

Edgar Filing: DONEGAL GROUP INC - Form 424B3

DONEGAL GROUP INC  
Form 424B3  
August 30, 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 JUNE 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  
incorporation or organization)

23-2424711  
-----

(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)

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: 6,097,805 shares of Class A  
Common Stock, \$0.01 par value and 2,982,314 shares of Class B Common Stock,  
\$0.01 par value, outstanding on July 31, 2002.

# Edgar Filing: DONEGAL GROUP INC - Form 424B3

## Part 1. Financial Information

### Item 1. Financial Statements.

#### DONEGAL GROUP INC. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS

	JUNE 30, 2002	DEC. 31,
	-----	-----
	(Unaudited)	
<b>ASSETS</b>		
-----		
Investments		
Fixed maturities		
Held to maturity, at amortized cost	\$ 79,078,178	\$ 85,32
Available for sale, at market value	182,294,132	173,71
Equity securities, available for sale, at market	19,929,888	17,51
Short-term investments, at cost, which approximates market	23,906,574	24,07
	-----	-----
Total investments	305,208,772	300,63
Cash	1,882,099	4,07
Accrued investment income	3,785,202	3,76
Premiums receivable	28,009,278	24,14
Reinsurance receivable	69,787,883	67,85
Deferred policy acquisition costs	14,930,615	13,60
Federal income tax receivable	--	29
Deferred federal income taxes	7,668,154	7,47
Prepaid reinsurance premiums	27,017,495	29,59
Property and equipment, net	4,657,313	4,56
Accounts receivable - securities	--	5
Due from affiliate	4,572,795	
Other	551,461	57
	-----	-----
Total assets	\$ 468,071,067	\$ 456,63
	=====	=====
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
-----		
<b>LIABILITIES</b>		
Losses and loss expenses	\$ 188,044,921	\$ 179,83
Unearned premiums	119,907,984	114,07
Accrued expenses	5,836,547	7,18
Reinsurance balances payable	1,073,569	83
Federal income taxes payable	465,436	
Cash dividend declared to stockholders	--	86
Borrowings under line of credit	19,800,000	27,60
Accounts payable - securities	255,500	
Due to affiliate	4,441,311	4,01
Other	1,795,819	1,27
	-----	-----
Total liabilities	341,621,087	335,70
	-----	-----

Edgar Filing: DONEGAL GROUP INC - Form 424B3

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 6,168,809 and 6,097,214 shares and outstanding 6,087,285 and 6,015,690 shares	61,688	6
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	30,231	3
Additional paid-in capital	59,615,073	58,88
Accumulated other comprehensive income	3,199,285	2,86
Retained earnings	64,435,451	59,97
Treasury stock	(891,748)	(89
	-----	-----
Total stockholders' equity	126,449,980	120,92
	-----	-----
Total liabilities and stockholders' equity	\$ 468,071,067	\$ 456,63
	=====	=====

See accompanying notes to consolidated financial statements.

1

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

	SIX MONTHS ENDED JUNE 30,	
	2002	2001
	----	----
REVENUES:		
Net premiums earned	\$ 91,562,772	\$ 81,692,892
Investment income, net of investment expenses	7,440,586	8,277,895
Realized gain	187,259	113,839
Lease income	389,086	399,616
Service charge income	1,191,146	804,753
	-----	-----
Total revenues	100,770,849	91,288,995
	-----	-----
EXPENSES:		
Net losses and loss expenses	63,433,588	54,089,873
Amortization of deferred policy acquisition costs	14,730,000	13,171,000
Other underwriting expenses	13,301,150	13,199,417
Policy dividends	571,366	716,702
Interest	620,808	1,392,001
Other expenses	713,577	1,077,715
	-----	-----
Total expenses	93,370,489	83,646,708

Edgar Filing: DONEGAL GROUP INC - Form 424B3

	-----	-----
Income before income taxes	7,400,360	7,642,287
Income taxes	2,040,810	1,990,423
	-----	-----
Net income	\$ 5,359,550	\$ 5,651,864
	=====	=====
Earnings per common share		
Basic	\$ 0.59	\$ 0.63
	=====	=====
Diluted	\$ 0.59	\$ 0.63
	=====	=====

