

DONEGAL GROUP INC
Form 10-Q
November 09, 2010

**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 September 30, 2010

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 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: 19,994,226 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, 2010.

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

	September 30, 2010	December 31, 2009
	(Unaudited)	
Assets		
Investments		
Fixed maturities		
Held to maturity, at amortized cost	\$ 66,005,469	\$ 73,807,126
Available for sale, at fair value	563,276,871	517,703,672
Equity securities, available for sale, at fair value	12,714,676	9,914,626
Investments in affiliates	9,183,620	9,309,347
Short-term investments, at cost, which approximates fair value	28,631,483	56,100,415
Total investments	679,812,119	666,835,186
Cash	12,729,268	12,923,898
Accrued investment income	6,420,863	6,202,710
Premiums receivable	71,950,432	61,187,021
Reinsurance receivable	95,514,905	84,670,009
Deferred policy acquisition costs	34,843,612	32,844,179
Deferred tax asset, net	1,552,566	5,086,949
Prepaid reinsurance premiums	64,497,515	56,040,728
Property and equipment, net	6,326,177	6,592,223
Accounts receivable securities	350,016	588,292
Federal income taxes recoverable		663,047
Other	2,104,526	1,967,685
Total assets	\$ 976,101,999	\$ 935,601,927
Liabilities and Stockholders Equity		
Liabilities		
Unpaid losses and loss expenses	\$ 278,635,509	\$ 263,598,844
Unearned premiums	268,150,466	241,821,419
Accrued expenses	9,699,243	10,578,695
Reinsurance balances payable	2,989,619	2,561,426
Federal income taxes payable	695,654	
Cash dividends declared to stockholders		2,798,378
Subordinated debentures	15,465,000	15,465,000
Accounts payable securities	1,553,931	6,828,873
Due to affiliate	893,040	3,813,294
Drafts payable	1,560,506	884,993
Other	1,683,525	1,745,306

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Total liabilities	581,326,493	550,096,228
Stockholders Equity		
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 20,628,243 and 20,569,930 shares and outstanding 19,965,942 and 19,917,331 shares	206,283	205,700
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	166,684,631	164,585,214
Accumulated other comprehensive income	22,473,601	15,007,044
Retained earnings	214,604,432	214,755,495
Treasury stock	(9,249,933)	(9,104,246)
Total stockholders equity	394,775,506	385,505,699
Total liabilities and stockholders equity	\$ 976,101,999	\$ 935,601,927

See accompanying notes to consolidated financial statements.

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

	Three Months Ended September	
	30,	
	2010	2009
Revenues:		
Net premiums earned	\$ 94,948,843	\$ 87,997,723
Investment income, net of investment expenses	4,709,458	5,107,356
Net realized investment gains	2,460,462	189,230
Lease income	231,905	232,762
Installment payment fees	1,399,650	1,349,016
Other income		6,080
Total revenues	103,750,318	94,882,167
Expenses:		
Net losses and loss expenses	67,401,697	58,609,247
Amortization of deferred policy acquisition costs	16,388,000	14,791,000
Other underwriting expenses	14,019,279	13,344,369
Policyholder dividends	220,536	251,573
Interest	183,616	185,315
Other expenses	502,279	335,410
Total expenses	98,715,407	87,516,914
Income before income tax expense	5,034,911	7,365,253
Income tax expense	125,032	620,402
Net income	\$ 4,909,879	\$ 6,744,851
Earnings per common share:		
Class A common stock basic	\$ 0.20	\$ 0.27
Class A common stock diluted	\$ 0.20	\$ 0.27
Class B common stock basic and diluted	\$ 0.18	\$ 0.24

Consolidated Statements of Comprehensive Income
(Unaudited)

Three Months Ended September
30,

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	2010	2009
Net income	\$ 4,909,879	\$ 6,744,851
Other comprehensive income, net of tax		
Unrealized income on securities:		
Unrealized holding income during the period, net of income tax	6,469,008	16,163,607
Reclassification adjustment, net of income tax	(1,623,905)	(122,999)
Other comprehensive income	4,845,103	16,040,608
Comprehensive income	\$ 9,754,982	\$ 22,785,459

See accompanying notes to consolidated financial statements.

