

DONEGAL GROUP INC
Form 10-Q
August 06, 2007

Table of Contents

**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 June 30, 2007

OR

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

For the transition period from _____ to _____.

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

(Exact name of registrant as specified in its charter)

Delaware

23-2424711

(State or other jurisdiction of
incorporation or organization)

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

1195 River Road, P.O. Box 302, Marietta, PA 17547-0302

(Address of principal executive offices) (Zip code)
(717) 426-1931

(Registrant's telephone number, including area code)
Not applicable

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

Indicate by check mark whether registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 19,621,931 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 July 31, 2007.

TABLE OF CONTENTS

Part I. Financial Information

Item 1. Financial Statements.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Part II. Other Information

Item 1. Legal Proceedings.

Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities.

Item 3. Defaults upon Senior Securities.

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

Item 5. Other Information.

Item 6. Exhibits.

Signatures

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

CERTIFICATION OF CHIEF FINANCIAL OFFICER

CHIEF EXECUTIVE OFFICER PURSUANT TO 18 U.S.C. SEC. 1350 OF TITLE 18

CHIEF FINANCIAL OFFICER PURSUANT TO 18 U.S.C. SEC. 1350 OF TITLE 18

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

	June 30, 2007 (Unaudited)	December 31, 2006
Assets		
Investments		
Fixed maturities		
Held to maturity, at amortized cost	\$ 163,073,794	\$ 169,178,137
Available for sale, at fair value	337,523,470	331,669,778
Equity securities, available for sale, at fair value	45,265,333	40,541,826
Investments in affiliates	8,322,310	8,463,059
Short-term investments, at cost, which approximates fair value	35,292,965	41,484,874
Total investments	589,477,872	591,337,674
Cash	5,782,211	531,756
Accrued investment income	5,906,127	5,769,087
Premiums receivable	54,076,946	49,948,454
Reinsurance receivable	92,495,037	97,677,015
Deferred policy acquisition costs	26,004,059	24,738,929
Deferred tax asset, net	10,344,228	9,085,688
Prepaid reinsurance premiums	49,512,448	44,376,953
Property and equipment, net	5,143,778	5,146,305
Accounts receivable securities	909,329	262,992
Federal income taxes recoverable		998,785
Other	1,702,438	1,824,173
Total assets	\$ 841,354,473	\$ 831,697,811
Liabilities and Stockholders Equity		
Liabilities		
Losses and loss expenses	\$ 251,228,681	\$ 259,022,459
Unearned premiums	210,744,292	196,902,972
Accrued expenses	10,632,642	12,754,012
Reinsurance balances payable	2,377,402	2,034,972
Federal income taxes payable	1,700,330	
Cash dividends declared to stockholders		2,442,958
Subordinated debentures	30,929,000	30,929,000
Accounts payable securities		3,392,329
Due to affiliate	111,970	1,567,091
Drafts payable	654,104	381,744
Other	1,041,614	1,468,012

Total liabilities	509,420,035	510,895,549
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 19,896,412 and 19,834,248 shares and outstanding 19,617,667 and 19,689,318 shares	198,964	198,342
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	153,592,137	152,391,301
Accumulated other comprehensive income	2,617,680	5,061,174
Retained earnings	178,436,557	163,986,701
Treasury stock	(2,967,392)	(891,748)
Total stockholders equity	331,934,438	320,802,262
Total liabilities and stockholders equity	\$ 841,354,473	\$ 831,697,811

See accompanying notes to consolidated financial statements.

Table of Contents

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

	Three Months Ended June 30,	
	2007	2006
Revenues:		
Net premiums earned	\$ 77,574,827	\$ 75,061,105
Investment income, net of investment expenses	5,562,185	5,054,284
Net realized investment gains	60,645	407,248
Lease income	261,886	241,923
Installment payment fees	1,145,633	1,095,927
 Total revenues	 84,605,176	 81,860,487
 Expenses:		
Net losses and loss expenses	40,548,719	40,783,828
Amortization of deferred policy acquisition costs	12,532,000	11,982,000
Other underwriting expenses	14,925,738	13,115,495
Policy dividends	258,968	150,198
Interest	718,531	691,516
Other expenses	520,987	671,212
 Total expenses	 69,504,943	 67,394,249
 Income before income tax expense	 15,100,233	 14,466,238
Income tax expense	4,319,277	4,245,655
 Net income	 \$ 10,780,956	 \$ 10,220,583
 Earnings per common share:		
Class A common stock basic	\$ 0.44	\$ 0.42
Class A common stock diluted	\$ 0.43	\$ 0.41
Class B common stock basic and diluted	\$ 0.39	\$ 0.38

Consolidated Statements of Comprehensive Income
(Unaudited)

	Three Months Ended June 30,	
	2007	2006
Net income	\$ 10,780,956	\$ 10,220,583
Other comprehensive loss, net of tax		

Edgar Filing: DONEGAL GROUP INC - Form 10-Q

Unrealized loss on securities:		
Unrealized holding loss during the period, net of income tax	(2,714,838)	(2,197,945)
Reclassification adjustment, net of income tax	(39,420)	(264,712)
Other comprehensive loss	(2,754,258)	(2,462,657)
Comprehensive income	\$ 8,026,698	\$ 7,757,926

See accompanying notes to consolidated financial statements.

2

Table of Contents

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

	Six Months Ended June 30,	
	2007	2006
Revenues:		
Net premiums earned	\$ 154,272,646	\$ 149,574,954
Investment income, net of investment expenses	11,066,244	10,038,812
Net realized investment gains	165,430	882,047
Lease income	523,418	484,162
Installment payment fees	2,259,454	2,163,407
Total revenues	168,287,192	163,143,382
Expenses:		
Net losses and loss expenses	91,144,146	84,072,340
Amortization of deferred policy acquisition costs	24,950,000	23,868,000
Other underwriting expenses	27,111,476	25,016,752
Policy dividends	507,119	521,970
Interest	1,427,022	1,335,894
Other expenses	1,012,721	1,064,107
Total expenses	146,152,484	135,879,063
Income before income tax expense	22,134,708	27,264,319
Income tax expense	5,863,814	7,913,549
Net income	\$ 16,270,894	\$ 19,350,770
Earnings per common share:		
Class A common stock basic	\$ 0.66	\$ 0.80
Class A common stock diluted	\$ 0.65	\$ 0.77
Class B common stock basic and diluted	\$ 0.59	\$ 0.72

Consolidated Statements of Comprehensive Income
(Unaudited)

	Six Months Ended June 30,	
	2007	2006
Net income	\$ 16,270,894	\$ 19,350,770
Other comprehensive loss, net of tax		

Edgar Filing: DONEGAL GROUP INC - Form 10-Q

Unrealized loss on securities:		
Unrealized holding loss during the period, net of income tax	(2,335,964)	(3,212,795)
Reclassification adjustment, net of income tax	(107,530)	(573,331)
Other comprehensive loss	(2,443,494)	(3,786,126)
Comprehensive income	\$ 13,827,400	\$ 15,564,644

See accompanying notes to consolidated financial statements.