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(Unaudited)

	SIX MONTHS ENDED JUNE 30,	
	2002	2001
	----	----
Net income	\$ 5,359,550	\$ 5,651,864
Other comprehensive income, net of tax		
Unrealized gains on securities:		
Unrealized holding gain during the period, net of income tax	461,111	1,371,342
Reclassification adjustment, net of income tax	(123,591)	(75,134)
	-----	-----
Other comprehensive income	337,520	1,296,208
	-----	-----
Comprehensive income	\$ 5,697,070	\$ 6,948,072
	=====	=====

See accompanying notes to consolidated financial statements.

2

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

	THREE MONTHS ENDED JUNE 30,	
	2002	2001
	-----	-----

Edgar Filing: DONEGAL GROUP INC - Form 424B3

	-----	-----
REVENUES:		
Net premiums earned	\$ 46,110,512	\$ 41,651,990
Investment income, net of investment expenses	3,710,282	4,236,709
Realized gain (loss)	60,481	(6,968)
Lease income	194,124	198,925
Service charge income	661,404	416,313
	-----	-----
Total revenues	50,736,803	46,496,969
	-----	-----
EXPENSES:		
Net losses and loss expenses	32,136,019	27,931,189
Amortization of deferred policy acquisition costs	7,345,000	6,668,000
Other underwriting expenses	6,188,900	6,694,388
Policy dividends	105,187	317,322
Interest	295,984	579,387
Other expenses	211,154	682,378
	-----	-----
Total expenses	46,282,244	42,872,664
	-----	-----
Income before income taxes	4,454,559	3,624,305
Income taxes	1,275,725	927,036
	-----	-----
Net income	\$ 3,178,834	\$ 2,697,269
	=====	=====
Earnings per common share		
Basic	\$ 0.35	\$ 0.30
	=====	=====
Diluted	\$ 0.35	\$ 0.30
	=====	=====

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(Unaudited)

	THREE MONTHS ENDED JUNE 30,	
	-----	-----
	2002	2001
	----	----
Net income	\$ 3,178,834	\$ 2,697,269
Other comprehensive income (loss), net of tax		
Unrealized gains (losses) on securities:		
Unrealized holding gain (loss)		
during the period, net of income tax	1,704,527	(543,813)
Reclassification adjustment, net		
of income tax	(39,918)	4,599
	-----	-----
Other comprehensive income (loss)	1,664,609	(539,214)
	-----	-----
Comprehensive income	\$ 4,843,443	\$ 2,158,055
	=====	=====

Edgar Filing: DONEGAL GROUP INC - Form 424B3

See accompanying notes to consolidated financial statements.

3

DONEGAL GROUP INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY  
(Unaudited)  
FOR THE SIX MONTHS ENDED JUNE 30, 2002

	Class A Shares -----	Class B Shares -----	Class A Amount -----	Class B Amount -----	Additional Paid-In Capital -----	Accumulated Other Comprehensive Income -----	Retained Earnings -----
Balance, December 31, 2001	6,097,214	3,021,965	\$ 60,972	\$ 30,220	\$ 58,887,715	\$ 2,861,765	\$ 59,979,4
Issuance of common stock	69,373		693		671,647		
Net income							5,359,5
Cash dividends							(876,8
Grant of stock options					26,657		(26,6
Exercise of stock options	2,222	1,111	23	11	29,054		
Other comprehensive income						337,520	
Balance, June 30, 2002	6,168,809	3,023,076	\$ 61,688	\$ 30,231	\$ 59,615,073	\$ 3,199,285	\$ 64,435,4

See accompanying notes to consolidated financial statements.