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

	Nine Months Ended September	
	30,	
	2010	2009
Revenues:		
Net premiums earned	\$ 279,323,348	\$ 263,887,611
Investment income, net of investment expenses	14,608,439	15,731,106
Net realized investment gains	4,447,065	893,225
Lease income	687,902	689,096
Installment payment fees	4,059,766	3,957,392
Other income		48,771
Total revenues	303,126,520	285,207,201
Expenses:		
Net losses and loss expenses	203,892,799	186,461,543
Amortization of deferred policy acquisition costs	48,549,000	44,158,000
Other underwriting expenses	40,834,990	38,548,332
Policyholder dividends	465,319	586,784
Interest	537,309	1,588,560
Other expenses	1,665,778	1,152,946
Total expenses	295,945,195	272,496,165
Income before income tax expense	7,181,325	12,711,036
Income tax expense	296,960	1,408,757
Net income	\$ 6,884,365	\$ 11,302,279
Earnings per common share:		
Class A common stock basic	\$ 0.28	\$ 0.45
Class A common stock diluted	\$ 0.28	\$ 0.45
Class B common stock basic and diluted	\$ 0.25	\$ 0.41

Consolidated Statements of Comprehensive Income
(Unaudited)

Nine Months Ended September
30,
2010 **2009**

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Net income	\$ 6,884,365	\$ 11,302,279
Other comprehensive income, net of tax		
Unrealized income on securities:		
Unrealized holding income during the period, net of income tax	10,401,620	22,084,037
Reclassification adjustment, net of income tax	(2,935,063)	(580,596)
Other comprehensive income	7,466,557	21,503,441
Comprehensive income	\$ 14,350,922	\$ 32,805,720

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, 2010

	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, September 30, 2009	20,569,930	5,649,240	\$ 205,700	\$ 56,492	\$ 164,585,214	\$ 15,007,044	\$ 214,755,495	\$ (9,104,246)	\$ 385,505,600
Issuance of common stock for stock compensation plans	58,313		583		799,921				800,507
Net income							6,884,365		6,884,365
Cash dividends declared							(5,735,932)		(5,735,932)
Reversal of stock options					1,299,496		(1,299,496)		
Repurchase of treasury stock								(145,687)	(145,687)
Other comprehensive income						7,466,557			7,466,557
Balance, September 30, 2010	20,628,243	5,649,240	\$ 206,283	\$ 56,492	\$ 166,684,631	\$ 22,473,601	\$ 214,604,432	\$ (9,249,933)	\$ 394,775,504

See accompanying notes to consolidated financial statements.

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

	Nine Months Ended September	
	30,	
	2010	2009
Cash Flows from Operating Activities:		
Net income	\$ 6,884,365	\$ 11,302,279
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,054,392	1,961,738
Net realized investment gains	(4,447,065)	(893,225)
Equity loss (income)	292,742	(48,771)
Changes in assets and liabilities:		
Losses and loss expenses	15,036,665	11,222,678
Unearned premiums	26,329,047	18,145,206
Premiums receivable	(10,763,411)	(8,171,563)
Deferred acquisition costs	(1,999,433)	(2,242,635)
Deferred income taxes	(486,071)	(66,092)
Reinsurance receivable	(10,844,896)	(5,246,931)
Prepaid reinsurance premiums	(8,456,787)	(6,824,930)
Accrued investment income	(218,153)	338,405
Due to affiliate	(2,920,254)	(2,345,677)
Reinsurance balances payable	428,193	1,991,578
Current income taxes	1,358,701	2,264,731
Accrued expenses	(879,452)	(3,487,075)
Other, net	476,909	1,018,363
Net adjustments	4,961,127	7,615,800
Net cash provided by operating activities	11,845,492	18,918,079
Cash Flows from Investing Activities:		
Purchases of fixed maturities:		
Available for sale	(152,968,758)	(93,510,595)
Purchases of equity securities, available for sale	(44,168,645)	(25,815,019)
Maturity of fixed maturities:		
Held to maturity	7,503,370	20,981,616
Available for sale	53,870,605	30,353,892
Sales of fixed maturities:		
Available for sale	62,607,346	12,121,541
Sales of equity securities, available for sale	42,088,169	25,847,613
Payments to Sheboygan policyholders		(5,676,678)
Net increase in investment in affiliates		(50,000)
Net purchases of property and equipment	(561,648)	(826,047)
Net sales of short-term investments	27,468,932	32,103,338

