

Edgar Filing: DONEGAL GROUP INC - Form 424B3

DONEGAL GROUP INC  
Form 424B3  
December 17, 2002

Filed pursuant to Rules 424(b)(3) and 424(c)  
Registration No. 333-63102

DONEGAL GROUP INC.

2001 AGENCY STOCK PURCHASE PLAN

PROSPECTUS SUPPLEMENT  
TO PROSPECTUS DATED APRIL 12, 2002

On November 14, 2002, Donegal Group Inc. (the "Company") filed with the Securities and Exchange Commission a Form 10-Q Quarterly Report for the quarter ended September 30, 2002, a copy of which, without exhibits, is attached to this Prospectus Supplement.

This Prospectus Supplement should be read in conjunction with the Company's Prospectus dated April 12, 2002.

The date of this Prospectus Supplement is December 11, 2002.

FORM 10-Q  
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, 2002

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

-----

(State or other jurisdiction of

23-2424711

-----

(I.R.S. Employer

## Edgar Filing: DONEGAL GROUP INC - Form 424B3

incorporation or organization)

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)

N/A

(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 x . No . .

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 6,152,298 shares of Class A Common Stock, \$0.01 par value and 2,983,314 shares of Class B Common Stock, \$0.01 par value, outstanding on October 31, 2002.

### Part 1. Financial Information

#### Item 1. Financial Statements.

#### Donegal Group Inc. and Subsidiaries Consolidated Balance Sheets

	September 30, 2002
	----- (Unaudited)
Assets	
-----	
Investments	
Fixed maturities	
Held to maturity, at amortized cost	\$ 84,760,364
Available for sale, at market value	191,793,062
Equity securities, available for sale, at market	18,376,095
Short-term investments, at cost, which approximates market	24,514,611
	-----
Total investments	319,444,132
Cash	6,655,691
Accrued investment income	3,492,481
Premiums receivable	27,317,441
Reinsurance receivable	73,303,791
Deferred policy acquisition costs	15,047,021
Federal income tax receivable	
Deferred federal income taxes	7,062,801

Edgar Filing: DONEGAL GROUP INC - Form 424B3

Prepaid reinsurance premiums	28,543,43
Property and equipment, net	4,521,55
Accounts receivable - securities	905,17
Due from affiliate	1,934,27
Other	542,55
Total assets	\$ 488,770,36

Liabilities and Stockholders' Equity

Liabilities

Losses and loss expenses	\$ 197,043,98
Unearned premiums	123,471,33
Accrued expenses	6,383,27
Reinsurance balances payable	1,068,78
Federal income taxes payable	594,40
Cash dividend declared to stockholders	
Borrowings under line of credit	19,800,00
Accounts payable - securities	3,341,79
Due to affiliate	4,441,31
Other	1,596,88

Total liabilities 357,741,77

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 6,216,161 and 6,097,214 shares and outstanding 6,134,637 and 6,015,690 shares	62,16
Class B common stock, \$.01 par value, authorized 10,000,000 shares, issued 3,023,076 and 3,021,965 shares and outstanding 2,982,314 and 2,981,203 shares	30,23
Additional paid-in capital	60,076,60
Accumulated other comprehensive income	5,178,48
Retained earnings	66,572,86
Treasury stock	891,74

Total stockholders' equity 131,028,59

Total liabilities and stockholders' equity \$ 488,770,36

See accompanying notes to consolidated financial statements.

DONEGAL GROUP INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME  
(Unaudited)

Edgar Filing: DONEGAL GROUP INC - Form 424B3

THREE MONTHS ENDED SEPTEMBER 30,

	2002	2001
	-----	-----
Revenues:		
-----		
Net premiums earned	\$ 46,792,748	\$ 42,598,703
Investment income, net of investment expenses	3,623,262	3,710,452
Net realized investment losses	(201,190)	(562,301)
Lease income	200,574	199,948
Service charge income	670,023	419,184
	-----	-----
Total revenues	51,085,417	46,365,986
	-----	-----
EXPENSES:		
Net losses and loss expenses	32,423,893	\$ 30,026,448
Amortization of deferred policy acquisition costs	7,365,000	6,997,000
Other underwriting expenses	6,511,832	6,944,584
Policy dividends	280,375	465,779
Interest	249,271	465,726
Other expenses	158,583	339,871
	-----	-----
Total expenses	46,988,954	45,239,408
	-----	-----
Income before income taxes	4,096,463	1,126,578
Income taxes	1,080,787	103,156
	-----	-----
Net income	\$ 3,015,676	\$ 1,023,422
	=====	=====
Earnings per common share		
Basic	\$ 0.33	\$ 0.11
	=====	=====
Diluted	\$ 0.33	\$ 0.11
	=====	=====