3

Table of Contents

Donegal Group Inc. and Subsidiaries
Consolidated Statement of Stockholders' Equity
(Unaudited)
Six Months Ended June 30, 2007

	Class A Shares	Class B Shares	Class A Amount	Class B Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Retained Earnings	Treasury Stock	Total Stockholders' Equity
Balance, December 31, 2006	19,834,248	5,649,240	\$ 198,342	\$ 56,492	\$ 152,391,301	\$ 5,061,174	\$ 163,986,701	\$ (891,748)	\$ 320,802,200
Change of common stock									
Issuance of common stock									
Stock compensation (expense)	62,164		622		1,123,942				1,124,568
Net income							16,270,894		16,270,894
Cash dividends							(1,781,879)		(1,781,879)
Grant of stock options					39,159		(39,159)		
Stock benefit on exercise of stock options					37,735				37,735
Repurchase of treasury stock								(2,075,644)	(2,075,644)
Other comprehensive income						(2,443,494)			(2,443,494)
Balance, June 30, 2007	19,896,412	5,649,240	\$ 198,964	\$ 56,492	\$ 153,592,137	\$ 2,617,680	\$ 178,436,557	\$ (2,967,392)	\$ 331,934,420

See accompanying notes to consolidated financial statements.

Table of Contents

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

	Six Months Ended June 30,	2007	2006
Cash Flows from Operating Activities:			
Net income	\$	16,270,894	\$ 19,350,770
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization		1,257,970	1,480,930
Realized investment gains		(165,430)	(882,047)
Changes in assets and liabilities:			
Losses and loss expenses		(7,793,778)	7,093,331
Unearned premiums		13,841,320	10,428,996
Premiums receivable		(4,128,492)	(2,212,937)
Deferred acquisition costs		(1,265,130)	(901,405)
Deferred income taxes		57,189	136,825
Reinsurance receivable		5,181,978	(10,131,505)
Prepaid reinsurance premiums		(5,135,495)	(3,735,200)
Accrued investment income		(137,040)	168,340
Due from affiliate		(1,455,121)	(2,562,253)
Reinsurance balances payable		342,430	210,206
Current income taxes		2,699,115	(638,149)
Accrued expenses		(2,121,370)	(2,438,868)
Other, net		(32,293)	39,949
Net adjustments		1,145,853	(3,943,787)
Net cash provided by operating activities		17,416,747	15,406,983
Cash Flows from Investing Activities:			
Purchases of fixed maturities:			
Available for sale		(30,111,074)	(35,028,111)
Purchases of equity securities, available for sale		(9,270,207)	(17,436,266)
Maturity of fixed maturities:			
Held to maturity		5,758,307	2,647,616
Available for sale		16,031,612	9,880,608
Sales of fixed maturities:			
Available for sale			15,428,417
Sales of equity securities, available for sale		4,765,861	10,553,932
Net decrease (increase) in investment in affiliates		61,144	(21,285)
Net purchase of property and equipment		(455,662)	(414,451)
Net sales (purchases) of short-term investments		6,191,909	(3,802,064)
Net cash used in investing activities		(7,028,110)	(18,191,604)

Cash Flows from Financing Activities:

Cash dividends paid	(4,224,837)	(3,773,809)
Issuance of common stock	1,124,564	4,171,642
Repurchase of treasury stock	(2,075,644)	
Tax benefit on exercise of stock options	37,735	1,728,072
Net cash provided by (used in) financing activities	(5,138,182)	2,125,905
Net increase (decrease) in cash	5,250,455	(658,716)
Cash at beginning of period	531,756	3,811,011
Cash at end of period	\$ 5,782,211	\$ 3,152,295
Cash paid during period Interest	\$ 1,424,785	\$ 1,296,090
Net cash paid during period Taxes	\$ 3,050,000	\$ 6,675,000

See accompanying notes to consolidated financial statements.

Table of Contents

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

1 Organization

We were organized as an insurance holding company by Donegal Mutual Insurance Company (Donegal Mutual) on August 26, 1986. Our insurance subsidiaries, Atlantic States Insurance Company (Atlantic States), Southern Insurance Company of Virginia (Southern), Le Mars Insurance Company (Le Mars) and the Peninsula Insurance Group (Peninsula), which consists of Peninsula Indemnity Company and The Peninsula Insurance Company, write personal and commercial lines of property and casualty insurance exclusively through a network of independent insurance agents in certain Mid-Atlantic, Midwest and Southern states. The personal lines products consist primarily of homeowners and private passenger automobile policies. The commercial lines products consist primarily of commercial automobile, commercial multi-peril and workers' compensation policies. Donegal Mutual and our insurance subsidiaries conduct business together as the Donegal Insurance Group. We also own approximately 48% of the outstanding stock of Donegal Financial Services Corporation (DFSC), a thrift holding company that owns Province Bank FSB. Donegal Mutual owns the remaining approximately 52% of the outstanding stock of DFSC.

At June 30, 2007, Donegal Mutual held approximately 42% of our outstanding Class A common stock and approximately 72% of our outstanding Class B common stock.

Atlantic States, our largest subsidiary, and Donegal Mutual have a pooling agreement under which both companies proportionately share their combined underwriting results, excluding certain reinsurance assumed by Donegal Mutual from our insurance subsidiaries. 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 market prices prevailing from time to time in the open market subject to the provisions of SEC Rule 10b-18 and in privately negotiated transactions. During the second quarter of 2007, we purchased 128,115 shares of our Class A common stock under this program.

2 Basis of Presentation

Our financial information for the interim periods included herein is unaudited; however, such information reflects all adjustments, consisting only of normal recurring adjustments that, in the opinion of management, are necessary for a fair presentation of our financial position, results of operations and cash flows for the interim periods included herein. Our results of operations for the six months ended June 30, 2007 are not necessarily indicative of our results of operations to be expected for the twelve months ending December 31, 2007.

These interim financial statements should be read in conjunction with the financial statements and notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2006.

3 Earnings Per Share

We have two classes of common stock, which we refer to as Class A common stock and Class B common stock. Our Class A common stock is entitled to cash dividends that are at least 10% higher than those declared and paid on our Class B common stock. Accordingly, we use the two-class method for the computation of earnings per common share pursuant to Statement of Financial Accounting Standards No. 128, Earnings Per Share. The two-class method is an earnings allocation formula that determines earnings per share separately for each class of common stock based on dividends declared and an allocation of remaining undistributed earnings using a participation percentage reflecting the dividend rights of each class. A reconciliation of the numerators and denominators used in the basic and diluted per share computations is presented below for each class of stock:

Table of Contents

(dollars in thousands, except per share data)

For the Three Months Ended June 30:	2007		2006	
	Class A	Class B	Class A	Class B
Basic net income per share:				
Numerator:				
Allocation of net income	\$ 8,589	\$ 2,192	\$ 8,120	\$ 2,101
Denominator:				
Weighted-average shares outstanding	19,684,922	5,576,775	19,325,683	5,576,775
Basic net income per share	\$ 0.44	\$ 0.39	\$ 0.42	\$ 0.38
Diluted net income per share:				
Numerator:				
Allocation of net income	\$ 8,589	\$ 2,192	\$ 8,120	\$ 2,101
Denominator:				
Number of shares used in basic computation	19,684,922	5,576,775	19,325,683	5,576,775
Weighted-average effect of dilutive securities				
Add: Director and employee stock options	251,136		648,293	
Number of shares used in per share computations	19,936,058	5,576,775	19,973,976	5,576,775
Diluted net income per share	\$ 0.43	\$ 0.39	\$ 0.41	\$ 0.38