4

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

Edgar Filing: DONEGAL GROUP INC - Form 424B3

	SIX MONTHS ENDED JUNE 30,	
	2002	2001
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 5,359,550	\$ 5,651,864
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	584,401	564,508
Realized investment gain	(187,259)	(113,839)
Changes in assets and liabilities:		
Losses and loss expenses	8,205,016	5,004,810
Unearned premiums	5,828,720	9,375,528
Premiums receivable	(3,865,747)	(5,594,205)
Deferred policy acquisition costs	(1,326,400)	(844,910)
Deferred income taxes	(367,290)	(297,391)
Reinsurance receivable	(1,934,709)	(2,917,784)
Prepaid reinsurance premiums	2,575,972	(2,939,417)
Accrued investment income	(20,126)	2,397
Due to affiliate	(4,146,558)	(921,430)
Reinsurance balances payable	234,413	(595,270)
Current income taxes	758,054	457,921
Other, net	(801,600)	(1,037,432)
Net adjustments	5,536,887	143,486
Net cash provided by operating activities	10,896,437	5,795,350
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of fixed maturities		
Held to maturity	(12,342,915)	(13,659,750)
Available for sale	(30,890,279)	(25,623,643)
Purchase of equity securities, available for sale	(4,322,178)	(6,742,189)
Maturity of fixed maturities		
Held to maturity	18,076,142	16,304,164
Available for sale	22,759,398	22,506,453
Sale of fixed maturities		
Held to maturity	415,000	--
Available for sale	461,965	4,271,591
Sale of equity securities, available for sale	1,886,265	5,180,419
Net purchase of property and equipment	(455,334)	(79,785)
Net sales of short-term investments	167,626	3,953,502
Net cash provided by (used in) investing activities	(4,244,310)	6,110,762
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Cash dividends paid	(1,746,744)	(1,661,212)
Issuance of common stock	701,428	801,652
Line of credit, net	(7,800,000)	(11,800,000)
Net cash used in financing activities	(8,845,316)	(12,659,560)
Net decrease in cash	(2,193,189)	(753,448)
Cash at beginning of period	4,075,288	5,182,988

Edgar Filing: DONEGAL GROUP INC - Form 424B3

Cash at end of period	\$ 1,882,099 =====	\$ 4,429,540 =====
Cash paid during period - Interest	\$ 97,093	\$ 2,045,457
Net cash paid during period - Taxes	\$ 1,640,000	\$ 1,825,000

See accompanying notes to consolidated financial statements.

5

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 stock insurance companies, 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. Prior to 2002, Southern ceded 50% of its business to the Mutual Company. At June 30, 2002, the Mutual Company held 63% of the outstanding Class A and Class B common stock of the 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 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 together. 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),



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

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 (and Delaware, Pioneer-Ohio, Southern Heritage and Pioneer-New York prior to their mergers) has 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 provide the Subsidiaries with the same A. M. Best rating (currently "A") as the Mutual Company, which they could not achieve without these agreements in place. These agreements do not transfer insurance risk. While the Subsidiaries ceded and reassumed amounts received from policyholders of \$25,183,072 and \$21,863,707 and claims of \$15,270,392 and \$11,863,674 under these agreements in the six months ended June 30, 2002 and 2001, respectively, the amounts are not reflected in the consolidated financial statements. The aggregate liabilities ceded and reassumed under this agreement were \$40,428,819 and \$44,321,246 at June 30, 2002 and December 31, 2001, respectively.

### 2 - BASIS OF PRESENTATION

The financial information for the interim period included herein is 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 period included herein. The Company's results of operations for the six months ended June 30, 2002, are not necessarily indicative of its results of operations for the twelve months ending December 31, 2002.

6

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:

	NET INCOME -----	WEIGHTED AVERAGE SHARES OUTSTANDING -----	EARNINGS PER SHARE -----
THREE MONTHS ENDED JUNE 30:			
2002			
-----			
Basic	\$3,178,834	9,059,477	\$ .35
Effect of stock options	--	116,252	--
	-----	-----	-----
Diluted	\$3,178,834	9,175,729	\$ .35
	=====	=====	=====
2001			
-----			
Basic	\$2,697,269	8,928,017	\$ .30

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

Effect of stock options	--	167,955	--
	-----	-----	-----
Diluted	\$2,697,269	9,095,972	\$ .30
	=====	=====	=====

SIX MONTHS ENDED JUNE 30:

2002

-----

Basic	\$5,359,550	9,044,899	\$ .59
Effect of stock options	--	105,309	--
	-----	-----	-----
Diluted	\$5,359,550	9,150,208	\$ .59
	=====	=====	=====