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(Unaudited)

THREE MONTHS ENDED SEPTEMBER 30,

	2002	2001
	-----	-----
Net income	\$3,015,676	\$1,023,422
Other comprehensive income, net of tax		
Unrealized gains on securities:		
Unrealized holding gain during the period, net of income tax	1,846,413	2,172,740
Reclassification adjustment, net of income tax	132,785	371,119
	-----	-----
Other comprehensive income	1,979,198	2,543,859
	-----	-----
Comprehensive income	\$4,994,874	\$3,567,281

=====

See accompanying notes to consolidated financial statements.

2

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

	Nine 2002 -----
<b>Revenues:</b>	
Net premiums earned	\$ 138,355,520
Investment income, net of investment expenses	11,063,848
Net realized investment losses	(13,931)
Lease income	589,660
Service charge income	1,861,169
Total revenues	151,856,266
<b>Expenses:</b>	
Net losses and loss expenses	95,857,481
Amortization of deferred policy acquisition costs	22,095,000
Other underwriting expenses	19,812,982
Policy dividends	851,741
Interest	870,079
Other expenses	872,160
Total expenses	140,359,443
Income before income taxes	11,496,823
Income taxes	3,121,597
Net income	\$ 8,375,226
<b>Earnings per common share</b>	
Basic	\$ 0.92
Diluted	\$ 0.91

Consolidated Statements of Comprehensive Income  
 (Unaudited)

	Nine 2002 -----
Net income	\$ 8,375,226
Other comprehensive income, net of tax	
Unrealized gains on securities:	
Unrealized holding gain during the period, net of income tax	2,307,524

Edgar Filing: DONEGAL GROUP INC - Form 424B3

Reclassification adjustment, net of income tax	9,194
Other comprehensive income	2,316,718
Comprehensive income	\$ 10,691,944

DONEGAL GROUP INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY  
(Unaudited)  
NINE MONTHS ENDED SEPTEMBER 30, 2002

	CLASS A SHARES	CLASS B SHARES	CLASS A AMOUNT	CLASS B AMOUNT	
	-----	-----	-----	-----	-----
Balance, December 31, 2001	6,097,214	3,021,965	\$ 60,972	\$ 30,220	\$ 5
Issuance of common stock	116,725		1,166		
Net income					
Cash dividends					
Grant of stock options					
Exercise of stock options	2,222	1,111	23	11	
Other comprehensive income	-----	-----	-----	-----	-----
Balance, September 30, 2002	6,216,161	3,023,076	\$ 62,161	\$ 30,231	\$ 6
	=====	=====	=====	=====	=====

	RETAINED EARNINGS	TREASURY STOCK	TOTAL STOCKHOLDERS' EQUITY
	-----	-----	-----
Balance, December 31, 2001	\$ 59,979,425	\$ (891,748)	\$ 120,928,349
Issuance of common stock			1,134,340
Net income	8,375,226		8,375,226
Cash dividends	(1,755,129)		(1,755,129)
Grant of stock options	(26,657)		--
Exercise of stock options			29,088

Edgar Filing: DONEGAL GROUP INC - Form 424B3

Other comprehensive income			2,316,718
	-----	-----	-----
Balance, September 30, 2002	\$ 66,572,865	\$ (891,748)	\$ 131,028,592
	=====	=====	=====

See accompanying notes to consolidated financial statements.