(dollars in thousands, except per share data)

For the Six Months Ended June 30:	2007		2006	
	Class A	Class B	Class A	Class B
Basic net income per share:				
Numerator:				
Allocation of net income	\$ 12,956	\$ 3,315	\$ 15,333	\$ 4,018
Denominator:				
Weighted-average shares outstanding	19,698,486	5,576,775	19,196,186	5,576,775
Basic net income per share	\$ 0.66	\$ 0.59	\$ 0.80	\$ 0.72
Diluted net income per share:				
Numerator:				
Allocation of net income	\$ 12,956	\$ 3,315	\$ 15,333	\$ 4,018
Denominator:				

Edgar Filing: DONEGAL GROUP INC - Form 10-Q

Number of shares used in basic computation	19,698,486	5,576,775	19,196,186	5,576,775
Weighted-average effect of dilutive securities				
Add: Director and employee stock options	327,581		670,131	
Number of shares used in per share computations	20,026,067	5,576,775	19,866,317	5,576,775
Diluted net income per share	\$ 0.65	\$ 0.59	\$ 0.77	\$ 0.72

Options to purchase the following number of shares of Class A 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:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
Number of shares	1,064,000		1,051,667	

We have historically presented a single EPS amount, rather than using the two-class method. During the preparation of our second quarter financial statements, we determined that the two-class presentation is appropriate for all periods following our recapitalization in 2001. We have evaluated the impact of not using the two-class method in our previously issued financial statements and have concluded that the effect is not material. The following table presents EPS amounts using the two-class method for the years ended December 31, 2006, 2005 and 2004:

Table of Contents

	2006		2005		2004	
	Basic	Diluted	Basic	Diluted	Basic	Diluted
Class A	\$ 1.65	\$ 1.60	\$ 1.57	\$ 1.51	\$ 1.38	\$ 1.32
Class B	\$ 1.48	\$ 1.48	\$ 1.41	\$ 1.41	\$ 1.25	\$ 1.24
As previously reported	\$ 1.61	\$ 1.57	\$ 1.54	\$ 1.49	\$ 1.35	\$ 1.31

4 Reinsurance

Atlantic States has participated in an inter-company pooling agreement with Donegal Mutual since 1986. Both Atlantic States and Donegal Mutual place all of their direct business into the pool, and Atlantic States and Donegal Mutual then proportionately share the pooled business in accordance with the terms of the pooling agreement. Atlantic States has a 70% share of the results of the pool, and Donegal Mutual has a 30% share of the results of the pool. There have been no changes to the pool participation percentages since July 1, 2000.

The risk profiles of the business written by Atlantic States and Donegal Mutual historically have been, and continue to be, substantially similar. The products, classes of business underwritten, pricing practices and underwriting standards of Donegal Mutual and our insurance subsidiaries are determined and administered by the same management and underwriting personnel. In addition, as the Donegal Insurance Group, Donegal Mutual and our insurance subsidiaries share a combined business plan to achieve market penetration and underwriting profitability objectives. The products offered by our insurance subsidiaries and Donegal Mutual are generally complementary, thereby allowing Donegal Insurance Group to offer a broader range of products to a given market and to expand Donegal Insurance Group's ability to service an entire personal lines or commercial lines account. Distinctions within the products of Donegal Mutual and our insurance subsidiaries generally relate to specific risk profiles targeted within similar classes of business, such as preferred tier versus standard tier products, but not all of the standard risk gradients are allocated to one company. Therefore, the underwriting profitability of the business directly written by the individual companies will vary. However, because the risk characteristics of all business written directly by Donegal Mutual and Atlantic States are homogenized within the pool and each company shares the results according to its participation level, Atlantic States realizes 70% of the underwriting profitability of the pool (because of its 70% participation in the pool), while Donegal Mutual realizes 30% of the underwriting profitability of the pool (because of Donegal Mutual's 30% participation in the pool). Pooled business represents the predominant percentage of the net underwriting activity of both Atlantic States and Donegal Mutual.

Atlantic States, Southern and Donegal Mutual purchase third-party reinsurance on a combined basis. Le Mars and Peninsula have separate third-party reinsurance programs that provide similar types of coverage and that are commensurate with their relative size and exposures. Several different reinsurers are used, all of which, consistent with Donegal Insurance Group's requirements, have an A.M. Best rating of A- (Excellent) or better or, with respect to foreign reinsurers, have a financial condition that, in the opinion of our management, is equivalent to a company with at least an A- rating. The following information relates to the external reinsurance Atlantic States, Southern and Donegal Mutual has in place during 2007:

excess of loss reinsurance, under which losses are automatically reinsured, through a series of contracts, over a set retention (\$400,000 for 2007), and

catastrophic reinsurance, under which Donegal Insurance Group recovers, through a series of contracts, 100% of an accumulation of many losses resulting from a single event, including natural disasters, over a set retention (\$3.0 million for 2007).

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

In addition to the pooling agreement and third-party reinsurance, Atlantic States, Southern, Le Mars and Peninsula have various reinsurance agreements with Donegal Mutual.

Table of Contents

There were no significant changes to the pooling agreement, third-party reinsurance or other reinsurance agreements between our insurance subsidiaries and Donegal Mutual during the six months ended June 30, 2007.

5 Segment Information

We evaluate the performance of our personal lines and commercial lines segments based upon the underwriting results of our insurance subsidiaries as determined under statutory accounting principles prescribed or permitted by various state insurance departments (SAP), which our management uses to measure performance for the total business of our insurance subsidiaries. Financial data by segment is as follows:

	Three Months Ended June 30,	
	2007	2006
	(\$ in thousands)	
Revenues:		
Premiums earned:		
Commercial lines	\$ 28,972	\$ 28,986
Personal lines	48,603	46,075
Net premiums earned	77,575	75,061
Net investment income	5,562	5,054
Realized investment gains	61	407
Other	1,407	1,338
Total revenues	\$ 84,605	\$ 81,860
Income before income taxes:		
Underwriting income:		
Commercial lines	\$ 7,978	\$ 4,937
Personal lines	524	3,124
SAP underwriting income	8,502	8,061
GAAP adjustments	807	969
GAAP underwriting income	9,309	9,030
Net investment income	5,562	5,054
Realized investment gains	61	407
Other	168	(25)
Income before income taxes	\$ 15,100	\$ 14,466
	Six Months Ended June 30,	
	2007	2006
	(\$ in thousands)	
Revenues:		
Premiums earned:		
Commercial lines	\$ 57,552	\$ 57,866
Personal lines	96,721	91,709

Edgar Filing: DONEGAL GROUP INC - Form 10-Q

Net premiums earned	154,273	149,575
Net investment income	11,066	10,039
Realized investment gains	165	882
Other	2,783	2,647
Total revenues	\$ 168,287	\$ 163,143
Income before income taxes:		
Underwriting income (loss):		
Commercial lines	\$ 10,933	\$ 8,925
Personal lines	(1,993)	5,504
SAP underwriting income	8,940	14,429
GAAP adjustments	1,620	1,667
GAAP underwriting income	10,560	16,096
Net investment income	11,066	10,039
Realized investment gains	165	882
Other	344	247
Income before income taxes	\$ 22,135	\$ 27,264

Table of Contents**6 Subordinated Debentures**

On May 15, 2003, we received \$15.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 15, 2033 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 4.10%, which is adjustable quarterly. At June 30, 2007, the interest rate on the debentures was 9.46%.

