

DONEGAL GROUP INC  
Form 10-Q  
November 06, 2009

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

(Mark One)

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

**For the quarterly period ended September 30, 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

(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 Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) 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 filer  Accelerated  
filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 19,905,297 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 October 31, 2009.

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

	<b>September 30, 2009</b>	<b>December 31, 2008</b>
	(Unaudited)	
<b>Assets</b>		
Investments		
Fixed maturities		
Held to maturity, at amortized cost	\$ 78,540,210	\$ 99,878,156
Available for sale, at fair value	527,575,236	445,815,749
Equity securities, available for sale, at fair value	8,416,214	5,894,975
Investments in affiliates	8,946,241	8,594,177
Short-term investments, at cost, which approximates fair value	39,849,131	71,952,469
Total investments	663,327,032	632,135,526
Cash	8,816,727	1,830,954
Accrued investment income	6,317,101	6,655,506
Premiums receivable	63,508,833	55,337,270
Reinsurance receivable	85,199,902	79,952,971
Deferred policy acquisition costs	31,783,916	29,541,281
Deferred tax asset, net		10,994,644
Prepaid reinsurance premiums	58,261,417	51,436,487
Property and equipment, net	6,725,115	6,686,684
Accounts receivable securities	171,377	862,790
Federal income taxes recoverable	326,197	2,590,928
Other	2,003,950	2,083,995
Total assets	\$ 926,441,567	\$ 880,109,036
<b>Liabilities and Stockholders Equity</b>		
<b>Liabilities</b>		
Unpaid losses and loss expenses	\$ 251,031,954	\$ 239,809,276
Unearned premiums	247,159,135	229,013,929
Accrued expenses	10,662,679	14,149,754
Reinsurance balances payable	3,558,394	1,566,816
Cash dividends declared to stockholders		2,602,104
Deferred tax liability, net	518,041	
Subordinated debentures	15,465,000	15,465,000
Accounts payable securities	1,502,962	1,820,574
Due to affiliate	802,380	3,148,057
Drafts payable	1,651,336	876,210
Due to Sheboygan policyholders	1,166,776	6,843,454
Other	1,393,188	1,229,997

Total liabilities	534,911,845	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 20,544,996 and 20,494,764 shares and outstanding 19,905,297 and 19,869,065 shares	205,450	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	164,134,080	163,136,938
Accumulated other comprehensive income	23,217,277	1,713,836
Retained earnings	212,825,904	207,182,253
Treasury stock	(8,909,481)	(8,710,602)
Total stockholders equity	391,529,722	363,583,865
Total liabilities and stockholders equity	\$ 926,441,567	\$ 880,109,036

See accompanying notes to consolidated financial statements.

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

	<b>Three Months Ended September</b>	
	<b>30,</b>	
	<b>2009</b>	<b>2008</b>
<b>Revenues:</b>		
Net premiums earned	\$ 87,997,723	\$ 88,170,757
Investment income, net of investment expenses	5,107,356	5,801,750
Net realized investment gains (losses)	189,230	(2,811,264)
Lease income	232,762	230,903
Installment payment fees	1,349,016	1,316,429
<b>Total revenues</b>	<b>94,876,087</b>	<b>92,708,575</b>
<b>Expenses:</b>		
Net losses and loss expenses	58,609,247	54,700,316
Amortization of deferred policy acquisition costs	14,791,000	14,818,000
Other underwriting expenses	13,344,369	14,240,659
Policyholder dividends	251,573	437,470
Interest	185,315	398,855
Other expenses	329,330	314,642
<b>Total expenses</b>	<b>87,510,834</b>	<b>84,909,942</b>
Income before income tax expense	7,365,253	7,798,633
Income tax expense	620,402	1,528,212
Net income	\$ 6,744,851	\$ 6,270,421
Earnings per common share:		
Class A common stock basic	\$ 0.27	\$ 0.25
Class A common stock diluted	\$ 0.27	\$ 0.25
Class B common stock basic and diluted	\$ 0.24	\$ 0.23

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

	<b>Three Months Ended September</b>	
	<b>30,</b>	
	<b>2009</b>	<b>2008</b>
Net income	\$ 6,744,851	\$ 6,270,421

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Other comprehensive income (loss), net of tax		
Unrealized income (loss) on securities:		
Unrealized holding income (loss) during the period, net of income tax (benefit)	16,163,607	(9,172,698)
Reclassification adjustment, net of income tax	(122,999)	1,827,322
Other comprehensive income (loss)	16,040,608	(7,345,376)
Comprehensive income (loss)	\$ 22,785,459	\$ (1,074,955)

See accompanying notes to consolidated financial statements.