3

DONEGAL GROUP INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

	NINE MONTHS ENDED SEPTEMBER 30,	
	2002	2001
	-----	----
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 8,375,226	\$ 6,675,286
	-----	-----
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	898,350	839,380
Realized investment loss	13,931	448,462
Changes in assets and liabilities:		
Losses and loss expenses	17,204,081	15,139,625
Unearned premiums	9,392,067	17,250,969
Premiums receivable	(3,173,917)	(7,103,343)
Deferred policy acquisition costs	(1,442,805)	(1,555,147)
Deferred income taxes	(781,528)	(569,391)
Reinsurance receivable	(5,450,622)	(9,656,435)
Prepaid reinsurance premiums	1,050,029	(6,712,215)
Accrued investment income	272,591	311,166
Due to affiliate	(1,508,039)	(260,353)
Reinsurance balances payable	229,633	(360,339)
Current income taxes	887,019	353,445
Other, net	(444,894)	(116,544)
	-----	-----
Net adjustments	17,145,896	8,009,280
	-----	-----
Net cash provided by operating activities	25,521,122	14,684,566
	-----	-----
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of fixed maturities		
Held to maturity	(28,117,044)	(36,895,097)
Available for sale	(50,953,675)	(53,380,298)
Purchase of equity securities, available for sale	(11,251,602)	(10,046,952)
Maturity of fixed maturities		
Held to maturity	28,917,827	40,209,398
Available for sale	38,528,033	36,307,020
Sale of fixed maturities		
Held to maturity	415,000	--
Available for sale	461,965	12,275,464

## Edgar Filing: DONEGAL GROUP INC - Form 424B3

Sale of equity securities, available for sale	9,243,147	5,770,980
Net purchase of property and equipment	(482,379)	(140,233)
Net sale (purchase) of short-term investments	(440,410)	2,630,069
	-----	-----
Net cash used in investing activities	(13,679,138)	(3,269,649)
	-----	-----
 CASH FLOWS FROM FINANCING ACTIVITIES:		
Cash dividends paid	(2,625,006)	(2,526,762)
Issuance of common stock	1,163,428	1,157,497
Line of credit, net	(7,800,000)	(11,800,000)
	-----	-----
Net cash used in financing activities	(9,261,578)	(13,169,265)
	-----	-----
 Net increase (decrease) in cash	 2,580,406	 (1,754,348)
Cash at beginning of period	4,075,288	5,182,988
	-----	-----
Cash at end of period	\$ 6,655,694	\$ 3,428,640
	=====	=====
 Cash paid during period - Interest	 \$ 584,185	 \$ 2,426,292
Net cash paid during period - Taxes	\$ 3,390,000	\$ 2,325,000

See accompanying notes to consolidated financial statements.

4

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

1. ORGANIZATION

Donegal Group Inc. (the "Company") was organized as a regional insurance holding company by Donegal Mutual Insurance Company (the "Mutual Company") on August 26, 1986 and operates in the Mid-Atlantic and Southern states through its wholly owned insurance subsidiaries, Atlantic States Insurance Company ("Atlantic States") and Southern Insurance Company of Virginia ("Southern") (collectively, the "Insurance Subsidiaries"). The Company has three operating segments: the investment function, the personal lines of insurance and the commercial lines of insurance. Products offered in the personal lines of insurance consist primarily of homeowners and private passenger automobile policies. Products offered in the commercial lines of insurance consist primarily of commercial automobile, commercial multiple peril and workers' compensation policies. The Insurance Subsidiaries are subject to regulation by Insurance Departments in those states in which they operate and undergo periodic examinations by those departments. The Insurance Subsidiaries are also subject to competition from other insurance companies in their operating areas. Atlantic States participates in an inter-company pooling arrangement with the Mutual Company and assumes 70% of the pooled business. At September 30, 2002, the Mutual Company held 63% of the outstanding Class A and Class B common stock of the Company.

Prior to 2002, Southern ceded 50% of its business to the Mutual Company. On January 1, 2002, the Mutual Company and Southern terminated their quota share agreement, under which Southern ceded 50% of its direct business, less



## Edgar Filing: DONEGAL GROUP INC - Form 424B3

reinsurance, to the Mutual Company. As a result of this termination, the Company's prepaid reinsurance premiums decreased \$7,310,471, unearned premiums decreased \$5,117,330, and deferred policy acquisition costs increased \$714,853. The Mutual Company transferred \$1,478,288 in cash to the Company related to this termination. The Company did not recognize a gain or loss on this transaction.

During 2000, the Company acquired 45% of the outstanding stock of Donegal Financial Services Corporation ("DFSC"), a bank holding company, for \$3,042,000 in cash. The remaining 55% of the outstanding stock of DFSC is owned by the Mutual Company.