On October 29, 2003, we received \$10.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on October 29, 2033 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At June 30, 2007, the interest rate on the debentures was 9.21%.

On May 24, 2004, we received \$5.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 24, 2034 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At June 30, 2007, the interest rate on the debentures was 9.21%.

7 Share-Based Compensation

Effective January 1, 2006, we adopted Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment which requires the measurement of all share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in our consolidated statements of income. In determining the expense to be recorded for stock options granted to directors and employees of our subsidiaries and affiliates other than Donegal Mutual, the fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model. The significant assumptions utilized in applying the Black-Scholes option pricing model are the risk-free interest rate, expected term, dividend yield, and expected volatility.

Under SFAS No. 123(R), the compensation expense for our stock compensation plans that has been charged against income before income taxes was \$154,143 and \$99,983 for the six months ended June 30, 2007 and 2006, respectively, with a corresponding income tax benefit of \$53,950 and \$34,994, respectively. As of June 30, 2007, our total unrecognized compensation cost related to nonvested share-based compensation granted under our stock compensation plans was \$449,198. The cost is expected to be recognized over a weighted average period of 2.5 years.

SFAS No. 123(R) does not set accounting requirements for share-based compensation to nonemployees. We continue to account for share-based compensation to employees and directors of Donegal Mutual under the provisions of FIN No. 44 and EITF 00-23, which state that when employees of a controlling entity are granted share-based compensation, the entity granting the share-based compensation should measure the fair value of the award at the grant date and recognize the fair value as a dividend to the controlling entity. These provisions apply to options granted to employees and directors of Donegal Mutual, the employer of record for the majority of employees that provide services to us. Implied dividends of \$39,159 and \$58,870 were recorded for the six months ended June 30, 2007 and 2006, respectively.

Cash received from option exercises under all stock compensation plans for the six months ended June 30, 2007 and 2006 was \$129,170 and \$3,490,968, respectively. The actual tax benefit realized for the tax deductions from option exercises of share-based compensation was \$37,735 and \$1,728,072 for the six months ended June 30, 2007 and 2006, respectively.

8 Impact of New Accounting Standards

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 (FIN No. 48). FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. Effective January 1, 2007, we adopted FIN No. 48. As of January 1, 2007, we had no material unrecognized tax benefits or accrued interest and penalties. Our policy is to account for interest as a component of interest expense and penalties as a component of other expense. Federal tax years 2003

Table of Contents

through 2006 were open for examination as of January 1, 2007. The adoption of FIN No. 48 did not have a significant effect on our results of operations or financial condition.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 108 to address diversity in practice in quantifying financial statement misstatements. SAB No. 108 requires that registrants quantify the impact on the current year's financial statements of correcting all misstatements, including the carryover and reversing effects of prior years' misstatements, as well as the effects of errors arising in the current year. The adoption of SAB No. 108 did not have a significant effect on our results of operations, financial condition or liquidity.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. This statement applies under other accounting pronouncements that require or permit fair value measurements. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. We are currently evaluating the impact of adopting this statement.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115. SFAS No. 159 permits companies to choose to measure many financial instruments and certain other items at fair value at specified election dates. Upon adoption, an entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. Most of the provisions apply only to entities that elect the fair value option. However, the amendment of SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, applies to all entities with available-for-sale and trading securities. SFAS No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. We are currently evaluating the impact of adopting this statement.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following information should be read in conjunction with the historical financial information and the notes thereto included in this Quarterly Report on Form 10-Q and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2006 as filed with the Securities and Exchange Commission on March 13, 2007.

Critical Accounting Policies and Estimates

Our financial statements are combined with those of our insurance subsidiaries and are presented on a consolidated basis in accordance with generally accepted accounting principles in the United States (GAAP).

Our insurance subsidiaries make estimates and assumptions that can have a significant effect on amounts and disclosures we report in our financial statements. The most significant estimates relate to the reserves of our insurance subsidiaries for property and casualty insurance unpaid losses and loss expenses, valuation of investments and our insurance subsidiaries' policy acquisition costs. While we believe our estimates and the estimates of our insurance subsidiaries are appropriate, the ultimate amounts may differ from the estimates provided. We regularly review these estimates and reflect any adjustment considered necessary in our current results of operations.

Liability for Losses and Loss Expenses

Liabilities for losses and loss expenses are estimates at a given point in time of the amounts an insurer expects to pay with respect to policyholder claims based on facts and circumstances then known. An insurer recognizes at the time of establishing its estimates that its ultimate liability for losses and loss expenses will exceed or be less than such estimates. Our insurance subsidiaries base their estimates of liabilities for losses and loss expenses on assumptions as to future loss trends and expected claims severity, judicial theories of liability and other factors. However, during the loss adjustment period, our insurance subsidiaries may learn additional facts regarding individual claims, and consequently it often becomes necessary for our insurance subsidiaries to refine and adjust their estimates of liability. Our insurance subsidiaries reflect any adjustments to their liabilities for losses and loss expenses in their results of operations in the period in which the changes in estimates are made.

Table of Contents

Our insurance subsidiaries maintain liabilities for the payment of losses and loss expenses with respect to both reported and unreported claims. It is our intent that the liabilities for loss expenses will cover the ultimate costs of settling all losses, including investigation and litigation costs from such losses. Our insurance subsidiaries base the amount of their liability for reported losses primarily upon a case-by-case evaluation of the type of risk involved, knowledge of the circumstances surrounding each claim and the insurance policy provisions relating to the type of loss. Our insurance subsidiaries determine the amount of their liability for unreported claims and loss expenses on the basis of historical information by line of insurance. Our insurance subsidiaries account for inflation in the reserving function through analysis of costs and trends and reviews of historical reserving results. Our insurance subsidiaries closely monitor their liabilities and recompute them periodically using new information on reported claims and a variety of statistical techniques. Our insurance subsidiaries do not discount their liabilities for losses and loss expenses.

Reserve estimates can change over time because of unexpected changes in assumptions related to our insurance subsidiaries' external environment and, to a lesser extent, assumptions as to our insurance subsidiaries' internal operations. Assumptions related to our insurance subsidiaries' external environment include the absence of significant changes in tort law and the legal environment that increase liability exposure, consistency in judicial interpretations of insurance coverage and policy provisions and stability in economic conditions and the rate of loss cost inflation. For example, our insurance subsidiaries have experienced a decrease in claims frequency on bodily injury liability claims during the past several years while claims severity has gradually increased. These trend changes give rise to greater uncertainty as to the pattern of future loss settlements on bodily injury claims. Related uncertainties regarding future trends include the cost of medical technologies and procedures and changes in the utilization of medical procedures. Internal assumptions include accurate measurement of the impact of rate changes and changes in policy provisions and consistency in the quality and characteristics of business written within a given line of business, among other items. To the extent our insurance subsidiaries determine that underlying factors impacting their assumptions have changed, our insurance subsidiaries attempt to make appropriate adjustments for such changes in their reserves. Accordingly, our insurance subsidiaries' ultimate liability for unpaid losses and loss expenses will likely differ from the amount recorded at June 30, 2007. For every 1% change in our estimate for loss and loss expense reserves of our insurance subsidiaries, net of reinsurance recoverable, the effect on our pre-tax results of operations would be approximately \$1.6 million.