Net cash used in investing activities	(4,160,629)	(4,470,339)
Cash Flows from Financing Activities:		
Cash dividends paid	(8,534,310)	(8,197,741)
Issuance of common stock	800,504	934,653
Purchase of treasury stock	(145,687)	(198,879)
Net cash used in financing activities	(7,879,493)	(7,461,967)
Net (decrease) increase in cash	(194,630)	6,985,773
Cash at beginning of period	12,923,898	1,830,954
Cash at end of period	\$ 12,729,268	\$ 8,816,727
Cash paid during period Interest	\$ 517,038	\$ 675,193
Net cash received during period Taxes	\$ (600,000)	\$ (792,582)

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 20 Mid-Atlantic, Midwestern, New England 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, 2010, 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 the underwriting results of the pool as provided in the pooling agreement, excluding certain reinsurance Donegal Mutual assumes 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. Donegal Mutual and Atlantic States amended the pooling agreement effective March 1, 2008 to increase Atlantic States' share of the results of the pool to 80% and to decrease Donegal Mutual's share of the results of the pool to 20% beginning on that date. See Note 4 Reinsurance for more information regarding the pooling agreement.

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 applicable SEC rules 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, 2010 and 2009, respectively. We purchased 9,702 and no shares of our Class A common stock under this program during the nine months ended September 30, 2010 and 2009, respectively. We have purchased a total of 17,371 shares of our Class A common stock under this program through September 30, 2010.

In October 2009, Donegal Mutual consummated an affiliation with Southern Mutual Insurance Company (Southern Mutual), pursuant to which Donegal Mutual purchased a surplus note of Southern Mutual in the principal amount of \$2.5 million, 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 Donegal Mutual assumes from Southern Mutual in the pooling agreement with Atlantic States. Southern Mutual writes primarily personal lines of insurance in Georgia and South Carolina and had direct premiums written of approximately \$13.3 million in 2009. Pursuant to applicable accounting standards, Southern Mutual is a variable interest entity, of which we are not the primary beneficiary.

In April 2010, DFSC and certain of its affiliates, including Donegal Mutual and us, and Union National Financial Corporation (UNNF) executed an agreement pursuant to which DFSC and UNNF would merge, with DFSC as the surviving company in the merger. The merger is subject to a number of conditions, including the approval of various federal bank regulatory agencies. Under the agreement, Province Bank FSB, which DFSC owns, and Union National Community Bank, which UNNF owns, would also merge. The combined bank would have total assets of approximately \$600 million and would have 13 branch locations in Lancaster County, Pennsylvania. The companies expect to complete the mergers in the fourth quarter of

2010. Following the mergers, we expect to continue using the equity method of accounting for our investment in DFSC. Under the equity method, we record our investment at cost, with adjustments for our share of DFSC's earnings and losses as well as changes in DFSC's equity due to unrealized gains and losses.

In July 2010, we executed an agreement pursuant to which we will acquire all of the outstanding stock of Michigan Insurance Company (MICO), an 83.6%-owned subsidiary of West Bend Mutual Insurance Company (WBM). MICO writes various lines of property and casualty insurance exclusively in the State of Michigan. MICO had direct written premiums of \$106.6 million and net written premiums of \$26.7 million for the year ended December 31, 2009. The purchase price will be calculated based on the United States generally accepted accounting principles (GAAP) book value of MICO as of the closing date of the acquisition. We estimate that the purchase price payable to the shareholders of MICO will be approximately \$39 million. The acquisition is subject to a number of conditions, including the approval of the Insurance Department of the State of Michigan. We expect to complete the acquisition in the fourth quarter of 2010.

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 those interim periods. Our results of operations for the nine months ended September 30, 2010 are not necessarily indicative of the results of operations we expect for the year ending December 31, 2010.

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, 2009.

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 for the periods indicated a reconciliation of the numerators and denominators we used to compute basic and diluted net income per share for each class of common stock:

For the Three Months Ended September 30:

	2010		2009	
	Class A	Class B	Class A	Class B
	(in thousands, except per share data)			
Basic and diluted net income per share:				
Numerator:				
Allocation of net income	\$ 3,925	\$ 985	\$ 5,386	\$ 1,359
Denominator:				
Weighted-average shares outstanding	19,965,942	5,576,775	19,905,174	5,576,775
Basic and diluted net income per share	\$ 0.20	\$ 0.18	\$ 0.27	\$ 0.24

For the Nine Months Ended September 30:

2010

2009