The Company has streamlined its corporate structure by merging a number of its subsidiaries. Delaware Atlantic Insurance Company ("Delaware"), Pioneer Insurance Company, New York, ("Pioneer-New York") and Pioneer Insurance Company, Ohio ("Pioneer-Ohio"), previously wholly owned subsidiaries, were merged into Atlantic States on August 1, 2001, September 30, 2001 and May 8, 2002, respectively. Southern Heritage Insurance Company ("Southern Heritage"), previously a wholly owned subsidiary, was merged into Southern on April 30, 2002. The mergers were accounted for as a reorganization of entities under common control as they were all within the consolidated group. The mergers had no financial impact on the consolidated entity.

Southern has (and Delaware, Pioneer-Ohio, Southern Heritage and Pioneer-New York had prior to their mergers) an agreement with the Mutual Company under which it cedes, and then reassumes back, 100% of its business net of reinsurance. The primary purpose of these agreements is to assist these subsidiaries in maintaining the same A. M. Best rating (currently "A") as the Mutual Company. These agreements do not transfer insurance risk. While these subsidiaries ceded and reassumed amounts received from policyholders of \$36,796,527 and \$31,932,359 and claims of \$23,320,493 and \$18,050,106 under these agreements in the nine months ended September 30, 2002 and 2001, respectively, the amounts are not reflected in the consolidated financial statements. The aggregate liabilities ceded and reassumed under these agreements were \$43,325,319 and \$44,321,246 at September 30, 2002 and December 31, 2001, respectively.

### 2. BASIS OF PRESENTATION

The financial information for the interim periods included herein are unaudited; however, such information reflects all adjustments, consisting only of normal recurring adjustments, that, in the opinion of management, are necessary to a fair presentation of the Company's financial position, results of operations and cash flow for the interim periods included herein. The Company's results of operations for the nine months ended September 30, 2002, are not necessarily indicative of its results of operations for the twelve months ending December 31, 2002.

5

These financial statements should be read in conjunction with the financial statements and notes thereto contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2001.

### 3. Earnings Per Share

The computation of basic and diluted earnings per share is as follows:

Edgar Filing: DONEGAL GROUP INC - Form 424B3

	Net Income -----	Weighted Average Shares Outstanding -----	Ea
Three Months Ended September 30:			
2002			
Basic	\$3,015,676	9,098,935	
Effect of stock options	---	98,998	
	-----	-----	
Diluted	\$3,015,676	9,197,933	
	=====	=====	
2001			
Basic	\$1,023,422	8,963,207	
Effect of stock options	---	172,497	
	-----	-----	
Diluted	\$1,023,422	9,135,704	
	=====	=====	
Nine Months Ended September 30:			
2002			
Basic	\$8,375,226	9,063,109	
Effect of stock options	---	103,205	
	-----	-----	
Diluted	\$8,375,226	9,166,314	
	=====	=====	
2001			
Basic	\$6,675,286	8,927,446	
Effect of stock options	---	1 46,295	
	-----	-----	
Diluted	\$6,675,286	9,073,741	
	=====	=====	

The following options to purchase shares of common stock were not included 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:

	For The Three Months Ended September 30, -----		For The Ended S -----
	2002 ----	2001 ----	2002 ----
Number of Options	941,501	1,042,338	941,501

=====

=====

=====

4. Segment Information

The Company evaluates the performance of the personal lines and commercial lines based upon underwriting results as determined under statutory accounting practices (SAP), which is used by management to measure performance for the total business of the Company. Financial data by segment is as follows:

	Three Months Ended September 2002 ----	Ended September 2001 ----
	(\$ in thousands)	
Revenues:		
Premiums earned:		
Commercial lines	\$ 16,473	\$ 16,473
Personal lines	30,319	26,319
	-----	-----
Total net premiums earned	46,792	42,792
	-----	-----
Net investment income	3,623	3,623
Realized investment loss	(201)	(566)
Other	871	871
	-----	-----
Total revenues	\$ 51,085	\$ 46,792
	=====	=====
Income before income taxes:		
Underwriting income (loss)		
Commercial lines	\$ 1,944	\$ (1,116)
Personal lines	(1,116)	2,316
	-----	-----
SAP underwriting income (loss)	828	(2,516)
GAAP adjustments	(616)	(616)
	-----	-----
GAAP underwriting income (loss)	212	(1,832)
Net investment income	3,623	3,623
Realized investment loss	(201)	(566)
Other	463	(1,116)
	-----	-----
Income before income taxes	\$ 4,097	\$ 1,116
	=====	=====