The establishment of appropriate liabilities is an inherently uncertain process, and there can be no assurance that the ultimate liability of our insurance subsidiaries will not exceed our insurance subsidiaries' loss and loss expense reserves and have an adverse effect on our results of operations and financial condition. Furthermore, the timing, frequency and extent of adjustments to our insurance subsidiaries' estimated future liabilities cannot be predicted, since the historical conditions and events that serve as a basis for our insurance subsidiaries' estimates of ultimate claim costs may change. As is the case for substantially all property and casualty insurance companies, our insurance subsidiaries have found it necessary in the past to increase their estimated future liabilities for losses and loss expenses in certain periods, and in other periods their estimates have exceeded their actual liabilities. Further adjustments could be required in the future. However, on the basis of our insurance subsidiaries' internal procedures, which analyze, among other things, their prior assumptions, their experience with similar cases and historical trends such as reserving patterns, loss payments, pending levels of unpaid claims and product mix, as well as court decisions, economic conditions and public attitudes, we believe that our insurance subsidiaries have made adequate provision for their liability for losses and loss expenses.

Excluding the impact of isolated catastrophic weather events, our insurance subsidiaries have noted slight downward trends in the number of claims incurred and the number of claims outstanding at period ends relative to their premium base in recent years across most of their lines of business. However, the amount of the average claim outstanding has increased gradually over the past several years as the property and casualty insurance industry has experienced increased litigation trends, periods in which economic conditions extended the estimated length of disabilities, increased medical loss cost trends and a general slowing of settlement rates in litigated claims.

Because of Atlantic States' participation in the pool with Donegal Mutual, Atlantic States is exposed to adverse loss development on the business of Donegal Mutual included in the pool. However, pooled business represents the

predominant percentage of the net underwriting activity of both companies, and Donegal Mutual and Atlantic States would proportionately share any adverse risk development of the pooled business. The business in the pool is homogenous, i.e., Atlantic States has a 70% share of the entire pool and Donegal Mutual has a 30% share of the entire pool. Since substantially all of the business of Atlantic States and Donegal Mutual is pooled and the results shared by each company according to its participation level under the terms of the pooling agreement, the underwriting pool is intended to produce a more uniform

Table of Contents

and stable underwriting result from year to year for each company than either would experience individually and to spread the risk of loss among each company.

Our insurance subsidiaries' liability for losses and loss expenses by major line of business as of June 30, 2007 and December 31, 2006 consisted of the following:

	June 30, 2007	December 31, 2006
(dollars in thousands)		
Commercial lines:		
Automobile	\$ 22,674	\$ 23,406
Workers compensation	39,002	39,563
Commercial multi-peril	24,976	25,994
Other	2,468	2,633
Total commercial lines	89,120	91,596
Personal lines:		
Automobile	58,528	59,657
Homeowners	10,825	10,360
Other	1,672	1,699
Total personal lines	71,025	71,716
Total commercial and personal lines	160,145	163,312
Plus reinsurance recoverable	91,084	95,710
Total liability for losses and loss expenses	\$ 251,229	\$ 259,022

We have evaluated the effect on our insurance subsidiaries' loss and loss expense reserves and our stockholders' equity in the event of reasonably likely changes in the variables considered in establishing loss and loss expense reserves. We established the range of reasonably likely changes based on a review of changes in accident year development by line of business and applied to our insurance subsidiaries' loss reserves as a whole. The selected range does not necessarily indicate what could be the potential best or worst case or likely scenario. The following table sets forth the effect on our insurance subsidiaries' loss and loss expense reserves and our stockholders' equity in the event of reasonably likely changes in the variables considered in establishing loss and loss expense reserves:

Change in Loss and Loss Expense Reserves Net of	Adjusted Loss and Loss Expense Reserves Net of Reinsurance as of June 30,		Percentage Change in Equity as of June 30,	Adjusted Loss and Loss Expense Reserves Net of	
					Percentage Change in Equity as of December 31,

Reinsurance	2007	2007(1) (dollars in thousands)	Reinsurance as of December 31, 2006	2006(1)
(10.0)%	\$ 144,131	3.1%	\$ 146,981	3.3%
(7.5)	148,134	2.4	151,064	2.5
(5.0)	152,138	1.6	155,146	1.7
(2.5)	156,141	0.8	159,229	0.8
Base	160,145		163,312	
2.5	164,149	-0.8	167,395	-0.8
5.0	168,152	-1.6	171,478	-1.7
7.5	172,156	-2.4	175,560	-2.5
10.0	176,160	-3.1	179,643	-3.3

(1) Net of income
tax effect.

Table of Contents**Investments**

We present our investments in available-for-sale fixed maturity and equity securities at estimated fair value, which generally represents quoted market prices.

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at June 30, 2007 as follows:

	Less than 12 months		12 months or longer	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 13,978,279	\$ 71,550	\$ 76,439,197	\$ 1,869,326
Obligations of states and political subdivisions	130,372,218	1,705,407	50,936,975	1,264,131
Corporate securities	9,818,157	131,093	3,785,652	66,755
Mortgage-backed securities	24,587,444	482,278	32,513,801	1,177,029
Equity securities	22,413,513	555,601	520,275	79,725
Totals	\$ 201,169,611	\$ 2,945,929	\$ 164,195,900	\$ 4,456,966

Of the total fixed maturity securities with an unrealized loss at June 30, 2007, we classified securities with a fair value of \$226.7 million and an unrealized loss of \$4.5 million as available for sale and carried them at fair value on our balance sheet, while we classified securities with a fair value of \$115.7 million and an unrealized loss of \$2.3 million as held to maturity on our balance sheet and carried them at amortized cost.

Substantially all of the unrealized losses within our fixed maturity investment portfolio resulted from increases in market interest rates and the related impact on our fixed maturity investment valuations. When determining possible impairment of our debt securities, we consider unrealized losses that are due to the impact of higher market interest rates to be temporary in nature because we have the ability and intent to hold our debt securities to recovery.

We make estimates concerning the valuation of our investments and the recognition of other than temporary declines in the value of our investments. When we consider the decline in value of an individual investment to be other than temporary, we write down the investment to its estimated net realizable value, and the amount of the write-down is reflected as a realized loss in our results of operations. We individually monitor all investments for other than temporary declines in value. Generally, if an individual equity security has depreciated in value by more than 20% of original cost, and has been in an unrealized loss position for more than six months, we assume there has been an other than temporary decline in value. With respect to debt securities, we assume there has been an other than temporary decline in value if it is probable that we will not receive contractual payments. In addition, we may write down securities in an unrealized loss position based on a number of other factors, including the fair value of the investment being significantly below its cost, the deteriorating financial condition of the issuer of a security and the occurrence of industry, company and geographic events that have negatively impacted the value of a security or rating agency downgrades. We determined that certain investments trading below cost had declined on an other than temporary basis during the first six months of 2007 and 2006. Losses of \$98,000 and \$47,538 were included in net realized investment gains for these investments in the first six months of 2007 and 2006, respectively.