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

	<b>Nine Months Ended September</b>	
	<b>30,</b>	
	<b>2009</b>	<b>2008</b>
<b>Revenues:</b>		
Net premiums earned	\$ 263,887,611	\$ 257,507,718
Investment income, net of investment expenses	15,731,106	17,287,476
Net realized investment gains (losses)	893,225	(2,789,535)
Lease income	689,096	705,198
Installment payment fees	3,957,392	3,760,768
 Total revenues	 285,158,430	 276,471,625
 <b>Expenses:</b>		
Net losses and loss expenses	186,461,543	164,849,522
Amortization of deferred policy acquisition costs	44,158,000	43,109,000
Other underwriting expenses	38,548,332	40,711,661
Policyholder dividends	586,784	924,537
Interest	1,588,560	1,545,571
Other expenses	1,104,175	1,211,480
 Total expenses	 272,447,394	 252,351,771
 Income before income tax expense	 12,711,036	 24,119,854
Income tax expense	1,408,757	4,972,173
 Net income	 \$ 11,302,279	 \$ 19,147,681
 Earnings per common share:		
Class A common stock basic	\$ 0.45	\$ 0.77
Class A common stock diluted	\$ 0.45	\$ 0.76
Class B common stock basic and diluted	\$ 0.41	\$ 0.69

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

	<b>Nine Months Ended September</b>	
	<b>30,</b>	
	<b>2009</b>	<b>2008</b>
Net income	\$ 11,302,279	\$ 19,147,681

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Other comprehensive income (loss), net of tax		
Unrealized income (loss) on securities:		
Unrealized holding income (loss) during the period, net of income tax (benefit)	22,084,037	(16,065,940)
Reclassification adjustment, net of income tax	(580,596)	1,813,198
Other comprehensive income (loss)	21,503,441	(14,252,742)
Comprehensive income	\$ 32,805,720	\$ 4,894,939

See accompanying notes to consolidated financial statements.

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**Donegal Group Inc. and Subsidiaries**  
**Consolidated Statement of Stockholders Equity**  
(Unaudited)  
**Nine Months Ended September 30, 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 Stockholder Equity
Balance, 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)	\$ 363,583,821
Issuance of common stock for stock compensation plans	50,232		502		934,151				934,655
Net income							11,302,279		11,302,279
Cash dividends declared							(5,595,637)		(5,595,637)
Reversal of stock options					62,991		(62,991)		
Repurchase of treasury stock								(198,879)	(198,879)
Other comprehensive income						21,503,441			21,503,441
Balance, September 30, 2009	20,544,996	5,649,240	\$ 205,450	\$ 56,492	\$ 164,134,080	\$ 23,217,277	\$ 212,825,904	\$ (8,909,481)	\$ 391,529,726

See accompanying notes to consolidated financial statements.