Nine Months Ended September  
2002  
-----

Edgar Filing: DONEGAL GROUP INC - Form 424B3

(\$ in thousands)

Revenues:		
Premiums earned:		
Commercial lines	\$ 49,245	\$ 46,
Personal lines	89,110	77,
	-----	-----
Total net premiums earned	138,355	124,
	-----	-----
Net investment income	11,064	1,
Realized investment loss	(14)	(4)
Other	2,451	1,
	-----	-----
Total revenues	\$ 151,856	\$ 137,
	=====	=====
Income before income taxes:		
Underwriting income (loss)		
Commercial lines	\$ 4,548	\$ (5,
Personal lines	(5,289)	(2,3
	-----	-----
SAP underwriting loss	(741)	(2,8
GAAP adjustments	479	1,
	-----	-----
GAAP underwriting loss	(262)	(1,3
Net investment income	11,064	11,
Realized investment loss	(14)	(4)
Other	709	(1,4
	-----	-----
Income before income taxes	\$ 11,497	\$ 8,
	=====	=====

5. Investments

During the first quarter of 2002, the Company sold Halliburton Company bonds that had been classified as held to maturity due to significant deterioration in the issuer's credit worthiness. These bonds had an amortized cost of \$488,901, and the sale resulted in a realized loss of \$73,901. There were no other sales or transfers from the held to maturity portfolio.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RESULTS OF OPERATIONS -THREE MONTHS ENDED SEPTEMBER 30, 2002 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2001

Total revenues for the three months ended September 30, 2002 were \$51,085,417, which were \$4,719,431, or 10.2%, greater than the same period in 2001. Net premiums earned increased to \$46,792,748, an increase of \$4,194,045, or 9.8%, over the third quarter of 2001. Direct premiums written of the combined pool of Atlantic States and the Mutual Company increased \$3,466,860, or 6.4%, with Southern posting an increase of 0.4% in direct premiums written. The Company reported a net realized investment loss of \$201,190 in the third quarter of 2002, compared to a loss of \$562,301 for the same period of 2001. The realized loss in 2002 included realized losses of \$226,244 which resulted from

## Edgar Filing: DONEGAL GROUP INC - Form 424B3

changes in the market value of securities that were determined to be other than temporary. The realized loss in 2001 included realized losses of \$604,235 which resulted from changes in the market value of securities that were determined to be other than temporary. Investment income was \$3,623,262, a decrease of \$87,190, or 2.3%, from the third quarter of 2001. An increase in average invested assets from \$290.5 million in the third quarter of 2001 to \$312.3 million in the third quarter of 2002 was more than offset by a decrease in the annualized average return on investments from 5.1% in the third quarter of 2001 to 4.7% in the third quarter of 2002 accounting for the decrease in investment income.

The GAAP combined ratio of insurance operations in the third quarter of 2002 was 99.5% compared to 104.3% for the same period in 2001. The GAAP combined ratio is the sum of the ratios of incurred losses and loss adjusting expenses to premiums earned (loss ratio), policyholders' dividends to premiums earned (dividend ratio) and underwriting expenses to premiums earned (expense ratio). The Company's loss ratio in the third quarter of 2002 was 69.3% compared to 70.5% in the third quarter of 2001. The Company's expense ratio for the third quarter of 2002 was 29.6% compared to 32.7% for the third quarter of 2001. The dividend ratio decreased to 0.6% for the third quarter of 2002 compared to 1.1% in the third quarter of 2001 because of more stringent qualification standards.

Federal income taxes for the third quarter of 2002 represented 26.4% of income before income taxes compared to 9.2% for the same period of 2001. The increase in the effective tax rate was due to the poor underwriting results during the third quarter of 2001 which resulted in tax-exempt investment income representing a much larger percentage of net income than in the third quarter of 2002. These rates varied from the expected rate of 34% primarily due to the effect of tax-exempt investment income.