Policy Acquisition Costs

We defer policy acquisition costs, consisting primarily of commissions, premium taxes and certain other underwriting costs that vary with and are directly related to the production of business, and amortize them over the period in which our insurance subsidiaries earn the premiums. The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value, which gives effect to the premiums to be earned, related investment income, losses and loss expenses and certain other costs we expect to incur as our insurance subsidiaries earn the premiums. Estimates in the calculation of policy acquisition costs have not shown material variability because of uncertainties in applying accounting principles or as a result of sensitivities to

changes in key assumptions.

Table of Contents**Results of Operations Three Months Ended June 30, 2007 Compared to Three Months Ended June 30, 2006**

Net Premiums Written. Net premiums written for the three months ended June 30, 2007 were \$83.1 million, an increase of \$3.0 million, or 3.7%, over the comparable period in 2006. Commercial lines net premiums written were unchanged from the comparable period in 2006. Personal lines net premiums written increased \$2.9 million, or 5.8%, in the second quarter of 2007 compared to the comparable period in 2006. We benefited during the second quarter of 2007 from the addition of new business related to increased agent utilization of our WritePro and WriteBiz automated underwriting and policy issuance systems.

Net Premiums Earned. Net premiums earned increased to \$77.6 million for the second quarter of 2007, an increase of \$2.5 million, or 3.3%, over the second quarter of 2006. Our insurance subsidiaries earn premiums and recognize them as revenue over the terms of their policies, which are one year or less in duration. Therefore, increases or decreases in net premiums earned generally reflect increases or decreases in net premiums written in the preceding twelve-month period compared to the comparable period one year earlier.

Investment Income. For the three months ended June 30, 2007, our net investment income increased 10.0% to \$5.6 million, compared to \$5.1 million for the comparable period one year ago. An increase in average invested assets from \$555.7 million in the second quarter of 2006 to \$591.0 million in the second quarter of 2007 and an increase in the annualized average rate of return on investments from 3.6% for the second quarter of 2006 to 3.8% for the second quarter of 2007 accounted for the increase in net investment income. The increase in our annualized average return reflects higher short-term interest rates during the second quarter of 2007 compared to the comparable period a year earlier. These increases were offset in part by decreases in our annualized average rate of return due to our increased holdings of tax-exempt fixed maturities in our investment portfolio during the second quarter of 2007 compared to the comparable period a year earlier. The increased holdings of tax-exempt fixed maturities in 2007 resulted from a continuing shift from taxable to tax-exempt fixed maturities in order to obtain more favorable after-tax yields.

Net Realized Investment Gains. Net realized investment gains in the second quarter of 2007 were \$60,645, compared to \$407,248 for the comparable period in 2006. During the second quarter of 2007 and 2006, impairment losses of \$98,000 and \$0, respectively, were included in net realized investment gains. The remaining net realized investment gains and losses in both periods resulted from normal turnover within our investment portfolio.

Losses and Loss Expenses. The loss ratio of our insurance subsidiaries, which is the ratio of incurred losses and loss expenses to premiums earned, for the second quarter of 2007 was 52.3%, compared to 54.3% for the second quarter of 2006. The commercial lines loss ratio decreased to 38.3% for the second quarter of 2007, compared to 50.1% for the second quarter of 2006, primarily due to decreases in the commercial multi-peril, workers compensation and commercial automobile loss ratios as a result of decreases in claim severity in those lines of business. The personal lines loss ratio increased from 57.2% for the second quarter of 2006 to 60.4% for the second quarter of 2007 due to an increase in the homeowners loss ratio primarily related to increases in claim frequency and severity in that line of business. Net losses incurred during the quarter benefited from a continuation of favorable prior accident year reserve development resulting from the settlements of open claims.

Underwriting Expenses. The expense ratio, which is the ratio of policy acquisition costs and other underwriting expenses to premiums earned, for the second quarter of 2007 and 2006 was 35.4% and 33.5%, respectively. The increased expense ratio reflected additional expenses incurred for the production of new business growth and increased underwriting-based incentive costs. The increase in underwriting-based incentive costs was directly related to the significant improvement in underwriting results during the second quarter of 2007 compared to those posted in the first quarter of 2007.

Combined Ratio. Our combined ratio of our insurance subsidiaries was 88.0% for both periods. The combined ratio represents the sum of the loss ratio, expense ratio and dividend ratio, which is the ratio of workers compensation policy dividends incurred to premiums earned.

Table of Contents

Interest Expense. Interest expense for the second quarter of 2007 was \$718,531, compared to \$691,516 for the second quarter of 2006, and reflected an increase in average interest rates on our subordinated debentures in the second quarter of 2007 compared to the comparable period in 2006.

Income Taxes. Income tax expense was \$4.3 million for the second quarter of 2007, representing an effective tax rate of 28.6%, compared to \$4.2 million for the second quarter of 2006, representing an effective tax rate of 29.3%. The change in effective tax rates is primarily due to tax-exempt interest income representing a larger proportion of income before income tax expense in the 2007 period compared to the 2006 period.

Net Income and Earnings Per Share. Our net income for the second quarter of 2007 was \$10.8 million, or \$.43 per share of Class A common stock and \$.39 per share of Class B common stock on a diluted basis, compared to net income of \$10.2 million, or \$.41 per share of Class A common stock and \$.38 per share of Class B common stock on a diluted basis, reported for the second quarter of 2006. Our fully diluted Class A shares outstanding for the second quarter of 2007 decreased to 19.9 million, compared to 20.0 million for the second quarter of 2006, as a result of our repurchase of outstanding stock. Our Class B shares outstanding were unchanged at 5.6 million.

Results of Operations Six Months Ended June 30, 2007 Compared to Six Months Ended June 30, 2006

Net Premiums Written. Net premiums written for the six months ended June 30, 2007 were \$163.0 million, an increase of \$6.7 million, or 4.3%, over the comparable period in 2006. Commercial lines net premiums written increased \$1.4 million, or 2.3%, in the first half of 2007 compared to the comparable period in 2006. Personal lines net premiums written increased \$5.3 million, or 5.6%, in the first half of 2007 compared to the comparable period in 2006.

Net Premiums Earned. Net premiums earned increased to \$154.3 million for the first half of 2007, an increase of \$4.7 million, or 3.1%, over the first half of 2006. Premiums are earned, or recognized as revenue, over the terms of our policies, which are one year or less in duration. Therefore, increases or decreases in net premiums earned generally reflect increases or decreases in net premiums written in the preceding twelve-month period compared to the comparable period one year earlier.

Investment Income. For the six months ended June 30, 2007, our net investment income increased 11.0% to \$11.1 million, compared to \$10.0 million for the comparable period one year ago. An increase in average invested assets from \$554.5 million in the first half of 2006 to \$590.4 million in the first half of 2007 and an increase in the annualized average rate of return on investments from 3.6% for the first half of 2006 to 3.7% for the first half of 2007 accounted for the increase in net investment income. We realized increases in our annualized average rate of return as a result of a shift from short-term investments to higher yielding fixed maturities in our investment portfolio in 2006 as well as higher short-term interest rates during the first half of 2007 compared to the comparable period a year earlier. These increases were offset in part by decreases in our annualized average rate of return on increased holdings of tax-exempt fixed maturities in our investment portfolio during the first half of 2007 compared to the comparable period a year earlier.

