

DONEGAL GROUP INC
Form 10-Q
May 07, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2012

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)

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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
(Address of principal executive offices) (Zip code)

(717) 426-1931
(Registrant's telephone number, including area code)

Not applicable
(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 20,038,469 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 April 30, 2012.

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DONEGAL GROUP INC.

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

	March 31, 2012 (Unaudited)	December 31, 2011
Assets		
Investments		
Fixed maturities		
Held to maturity, at amortized cost	\$ 56,384,171	\$ 58,489,619
Available for sale, at fair value	671,689,994	646,598,178
Equity securities, available for sale, at fair value	4,391,697	7,437,538
Investments in affiliates	33,189,375	32,322,246
Short-term investments, at cost, which approximates fair value	16,826,080	40,461,410
Total investments	782,481,317	785,308,991
Cash	15,985,551	13,245,378
Accrued investment income	7,069,065	6,713,038
Premiums receivable	110,775,307	104,715,327
Reinsurance receivable	202,172,794	209,823,907
Deferred policy acquisition costs	37,263,527	36,424,955
Deferred tax asset, net	8,395,214	9,919,720
Prepaid reinsurance premiums	108,904,124	106,450,018
Property and equipment, net	5,886,247	6,154,383
Accounts receivable - securities		1,507,500
Federal income taxes recoverable	1,465,293	2,661,808
Goodwill	5,625,354	5,625,354
Other intangible assets	958,010	958,010
Other	1,323,262	1,285,089
Total assets	\$ 1,288,305,065	\$ 1,290,793,478
Liabilities and Stockholders' Equity		
Liabilities		
Unpaid losses and loss expenses	\$ 437,278,505	\$ 442,407,615
Unearned premiums	346,018,101	336,937,261
Accrued expenses	17,856,990	20,956,549
Reinsurance balances payable	16,896,964	20,039,339
Borrowings under line of credit	54,500,000	54,500,000
Cash dividends declared to stockholders		2,996,076
Subordinated debentures	20,465,000	20,465,000
Due to affiliate	1,494,596	5,386,391
Drafts payable	808,812	1,548,953
Other	2,060,381	2,104,702
Total liabilities	897,379,349	907,341,886
Stockholders' Equity		

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Preferred stock, \$1.00 par value, authorized 2,000,000 shares; none issued		
Class A common stock, \$.01 par value, authorized 30,000,000 shares, issued 20,784,419 and 20,752,999 shares and outstanding 20,002,861 and 19,971,441 shares	207,845	207,530
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	171,402,865	170,836,943
Accumulated other comprehensive income	22,451,600	23,533,447
Retained earnings	207,594,434	199,604,700
Treasury stock	(10,787,520)	(10,787,520)
Total stockholders' equity	390,925,716	383,451,592
Total liabilities and stockholders' equity	\$ 1,288,305,065	\$ 1,290,793,478

See accompanying notes to consolidated financial statements.

Table of Contents**Donegal Group Inc. and Subsidiaries****Consolidated Statements of Income**

(Unaudited)

	Three Months Ended March 31,	
	2012	2011
Revenues:		
Net premiums earned	\$ 114,691,791	\$ 103,795,279
Investment income, net of investment expenses	5,089,722	5,230,144
Net realized investment gains	2,309,980	373,073
Lease income	247,365	231,682
Installment payment fees	1,834,785	1,833,864
Equity in earnings of Donegal Financial Services Corporation	1,174,519	119,400
Total revenues	125,348,162	111,583,442
Expenses:		
Net losses and loss expenses	76,609,219	73,079,565
Amortization of deferred policy acquisition costs	17,881,000	16,992,000
Other underwriting expenses	19,246,819	17,446,912
Policyholder dividends	289,324	207,014
Interest	570,544	443,470
Other expenses	903,522	818,346
Total expenses	115,500,428	108,987,307
Income before income tax expense	9,847,734	2,596,135
Income tax expense	1,837,587	390,199
Net income	\$ 8,010,147	\$ 2,205,936
Earnings per common share:		
Class A common stock basic	\$ 0.32	\$ 0.09
Class A common stock diluted	\$ 0.31	\$ 0.09
Class B common stock basic and diluted	\$ 0.29	\$ 0.08