### RESULTS OF OPERATIONS -NINE MONTHS ENDED SEPTEMBER 30, 2002 COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2001

Total revenues for the nine months ended September 30, 2002 were \$151,856,266, which were \$14,201,285, or 10.3%, greater than the same period in 2001. Net premiums earned increased to \$138,355,520, an increase of \$14,063,925, or 11.3%, over the first nine months of 2001. Direct premiums written of the combined pool of Atlantic States and the Mutual Company increased \$17,473,905, or 11.2%. This increase was tempered somewhat by a 3.5% increase in the direct premiums written of Southern. The Company reported a net realized investment loss of \$13,931 in the first nine months of 2002 compared to a loss of \$448,462 for the same period of 2001. The realized loss in 2002 included realized losses of \$358,574 which resulted from changes in the market value of securities that were determined to be other than temporary. The realized loss in 2001 included realized losses of \$1,067,970 which resulted from changes in the market value of securities that were determined to be other than temporary. Investment income for the third quarter of 2002 was \$11,063,848, a decrease of \$924,499, or 7.7%, from the first nine months of 2001. An increase in average invested assets from \$296.9 million in the first nine months of 2001 to \$310.0 million in the first nine months of 2002 was more than offset by a decrease in the annualized average return on investments from 5.3% in the first nine months of 2001 to 4.8% in the first nine months of 2002 accounting for the decrease in investment income.

The GAAP combined ratio of insurance operations in the first nine months of 2002 was 100.2% compared to 101.1% for the same period in 2001. The GAAP combined ratio is the sum of the ratios of incurred losses and loss adjusting expenses to premiums earned (loss ratio), policyholders' dividends to premiums earned (dividend ratio) and underwriting expenses to premiums earned (expense ratio). The Company's loss ratio in the first nine months of 2002 was 69.3% compared to 67.7% in the first nine months of 2001. The increase in loss ratio was due to higher losses in personal lines during the first quarter of 2002 and storm related losses of \$1.1 million in the second quarter of 2002 that were

## Edgar Filing: DONEGAL GROUP INC - Form 424B3

somewhat offset by a lower loss ratio in commercial lines during the third quarter. The Company's expense ratio for the first nine months of 2002 was 30.3%, compared to 32.4% for the first nine months of 2001. The dividend ratio decreased to 0.6% for the first three quarters of 2002 from 1.0% in the first three quarters of 2001.

9

Federal income taxes for the first nine months of 2002 represented 27.2% of income before income taxes compared to 23.9% for the same period of 2001. These rates varied from the expected rate of 34% primarily due to the effect of tax-exempt investment income.

### LIQUIDITY AND CAPITAL RESOURCES

The Company generates sufficient funds from its operations and maintains a high degree of liquidity in its investment portfolio. The primary source of funds to meet the demands of claim settlements and operating expenses are premium collections, investment income and maturing investments. The Company had no significant commitments for capital expenditures as of September 30, 2002.

In investing funds made available from operations, the Company maintains securities maturities consistent with its projected cash needs for the payment of claims and expenses. The Company maintains a portion of its investment portfolio in relatively short-term and highly liquid assets to ensure the availability of funds.

As of September 30, 2002, under a credit agreement dated December 29, 1995, and amended as of July 27, 1998, with Fleet National Bank of Connecticut ("the Bank"), the Company had unsecured borrowings of \$19.8 million. Per the terms of the credit agreement, the Company may borrow up to \$24 million at interest rates equal to the Bank's then current prime rate or the then current London interbank eurodollar bank rate plus 1.70%. At September 30, 2002, the interest rate on the outstanding balances was 3.55% on outstanding eurodollar balances of \$19.8 million. In addition, the Company pays a non-use fee at a rate of 3/10 of 1% per annum on the average daily unused portion of the Bank's commitment. Each July 27th the credit line is reduced by \$8 million and is currently \$24 million. Any outstanding loan in excess of the remaining credit line, after such reduction, will then be payable.

The Company's principal source of cash with which to pay stockholder dividends is dividends from Atlantic States and Southern. Atlantic States and Southern are required by law to maintain certain minimum surplus on a statutory basis, and are subject to regulations under which payment of dividends from statutory surplus is restricted and may require prior approval of their domiciliary insurance regulatory authorities. Atlantic States and Southern are subject to Risk-Based Capital (RBC) requirements. At December 31, 2001, each Atlantic States' and Southern's capital was substantially above the RBC requirements. In 2002, amounts available for distribution as dividends to the Company without prior approval of their domiciliary insurance regulatory authorities were \$9,164,937 from Atlantic States and \$4,600,835 from Southern.