Net Realized Investment Gains. Net realized investment gains in the first half of 2007 were \$165,430, compared to \$882,047 for the comparable period in 2006. Impairment charges of \$98,000 were recognized in the first half of 2007, compared to impairment charges of \$47,538 recognized in the first half of 2006. The impairment charges for both periods were the result of declines in the market value of equity securities that we deemed to be other than temporary. The remaining net realized investment gains and losses in both periods resulted from normal turnover within our investment portfolio.

Losses and Loss Expenses. Our loss ratio in the first half of 2007 was 59.1%, compared to 56.2% in the first half of 2006. The commercial lines loss ratio improved to 47.1% in the first half of 2007, compared to 51.4% in the first half of 2006, primarily due to improved experience in our workers compensation line of business. The personal lines loss ratio increased from 59.6% in the first half of 2006 to 66.3% in the first half of 2007 due to increased claim severity in our personal automobile and homeowners lines of business.

Underwriting Expenses. Our expense ratio for the first half of 2007 was 33.8%, compared to 32.7% in the first half of 2006. The increase in the first half of 2007 expense ratio reflects additional costs incurred in the production of new business growth.

Combined Ratio. Our combined ratio was 93.2% and 89.2% for the six months ended June 30, 2007 and 2006, respectively. The combined ratio represents the sum of the loss ratio, expense ratio and

Table of Contents

dividend ratio. The increase in the combined ratio was largely attributable to the increase in the loss ratio for the 2007 period compared to the 2006 period.

Interest Expense. Interest expense for the first half of 2007 was \$1.4 million, compared to \$1.3 million for the first half of 2006, and reflected an increase in average interest rates on our subordinated debentures in the first six months of 2007 compared to the comparable period in 2006.

Income Taxes. Income tax expense was \$5.9 million for the first half of 2007, representing an effective tax rate of 26.5%, compared to \$7.9 million for the first half of 2006, representing an effective tax rate of 29.0%. The change in effective tax rates is primarily due to tax-exempt interest income representing a greater proportion of net income before taxes in the 2007 period compared to the 2006 period.

Net Income and Earnings Per Share. Our net income for the first half of 2007 was \$16.3 million, or \$.65 per share of Class A common stock and \$.59 per share of Class B common stock on a diluted basis, a decrease of 16.0% over our net income of 19.4 million, or \$.77 per share of Class A common stock and \$.72 per share of Class B common stock on a diluted basis, for the first half of 2006. Our fully diluted Class A shares outstanding for the first half of 2007 increased to 20.6 million, compared to 19.8 million for the first half of 2006. Our Class B shares outstanding were unchanged at 5.6 million.

Liquidity and Capital Resources

Liquidity is a measure of an entity's ability to secure enough cash to meet its contractual obligations and operating needs as they arise. Our major sources of funds from operations are the net cash flows generated from our insurance subsidiaries' underwriting results, investment income and maturing investments.

We have historically generated sufficient net positive cash flow from our operations to fund our commitments and build our investment portfolio, thereby increasing future investment returns. The impact of the pooling agreement with Donegal Mutual historically has been cash flow positive because of the historical underwriting profitability of the pool. The pool is settled monthly, thereby resulting in cash flows substantially similar to cash flows that would result from the underwriting of direct business. We have not experienced any unusual variations in the timing of claim payments associated with the loss reserves of our insurance subsidiaries. We maintain a high degree of liquidity in our investment portfolio in the form of readily marketable fixed maturities, equity securities and short-term investments. Our fixed-maturity investment portfolio is structured following a laddering approach, so that projected cash flows from investment income and principal maturities are evenly distributed from a timing perspective, thereby providing an additional measure of liquidity to meet our obligations should an unexpected variation occur in the future. Net cash flows provided by operating activities in the first six months of 2007 and 2006 were \$17.4 million and \$15.4 million, respectively.

On November 25, 2003, we entered into a credit agreement with Manufacturers and Traders Trust Company (M&T) relating to a four-year \$35.0 million unsecured, revolving line of credit. On July 20, 2006, we amended the agreement with M&T to extend the credit agreement for four years from the date of amendment on substantially the same terms. As of June 30, 2007, we have the ability to borrow \$35.0 million at interest rates equal to M&T's current prime rate or the then current LIBOR rate plus between 1.50% and 1.75%, depending on our leverage ratio. In addition, we pay a fee of 0.15% per annum on the loan commitment amount, regardless of usage. The agreement requires our compliance with certain covenants, which include minimum levels of our net worth, leverage ratio and statutory surplus and A.M. Best ratings of our insurance subsidiaries. During the six months ended June 30, 2007, we had no borrowings outstanding under the credit agreement, and we were in compliance with all requirements of the credit agreement.

The following table shows our expected payments for significant contractual obligations as of June 30, 2007.

(\$ in thousands)	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Net liability for unpaid losses and loss expenses of our insurance subsidiaries	\$ 160,145	\$ 70,278	\$ 71,715	\$ 8,269	\$ 9,883

Edgar Filing: DONEGAL GROUP INC - Form 10-Q

Subordinated debentures	30,929				30,929
Total contractual obligations	\$ 191,074	\$ 70,278	\$ 71,715	\$ 8,269	\$ 40,812

17

Table of Contents

We estimate the timing of the amounts for the net liability for unpaid losses and loss expenses of our insurance subsidiaries based on historical experience and expectations of future payment patterns. The liability is shown net of reinsurance recoverable on unpaid losses and loss expenses to reflect expected future cash flows related to such liability. Amounts assumed by Atlantic States from the pooling agreement with Donegal Mutual represent a substantial portion of our insurance subsidiaries' gross liability for unpaid losses and loss expenses, and amounts ceded by Atlantic States to the pooling agreement represent a substantial portion of our insurance subsidiaries' reinsurance recoverable on unpaid losses and loss expenses. Future cash settlement of Atlantic States' assumed liability from the pool will be included in monthly settlements of pooled activity, wherein amounts ceded to and assumed from the pool are netted. Although Donegal Mutual and we do not anticipate any changes in the pool participation levels in the foreseeable future, any such change would be prospective in nature and therefore would not impact the timing of expected payments for Atlantic States' proportionate liability for pooled losses occurring in periods prior to the effective date of such change.

The timing of the amounts for the subordinated debentures is based on their contractual maturities. The debentures are redeemable at our option, at par, after five years from their issuance dates as discussed in Note 6 Subordinated Debentures.

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 market prices prevailing from time to time in the open market subject to the provisions of SEC Rule 10b-18 and in privately negotiated transactions. During the second quarter of 2007, we purchased 128,115 shares of our Class A common stock under this program.