Donegal Group Inc. and Subsidiaries**Consolidated Statements of Comprehensive Income**

(Unaudited)

	Three Months Ended March 31,	
	2012	2011
Net income	\$ 8,010,147	\$ 2,205,936
Other comprehensive (loss) income, net of tax		

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Unrealized (loss) gain on securities:		
Unrealized holding income during the period, net of income tax of \$202,864 and \$242,490	442,740	461,001
Reclassification adjustment for gains included in net income, net of income tax of \$785,393 and \$126,845	(1,524,587)	(246,228)
Other comprehensive (loss) income	(1,081,847)	214,773
Comprehensive income	\$ 6,928,300	\$ 2,420,709

See accompanying notes to consolidated financial statements.

Table of Contents**Donegal Group Inc. and Subsidiaries****Consolidated Statement of Stockholders Equity**

(Unaudited)

Three Months Ended March 31, 2012

	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, 2011	20,752,999	5,649,240	\$ 207,530	\$ 56,492	\$ 170,836,943	\$ 23,533,447	\$ 199,604,700	\$ (10,787,520)	\$ 383,451,592
Issuance of common stock (stock compensation plans)	31,420		315		540,803				541,118
Net income							8,010,147		8,010,147
Cash dividends declared							(2,401)		(2,401)
Grant of stock options					18,012		(18,012)		
Tax benefit on exercise of stock options					7,107				7,107
Other comprehensive loss						(1,081,847)			(1,081,847)
Balance, March 31, 2012	20,784,419	5,649,240	\$ 207,845	\$ 56,492	\$ 171,402,865	\$ 22,451,600	\$ 207,594,434	\$ (10,787,520)	\$ 390,925,716

See accompanying notes to consolidated financial statements.

Table of Contents**Donegal Group Inc. and Subsidiaries****Consolidated Statements of Cash Flows**

(Unaudited)

	Three Months Ended March 31,	
	2012	2011
Cash Flows from Operating Activities:		
Net income	\$ 8,010,147	\$ 2,205,936
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,106,129	1,131,706
Net realized investment gains	(2,309,980)	(373,073)
Equity in earnings of Donegal Financial Services Corporation	(1,174,519)	(119,400)
Changes in assets and liabilities:		
Losses and loss expenses	(5,129,110)	5,768,001
Unearned premiums	9,080,840	17,070,402
Premiums receivable	(6,059,980)	(5,401,141)
Deferred acquisition costs	(838,572)	(218,299)
Deferred income taxes	2,107,034	(1,087,865)
Reinsurance receivable	7,651,113	(716,966)
Prepaid reinsurance premiums	(2,454,106)	(8,675,686)
Accrued investment income	(356,027)	314,654
Due to affiliate	(3,891,795)	(1,458,178)
Reinsurance balances payable	(3,142,375)	(832,854)
Current income taxes	1,196,515	1,372,287
Accrued expenses	(3,099,559)	(1,314,721)
Other, net	(822,638)	(1,523,197)
Net adjustments	(8,137,030)	3,935,670
Net cash (used in) provided by operating activities	(126,883)	6,141,606
Cash Flows from Investing Activities:		
Purchases of fixed maturities, available for sale	(65,787,791)	(53,208,414)
Purchases of equity securities, available for sale	(1,000,111)	(9,128,187)
Maturity of fixed maturities:		
Held to maturity	2,010,962	600,981
Available for sale	25,742,108	15,813,825
Sales of fixed maturities, available for sale	16,266,860	30,493,102
Sales of equity securities, available for sale	4,428,189	1,348,466
Purchase of Michigan Insurance Company		(7,207,471)
Net sales of property and equipment	21,761	
Net sales of short-term investments	23,635,330	14,988,472
Net cash provided by (used in) investing activities	5,317,308	(6,299,226)
Cash Flows from Financing Activities:		
Cash dividends paid	(2,998,477)	(2,873,125)
Issuance of common stock	548,225	272,488
Borrowings under line of credit		3,888,282
Net cash (used in) provided by financing activities	(2,450,252)	1,287,645

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Net increase in cash		2,740,173	1,130,025
Cash at beginning of period		13,245,378	16,342,212
Cash at end of period		\$ 15,985,551	\$ 17,472,237
Cash paid during period	Interest	\$ 510,916	\$ 355,455
Net cash paid (received) during period	Taxes	\$ (1,423,035)	\$
	See accompanying notes to consolidated financial statements.		