2001

-----

Basic	\$5,651,864	8,909,270	\$ .63
Effect of stock options	--	133,194	--
	-----	-----	-----
Diluted	\$5,651,864	9,042,464	\$ .63
	=====	=====	=====

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:

	FOR THE THREE MONTHS		FOR THE SIX MONTHS	
	ENDED JUNE 30,		ENDED JUNE 30,	
	2002	2001	2002	2001
	-----	-----	-----	-----
	----	----	----	----
Number of Options	941,501	1,042,338	941,501	1,042,338
	=====	=====	=====	=====

7

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 JUNE 30,	
	2002	2001
	-----	-----
	-----	-----
	-----	-----
	-----	-----
	-----	-----
	-----	-----
	-----	-----
	-----	-----
Revenues:		
Premiums earned:		
Commercial lines	\$16,278	\$15,574
Personal lines	29,833	26,078

Edgar Filing: DONEGAL GROUP INC - Form 424B3

Total net premiums earned	46,111	41,652
Net investment income	3,710	4,237
Realized investment gain (loss)	60	(7)
Other	856	615
Total revenues	\$50,737	\$46,497
Income before income taxes:		
Underwriting income (loss)		
Commercial lines	\$ 1,475	\$ (760)
Personal lines	(1,656)	(109)
SAP underwriting loss	(181)	(869)
GAAP adjustments	517	910
GAAP underwriting income	336	41
Net investment income	3,710	4,237
Realized investment gain (loss)	60	(7)
Other	349	(647)
Income before income taxes	\$ 4,455	\$ 3,624

SIX MONTHS ENDED JUNE 30,

2002                      2001

(\$ in thousands)

Revenues:		
Premiums earned:		
Commercial lines	\$ 32,772	\$30,583
Personal lines	58,791	51,110
Total net premiums earned	91,563	81,693
Net investment income	7,441	8,278
Realized investment gain	187	114
Other	1,580	1,204
Total revenues	\$100,771	\$91,289
Income before income taxes:		
Underwriting income (loss)		
Commercial lines	\$ 2,604	\$ (430)
Personal lines	(4,173)	51
SAP underwriting loss	(1,569)	(379)
GAAP adjustments	1,095	895
GAAP underwriting income (loss)	(474)	516
Net investment income	7,441	8,278
Realized investment gain	187	114
Other	246	(1,266)
Income before income taxes	\$ 7,400	\$ 7,642

## 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 JUNE 30, 2002 COMPARED TO  
THREE MONTHS ENDED JUNE 30, 2001  
-----

Total revenues for the three months ended June 30, 2002 were \$50,736,803, which were \$4,239,834, or 9.1%, greater than the same period in 2001. Net premiums earned increased to \$46,110,512, an increase of \$4,458,522, or 10.7%, over the second quarter of 2001. Direct premiums written of the combined pool of Atlantic States and Donegal Mutual increased \$6,666,644, or 12.1%, with Southern posting an increase of 0.9% in direct premiums written. The Company reported net realized investment gains of \$60,481 in the second quarter of 2002 compared to a loss of \$6,968 for the same period of 2001. The realized gain in 2002 was net of realized losses of \$92,440 which resulted from changes in the market value of securities that were determined to be other than temporary. The realized gain in 2001 was net of realized losses of \$463,735 which resulted from changes in the market value of securities that were determined to be other than temporary. Investment income was \$3,710,282, a decrease of \$526,427, or 12.4%, from the second quarter of 2001. An increase in average invested assets from \$281.9 million in the second quarter of 2001 to \$306.3 million in the second quarter of 2002 was more than offset by a decrease in the annualized average return on investments from 6.0% in the second quarter of 2001 to 4.8% in the second quarter of 2002 accounting for the decrease in investment income.

The GAAP combined ratio of insurance operations in the second quarter of 2002 was 99.3% compared to 99.9% 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 second quarter of 2002 was 69.7% compared to 67.1% in the second quarter of 2001. The increase in loss ratio was due to losses related to storm activity that totaled \$1.1 million in the quarter. The Company's expense ratio for the second quarter of 2002 was 29.4% compared to 32.1% for the second quarter of 2001. The dividend ratio decreased to 0.2% compared to 0.8% in the second quarter of 2001 because of more stringent qualification standards.