On July 19, 2007, our board of directors declared quarterly cash dividends of 9.0 cents per share for our Class A common stock and 7.75 cents per share for our Class B common stock, payable August 15, 2007 to stockholders of record as of the close of business on August 1, 2007. There are no regulatory restrictions on the payment of dividends to our stockholders, although there are state law restrictions on the payment of dividends from our insurance subsidiaries to us. Our insurance subsidiaries 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 the applicable domiciliary insurance regulatory authorities. Our insurance subsidiaries are subject to risk-based capital (RBC) requirements. At December 31, 2006, our insurance subsidiaries' capital levels were each substantially above RBC requirements. At January 1, 2007, amounts available for distribution as dividends to us from our insurance subsidiaries without prior approval of their domiciliary insurance regulatory authorities were \$26.7 million from Atlantic States, \$5.9 million from Southern, \$2.5 million from Le Mars and \$3.3 million from Peninsula, all of which remained available at June 30, 2007.

As of June 30, 2007, we had no material commitments for capital expenditures.

Equity Price Risk

Our portfolio of marketable equity securities, which is carried on our consolidated balance sheets at estimated fair value, has exposure to the risk of loss resulting from an adverse change in prices. We manage this risk by performing an analysis of prospective investments and through regular reviews of our portfolio by our investment staff.

Credit Risk

Our portfolio of fixed-maturity securities and, to a lesser extent, our portfolio of short-term investments is subject to credit risk. This risk is defined as the potential loss in market value resulting from adverse changes in the borrower's ability to repay the debt. We manage this risk by performing an analysis of prospective investments and through regular reviews of our portfolio by our investment staff. We also

Table of Contents

limit the percentage and amount of our total investment portfolio that can be invested in the securities of any one issuer.

Our insurance subsidiaries provide property and liability insurance coverages through independent insurance agencies located throughout our operating area. The majority of this business is billed directly to the insured, although a portion of the commercial business is billed through agents to whom our insurance subsidiaries extend credit in the normal course of business.

Because the pooling agreement does not relieve Atlantic States of primary liability as the originating insurer, Atlantic States is subject to a concentration of credit risk arising from business ceded to Donegal Mutual. Our insurance subsidiaries maintain reinsurance agreements in place with Donegal Mutual 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, our insurance subsidiaries attempt, in establishing rates, to anticipate the potential impact of inflation.

Risk Factors

The business, results of operations and financial condition, and therefore the value of our common stock, are subject to a number of risks. For a description of certain risks, reference is made to our 2006 annual report on Form 10-K filed with the Securities and Exchange Commission on March 13, 2007.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

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

Other than our continuing shift from taxable to tax-exempt fixed maturity investments, we have maintained approximately the same investment mix and duration of our investment portfolio to our liabilities from December 31, 2006 to June 30, 2007.

There have been no material changes to our quantitative or qualitative market risk exposure from December 31, 2006 through June 30, 2007.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

We conducted an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information we (including our consolidated subsidiaries) are required to disclose in our periodic filings with the Securities and Exchange Commission is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

Table of Contents

Changes in Internal Control Over Financial Reporting

There has been no change in our internal control over financial reporting during the quarter covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Safe Harbor Statement Under the Private Securities Litigation Reform Act of 1995

Certain forward-looking statements contained herein involve risks and uncertainties. These statements include certain discussions relating to underwriting, premium and investment income volume, business strategies and our business activities during 2007 and beyond. In some cases, you can identify forward-looking statements by terms such as may, will, should, could, would, expect, plan, intend, anticipate, believe, estimate, project, or similar expressions. These forward-looking statements reflect our current views about future events, are based on assumptions that reflect current conditions and are subject to known and unknown risks and uncertainties that may cause our actual results to differ materially from those anticipated by these forward-looking statements. Many of the factors that will determine future events or our future results of operations are beyond our ability to control or predict.

Table of Contents**Part II. Other Information****Item 1. Legal Proceedings.**

None.

Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities.

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
Month #1 April 1-30, 2007	Class A 13,000	Class A \$15.45	Class A 13,000	(2)
	Class B 394	Class B \$17.40	Class B 394	(1)
Month #2 May 1-31, 2007	Class A 81,292	Class A \$15.59	Class A 81,292	(2)
	Class B 66,835	Class B \$18.96	Class B 66,835	(1)
Month #3 June 1-30, 2007	Class A 2,800	Class A \$14.87	Class A 2,800	(1)
	Class A 33,823	Class A \$15.10	Class A 33,823	(2)
	Class B 1,534	Class B \$18.29	Class B 1,534	(1)
Total	Class A 130,915	Class A \$15.43	Class A 130,915	
	Class B 68,763	Class B \$18.78	Class B 68,763	

(1) Donegal Mutual purchased these shares pursuant to its announcement on August 17, 2004 that it will, at its discretion, purchase shares of our Class A common stock and Class B common stock at market prices prevailing from time to time in the open market subject to the provisions of SEC

Rule 10b-18 and in privately negotiated transactions.

Such announcement did not stipulate a maximum number of shares that may be purchased under this program.

- (2) We purchased these shares pursuant to our announcement on March 7, 2007 that we will purchase up to 500,000 shares of our Class A common stock at market prices prevailing from time to time in the open market subject to the provisions of SEC Rule 10b-18 and in privately negotiated transactions.

Item 3. Defaults upon Senior Securities.

None.

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

We held our annual meeting of stockholders on April 19, 2007 (the Meeting), with the following results:

The total number of votes represented at the Meeting in person or by proxy was 7,363,281 of the 7,548,285 votes for holders of common stock outstanding and entitled to vote at the Meeting.

On the resolution to elect John J. Lyons, S. Trezevant Moore, Jr. and R. Richard Sherbahn as Class C Directors to serve until the expiration of their respective terms and until their successors are duly elected, the nominees for director received the number of votes set forth opposite their respective names below:

Table of Contents

	Number of Votes	
	For	Withheld
John J. Lyons	7,271,159	92,122
S. Trezevant Moore, Jr.	7,288,391	74,890
R. Richard Sherbahn	6,711,363	651,918

There were no abstentions or broker non-votes recorded. On the basis of the above vote, John J. Lyons, S. Trezevant Moore, Jr. and R. Richard Sherbahn were elected as Class C Directors to serve until the expiration of their respective terms and until their successors are duly elected.

On the resolution to approve the 2007 Equity Incentive Plan for Employees, the following votes were received: 5,740,362 votes for the resolution, 811,642 votes against the resolution and 27,016 abstentions. On the basis of such vote, the 2007 Equity Incentive Plan for Employees was approved.

On the resolution to approve the 2007 Equity Incentive Plan for Directors, the following votes were received: 6,256,915 votes for the resolution, 285,755 votes against the resolution and 36,350 abstentions. On the basis of such vote, the 2007 Equity Incentive Plan for Directors was approved.

Item 5. Other Information.

None.

Table of Contents

Item 6. Exhibits.

Exhibit No.	Description
Exhibit 31.1	Certification of Chief Executive Officer
Exhibit 31.2	Certification of Chief Financial Officer
Exhibit 32.1	Statement of Chief Executive Officer pursuant to 18 U.S.C. Section 1350 of Title 18 of the United States Code
Exhibit 32.2	Statement of Chief Financial Officer pursuant to 18 U.S.C. Section 1350 of Title 18 of the United States Code

Table of Contents

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 6, 2007

By: /s/ Donald H. Nikolaus
Donald H. Nikolaus, President
and Chief Executive Officer

August 6, 2007

By: /s/ Jeffrey D. Miller
Jeffrey D. Miller, Senior Vice President
and Chief Financial Officer