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DONEGAL GROUP INC. AND SUBSIDIARIES

(Unaudited)

Notes to Consolidated Financial Statements

1 Organization

Donegal Mutual Insurance Company (Donegal Mutual) organized us as an insurance holding company 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), the Peninsula Insurance Group (Peninsula), which consists of Peninsula Indemnity Company and The Peninsula Insurance Company, Sheboygan Falls Insurance Company (Sheboygan) and Michigan Insurance Company (MICO), write personal and commercial lines of property and casualty coverages exclusively through a network of independent insurance agents in certain Mid-Atlantic, Midwestern, New England and Southern states. We have three operating segments: our investment function, our personal lines of insurance and our commercial lines of insurance. The personal lines products of our insurance subsidiaries consist primarily of homeowners and private passenger automobile policies. The commercial lines products of our insurance subsidiaries consist primarily of commercial automobile, commercial multi-peril and workers' compensation policies. We also own 48.2% of the outstanding stock of Donegal Financial Services Corporation (DFSC), a grandfathered savings and loan holding company that owns Union Community Bank FSB (UCB). Donegal Mutual owns the remaining 51.8% of the outstanding stock of DFSC.

At March 31, 2012, Donegal Mutual held approximately 39% of our outstanding Class A common stock and approximately 75% of our outstanding Class B common stock. This ownership provides Donegal Mutual with approximately two-thirds of the total voting power of our outstanding common stock. Our insurance subsidiaries and Donegal Mutual have interrelated operations. While each company maintains its separate corporate existence, our insurance subsidiaries and Donegal Mutual conduct business together as the Donegal Insurance Group. As such, Donegal Mutual and our insurance subsidiaries share the same business philosophy, the same management, the same employees and the same facilities and offer the same types of insurance products.

Atlantic States, our largest subsidiary, participates in a pooling agreement with Donegal Mutual. Under the pooling agreement, the two companies pool their insurance business, and each company receives an allocated percentage of the pooled business. Atlantic States has an 80% share of the results of the pooled business, and Donegal Mutual has a 20% share of the results of the pooled business.

On February 23, 2009, our board of directors authorized a share repurchase program pursuant to which we may purchase up to 300,000 shares of our Class A common stock at prices prevailing from time to time in the open market subject to the provisions of applicable rules of the Securities and Exchange Commission (SEC) and in privately negotiated transactions. We did not purchase any shares of our Class A common stock under this program during the three-month periods ended March 31, 2012 and 2011, respectively. We have purchased a total of 136,628 shares of our Class A common stock under this program from its inception through March 31, 2012.

2 Basis of Presentation

Our financial information for the interim periods included in this Form 10-Q Report is unaudited; however, such information reflects all adjustments, consisting only of normal recurring adjustments that, in the opinion of our management, are necessary for a fair presentation of our financial position, results of operations and cash flows for those interim periods. Our results of operations for the three months ended March 31, 2012 are not necessarily indicative of the results of operations we expect for the year ending December 31, 2012.

You should read these interim financial statements in conjunction with the financial statements and notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2011.