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

	<b>Nine Months Ended September</b>	
	<b>30,</b>	
	<b>2009</b>	<b>2008</b>
<b>Cash Flows from Operating Activities:</b>		
Net income	\$ 11,302,279	\$ 19,147,681
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,961,738	1,786,722
Net realized investment (gains) losses	(893,225)	2,789,535
Changes in assets and liabilities:		
Losses and loss expenses	11,222,678	18,321,092
Unearned premiums	18,145,206	36,449,339
Premiums receivable	(8,171,563)	(8,221,167)
Deferred acquisition costs	(2,242,635)	(4,636,597)
Deferred income taxes	(66,092)	(1,534,983)
Reinsurance receivable	(5,246,931)	(7,612,143)
Prepaid reinsurance premiums	(6,824,930)	(7,616,205)
Accrued investment income	338,405	(23,675)
Due to affiliate	(2,345,677)	216,870
Reinsurance balances payable	1,991,578	(112,419)
Current income taxes	2,264,731	(300,535)
Accrued expenses	(3,487,075)	(1,065,974)
Other, net	1,018,363	873,144
Net adjustments	7,664,571	29,313,004
Net cash provided by operating activities	18,966,850	48,460,685
<b>Cash Flows from Investing Activities:</b>		
Purchases of fixed maturities:		
Available for sale	(93,510,595)	(149,742,022)
Purchases of equity securities, available for sale	(25,815,019)	(12,890,734)
Maturity of fixed maturities:		
Held to maturity	20,981,616	49,698,926
Available for sale	30,353,892	43,899,947
Sales of fixed maturities:		
Available for sale	12,121,541	25,215,920
Sales of equity securities, available for sale	25,847,613	31,922,932
Payments to Sheboygan policyholders	(5,676,678)	
Net (increase) decrease in investment in affiliates	(98,771)	401,828
Net purchases of property and equipment	(826,047)	(932,986)
Net sales (purchases) of short-term investments	32,103,338	(12,561,772)

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Net cash used in investing activities	(4,519,110)	(24,987,961)
<b>Cash Flows from Financing Activities:</b>		
Cash dividends paid	(8,197,741)	(7,417,380)
Redemption of subordinated debentures		(15,464,000)
Issuance of common stock	934,653	3,352,100
Purchase of treasury stock	(198,879)	(2,449,448)
Tax benefit on exercise of stock options		683,216
Net cash used in financing activities	(7,461,967)	(21,295,512)
Net increase in cash	6,985,773	2,177,212
Cash at beginning of period	1,830,954	4,289,365
Cash at end of period	\$ 8,816,727	\$ 6,466,577
Cash paid during period Interest	\$ 675,193	\$ 1,772,648
Net cash (recovered) paid during period Taxes	\$ (792,582)	\$ 6,125,000

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 a downstream 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, Midwestern and Southeastern 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 unitary thrift holding company that owns Province Bank FSB. Donegal Mutual owns the remaining approximately 52% of the outstanding stock of DFSC.

At September 30, 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 share proportionately 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% and to decrease Donegal Mutual's share of the pool to 20%. 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 did not purchase any shares of our Class A common stock under this program during the three months ended September 30, 2009. We purchased 4,000 shares of our Class A common stock under this program during the three months ended September 30, 2008. We purchased 14,000 and 144,243 shares of our Class A common stock under this program during the nine months ended September 30, 2009 and 2008, respectively. We have purchased a total of 494,769 shares of our Class A common stock under this program through September 30, 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 since December 1, 2008.

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 nine months ended September 30, 2009.

In October 2009, Donegal Mutual consummated an agreement with Southern Mutual Insurance Company ( Southern Mutual ), under which Donegal Mutual purchased a surplus note of Southern Mutual in the principal amount of \$2,500,000, Donegal Mutual designees became a majority of the members of Southern Mutual's board of directors and Donegal Mutual agreed to provide quota share reinsurance to Southern Mutual for 100% of its business. Effective October 31, 2009, Donegal Mutual began to include business assumed from Southern Mutual in its pooling agreement with Atlantic States. Southern Mutual writes primarily personal lines of insurance in Georgia and South Carolina and had net written premiums of approximately \$12 million in 2008.

## 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. Our results of operations for the nine months ended September 30, 2009 are not necessarily indicative of the results of operations we expect 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 net losses and loss expenses incurred for the third 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 of directors declared the dividend on our Class B common stock. Accordingly, we use the two-class method to compute our earnings per common 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 we have declared and an allocation of our remaining undistributed earnings using a participation percentage that reflects the dividend rights of each class. The table below presents a reconciliation of the numerators and denominators we use to compute basic and diluted net income per share for each class of common stock:

### For the Three Months Ended September 30:

	(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	\$ 5,386	\$ 1,359	\$ 5,009	\$ 1,261
Denominator:				
Weighted-average shares outstanding	19,905,174	5,576,775	19,882,405	5,576,775
Basic net income per share	\$ 0.27	\$ 0.24	\$ 0.25	\$ 0.23