### CREDIT RISK

The Company provides property and liability insurance coverages through the independent agency systems located throughout its operating area. The majority of this business is billed directly to the insured, although a portion of the Company's commercial business is billed through its agents who are

## Edgar Filing: DONEGAL GROUP INC - Form 424B3

extended credit in the normal course of business.

The Company's subsidiaries have reinsurance agreements in place with the Mutual Company and with a number of other major unaffiliated authorized reinsurers.

### IMPACT OF INFLATION

Property and casualty insurance premium rates are established before the amount of losses and loss settlement expenses, or the extent to which inflation may impact such expenses, are known. Consequently, the Company attempts, in establishing rates, to anticipate the potential impact of inflation.

### RECENT ACCOUNTING PRONOUNCEMENTS

In June 2002, the Financial Accounting Standards Board issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." SFAS No. 146 addresses the timing and amount of costs recognized as a result of restructuring and similar activities. The Company will apply SFAS No. 146 to activities initiated after December 31, 2002. The adoption of SFAS No. 146 is not expected to have a material impact on the Company's consolidated statements of income or balance sheet.

10

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company's market risk generally represents the risk of gain or loss that may result from the potential change in the fair value of the Company's investment portfolio as a result of fluctuations in prices and interest rates and, to a lesser extent, its debt obligations. The Company attempts to manage its interest rate risk by maintaining an appropriate relationship between the average duration of the investment portfolio and the approximate duration of its liabilities, i.e., policy claims and debt obligations.

The Company has maintained approximately the same duration of its investment portfolio to its liabilities from December 31, 2001 to September 30, 2002. In addition, the Company has maintained approximately the same investment mix during this period.

There have been no material changes to the Company's quantitative or qualitative market risk exposure from December 31, 2001 through September 30, 2002.

11

### Item 4. Control and Procedures

Within 90 days prior to the date of filing of this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including its Chief Executive Officer and its Chief Financial Officer, of the design and operation of the Company's disclosure controls and procedures. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective for gathering, analyzing and disclosing

## Edgar Filing: DONEGAL GROUP INC - Form 424B3

the information the Company is required to disclose in the reports it files under the Securities Exchange Act of 1934, within the time periods specified in the SEC's rules and forms. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to the date of this evaluation.

12

### Part II. Other Information

Item 1. Legal Proceedings.

None.

Item 2. Changes in Securities and Use of Proceeds.

None.

Item 3. Defaults upon Senior Securities.

None.

Item 4. Submission of Matters to a Vote of Security Holders.

None.

Item 5. Other Information.

None.

Item 6. Exhibits and Reports on Form 8-K.

(a) Exhibits

Exhibit No.	Description
Exhibit 99.1	Statement of Chief Executive Officer pursuant to 18 U.S.C. Section 1350 of Title 18 of the United States Code
Exhibit 99.2	Statement of Chief Financial Officer pursuant to 18 U.S.C. Section 1350 of Title 18 of the United States Code

(b) Reports on Form 8-K:

None.

13



Edgar Filing: DONEGAL GROUP INC - Form 424B3

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

DONEGAL GROUP INC.

November , 2002

By: \_\_\_\_\_  
Donald H. Nikolaus, President  
and Chief Executive Officer

November , 2002

By: \_\_\_\_\_  
Ralph G. Spontak, Senior Vice President,  
Chief Financial Officer and Secretary

14

CERTIFICATION

I, Donald H. Nikolaus, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Donegal Group, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

- (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly

Edgar Filing: DONEGAL GROUP INC - Form 424B3

report is being prepared;

- (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
- (c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

- (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
- (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November , 2002

-----  
Donald H. Nikolaus  
President and Chief Executive Officer

15

CERTIFICATION

I, Ralph G. Spontak, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Donegal Group, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

Edgar Filing: DONEGAL GROUP INC - Form 424B3

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

- (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
- (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
- (c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date; and

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

- (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
- (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November , 2002

-----  
Ralph G. Spontak  
Senior Vice President and  
Chief Financial Officer

