we discovered an immaterial error in the amount recorded for losses and loss expenses incurred for the first quarter of 2008. We adjusted our 2008 financial information included in this Form 10-Q Report to correct this error.

## 3 Earnings Per Share

We have two classes of common stock, which we refer to as our Class A common stock and our Class B common stock. Our certificate of incorporation provides that whenever our board of directors declares a dividend on our Class B common stock, our board of directors must also declare a dividend on our Class A common stock that is payable at the same time to holders as of the same record date at a rate that is at least 10% greater than the rate at which our board declared the dividend on our Class B common stock. Accordingly, we use the two-class method for the computation of earnings per common share pursuant to Statement of Financial Accounting Standards (SFAS) No. 128, Earnings Per Share. The two-class method is an earnings allocation formula that determines earnings per share separately for each class of common stock based on dividends declared and an allocation of remaining undistributed earnings using a participation percentage reflecting the dividend rights of each class. The table below presents a reconciliation of the numerators and denominators used in the basic and diluted per share computations for each class of stock:

### For the Three Months Ended March 31:

	(in thousands, except per share data)			
	2009		2008	
	Class A	Class B	Class A	Class B
Basic net income per share:				
Numerator:				
Allocation of net income	\$ 136	\$ 34	\$ 5,188	\$ 1,371
Denominator:				
Weighted-average shares outstanding	19,883,429	5,576,775	19,787,849	5,576,775
Basic net income per share	\$ 0.01	\$ 0.01	\$ 0.26	\$ 0.24
Diluted net income per share:				
Numerator:				
Allocation of net income	\$ 136	\$ 34	\$ 5,188	\$ 1,371
Denominator:				
Number of shares used in basic computation	19,883,429	5,576,775	19,787,849	5,576,775

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Weighted-average effect of dilutive securities				
Director and employee stock options			142,831	
Number of shares used in per share computations	19,883,429	5,576,775	19,930,680	5,576,775
Diluted net income per share	\$ 0.01	\$ 0.01	\$ 0.26	\$ 0.24

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We did not include options to purchase the following number of shares of Class A common stock in the computation of diluted earnings per share because the exercise price of the options was greater than the average market price during the relevant period:

	Three Months Ended	
	2009	2008
Number of shares	3,422,432	1,032,667

#### 4 Reinsurance

Atlantic States has participated in a pooling agreement with Donegal Mutual since 1986 under which each company places all of its direct written business into the pool, and Atlantic States and Donegal Mutual then share the underwriting results of the pool in accordance with the terms of the pooling agreement. From July 1, 2000 through February 29, 2008, Atlantic States had a 70% share of the results of the pool, and Donegal Mutual had a 30% share of the results of the pool. Effective March 1, 2008, Donegal Mutual and Atlantic States amended the pooling agreement to increase Atlantic States' share of the results of the pool to 80%. In connection with this amendment to the pooling agreement, Donegal Mutual transferred approximately \$11.9 million of cash and net liabilities to Atlantic States as of March 1, 2008 as follows:

	(in thousands)
Unearned premiums (net of reinsurance)	\$ 13,626
Less: Ceding commissions	(1,709)
Net liabilities transferred	\$ 11,917

Atlantic States, Southern and Donegal Mutual purchase third-party reinsurance on a combined basis. Le Mars, Peninsula and Sheboygan have separate third-party reinsurance programs that provide similar types of coverage and that are commensurate with their relative size and exposures. Our insurance subsidiaries place reinsurance with various reinsurers, all of which, consistent with Donegal Insurance Group's requirements, have an A.M. Best rating of A- (Excellent) or better or, with respect to foreign reinsurers, have a financial condition that, in the opinion of our management, is equivalent to a company with at least an A- rating. The following information relates to the external reinsurance Atlantic States, Southern and Donegal Mutual have in place during 2009:

excess of loss reinsurance, under which losses are automatically reinsured, through a series of contracts, over a set retention (\$750,000 for 2009), and

catastrophe reinsurance, under which they recover, through a series of contracts, 100% of an accumulation of many losses resulting from a single event, including natural disasters, over a set retention (\$3.0 million for 2009).

Our insurance subsidiaries and Donegal Mutual also purchase facultative reinsurance to cover exposures from losses that exceed the limits provided by their respective treaty reinsurance.

In addition to the pooling agreement and third-party reinsurance, our insurance subsidiaries have various reinsurance agreements with Donegal Mutual.

We renewed our 2009 reinsurance program at rates comparable to 2008, largely attributable to our decision to increase our excess of loss reinsurance retention from \$600,000 to \$750,000 effective January 1, 2009. We made no other significant changes to our third-party reinsurance or other reinsurance agreements between our insurance subsidiaries and Donegal Mutual during the three months ended March 31, 2009.



**5 Investments**

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at March 31, 2009 as follows:

	Less than 12 months		12 months or longer	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)			
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 5,295	\$ 63	\$	\$
Obligations of states and political subdivisions	103,291	4,791	50,938	1,741
Corporate securities	16,393	1,088	1,635	630
Mortgage-backed securities	1,045	7	587	5
Equity securities	3,555	275		
Total	\$ 129,579	\$ 6,224	\$ 53,160	\$ 2,376

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at December 31, 2008 as follows:

	Less than 12 months		12 months or longer	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)			
Obligations of states and political subdivisions	\$ 117,360	\$ 6,881	\$ 65,627	\$ 3,331
Corporate securities	16,781	449	2,536	733
Mortgage-backed securities	2,925	24	2,929	23
Equity securities	484	59		