Federal income taxes for the second quarter of 2002 represented 28.6% of income before income taxes compared to 25.6% for the same period of 2001. These rates vary from the expected rate of 34% primarily due to the effect of tax-exempt investment income.

RESULTS OF OPERATIONS -SIX MONTHS ENDED JUNE 30, 2002 COMPARED TO  
SIX MONTHS ENDED JUNE 30, 2001

-----

Total revenues for the six months ended June 30, 2002 were \$100,770,849, which were \$9,481,854, or 10.4%, greater than the same period in 2001. Net premiums earned increased to \$91,562,772, an increase of \$9,869,880, or 12.1%, over the first six months of 2001. Direct premiums written of the combined pool of Atlantic States and Donegal Mutual increased \$14,007,045, or 13.8%. This increase was tempered somewhat by a 5.0% increase in the direct premiums written of Southern. The Company reported net realized investment gains of \$187,259 in the first six months of 2002 compared to a gain of \$113,839 for the same period of 2001. The realized gain in 2002 was net of realized losses of \$152,518 which resulted from changes in the market value of securities that were determined to be other than temporary. The realized gain in 2001 was net of realized losses of \$463,735 which resulted from changes in the market value of securities that were determined to be other than temporary. Investment income was \$7,440,586, a decrease of \$837,309, or 10.1%, from the first six months of 2001. An increase in average invested assets from \$282.9 million in the first six months of 2001 to \$302.9 million in the first six months of 2002 was more than offset by a decrease in the annualized average return on investments from 5.9% in the first six months of 2001 to 4.9% in the first six months of 2002 accounting for the decrease in investment income.

The GAAP combined ratio of insurance operations in the first six months of 2002 was 100.5% compared to 99.4% 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 half of 2002 was 69.3% compared to 66.2% in the first half of 2001. The increase in loss ratio was due to higher losses in personal lines during the first quarter and storm related losses of \$1.1 million in the second quarter. The Company's expense ratio for the first six months of 2002 was 30.6% compared to 32.3% for the first six months of 2001. The dividend ratio decreased to 0.6% for the first half of 2002 from 0.9% in the first half of 2001.

9

Federal income taxes for the first six months of 2002 represented 27.6% of income before income taxes compared to 26.0% for the same period of 2001. These rates vary 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 June 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 June 30, 2002, under a credit agreement dated December 29, 1995, and

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

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 \$32 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 June 30, 2002, the interest rates on the outstanding balances were 3.6625% on an outstanding eurodollar balance of \$4.8 million and 3.6375% on an outstanding eurodollar rate balance of \$15.0 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. On each July 27, commencing July 27, 2001, 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 of the Companies' capital was substantially above the RBC requirements. In 2002, amounts available for distribution as dividends to the Company without prior approval of the insurance regulatory authorities are \$9,164,937 from Atlantic States and \$4,600,835 from Southern.

### CREDIT RISK

-----

The Company provides property and liability insurance coverages through its subsidiaries' 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 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.

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.

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

The Company has maintained approximately the same duration of its investment portfolio to its liabilities from December 31, 2001 to June 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 June 30, 2002.

11

### 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.

-----

Annual Stockholders meeting held April 18, 2002.

Directors elected at meeting:

Robert S. Bolinger	
Votes for	3,191,615
Votes withheld	22,527
Patricia A. Gilmartin	
Votes for	3,191,615
Votes withheld	22,527
Philip H. Glatfelter, II	
Votes for	3,191,760
Votes withheld	22,382

Directors Continuing:

Thomas J. Finley, Jr.  
C. Edwin Ireland  
John J. Lyons  
Donald H. Nikolaus  
R. Richard Sherbahn

Election of KPMG LLP as Auditors for 2002:

Votes for	3,196,611
Against	16,565
Abstain	968

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.

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.

AUGUST 14, 2002

BY:

-----

Donald H. Nikolaus, President  
and Chief Executive Officer



Edgar Filing: DONEGAL GROUP INC - Form 424B3

AUGUST 14, 2002

BY:

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

14