3 Earnings Per Share

We have two classes of common stock, which we refer to as our Class A common stock and our Class B common stock. Our certificate of incorporation provides that whenever our board of directors declares a dividend on our Class B common stock, our board of directors must also declare a dividend on our Class A common stock that is payable at the same time to holders as of the same record date at a rate that is at least

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10% greater than the rate at which our board of directors declared a dividend on our Class B common stock. Accordingly, we use the two-class method to compute our earnings per common share. The two-class method is an earnings allocation formula that determines earnings per share separately for each class of common

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stock based on dividends we have declared and an allocation of our remaining undistributed earnings using a participation percentage that reflects the dividend rights of each class. The table below presents for the periods indicated a reconciliation of the numerators and denominators we used to compute basic and diluted net income per share for each class of our common stock:

	Three Months Ended March 31,			
	2012		2011	
	Class A	Class B	Class A	Class B
	(in thousands, except per share data)			
Basic and diluted net income per share:				
Numerator:				
Allocation of net income	\$ 6,390	\$ 1,620	\$ 1,772	\$ 434
Denominator:				
Weighted-average shares outstanding	19,996,285	5,576,775	20,012,648	5,576,775
Basic net income per share	\$ 0.32	\$ 0.29	\$ 0.09	\$ 0.08
Diluted net income per share:				
Numerator:				
Allocation of net income	\$ 6,390	\$ 1,620	\$ 1,772	\$ 434
Denominator:				
Number of shares used in basic computation	19,996,285	5,576,775	20,012,648	5,576,775
Weighted-average shares effect of dilutive securities				
Add: Director and employee stock options	364,836			
Number of shares used in per share computations	20,361,121	5,576,775	20,012,648	5,576,775
Diluted net income per share	\$ 0.31	\$ 0.29	\$ 0.09	\$ 0.08

We did not include outstanding options to purchase the following number of shares of Class A common stock in our computation of diluted earnings per share because the exercise price of the options was greater than the average market price of our Class A common stock during the period:

	Three Months Ended March 31,	
	2012	2011
Number of shares excluded	1,235,000	4,001,667

4 Reinsurance

Atlantic States and Donegal Mutual have participated in a pooling agreement since 1986 under which each company places all of its direct written business into the pool, and Atlantic States and Donegal Mutual then share the underwriting results of the pool in accordance with the terms of the pooling agreement. Atlantic States has an 80% share of the results of the pool, and Donegal Mutual has a 20% share of the results of the pool.

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Our insurance subsidiaries and Donegal Mutual purchase certain third-party reinsurance on a combined basis. Le Mars, MICO, Peninsula and Sheboygan also purchase separate third-party reinsurance that provides coverage that is commensurate with their relative size and exposures. Our insurance subsidiaries use several different reinsurers, all of which, consistent with requirements of our insurance subsidiaries and Donegal Mutual, 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 from A.M. Best. The following information describes the external reinsurance our insurance subsidiaries have in place during 2012:

excess of loss reinsurance, under which losses are automatically reinsured, through a series of reinsurance agreements, over a set retention (generally \$1.0 million), and

catastrophe reinsurance, under which Donegal Mutual, Atlantic States and Southern recover, through a series of reinsurance agreements, 90% to 100% of an accumulation of many losses resulting from a single event, including natural disasters, over a set retention (generally \$5.0 million).

Our insurance subsidiaries and Donegal Mutual also purchase facultative reinsurance to cover exposures from losses that exceed the limits provided by their reinsurance agreements with third parties.

MICO maintains a quota-share reinsurance agreement with third-party reinsurers to reduce its net exposures. Effective from December 1, 2010 to December 31, 2011, the quota-share reinsurance percentage was 50%. Effective January 1, 2012, MICO reduced the quota-share reinsurance percentage from 50% to 40%.

In addition to the pooling agreement and third-party reinsurance, our insurance subsidiaries have various reinsurance agreements with Donegal Mutual.

Other than a change in the MICO quota-share reinsurance agreement we discuss above, we made no significant changes to our third-party reinsurance or the reinsurance agreements between our insurance subsidiaries and Donegal Mutual during the three months ended March 31, 2012.

5 Investments

The amortized cost and estimated fair values of our fixed maturities and equity securities at March 31, 2012 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
Held to Maturity				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 1,000	\$ 44	\$	\$ 1,044
Obligations of states and political subdivisions	54,912	2,426		57,338
Corporate securities	250	2		252
Residential mortgage-backed securities	222	17		239
Totals	\$ 56,384	\$ 2,489	\$	\$ 58,873

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
Available for Sale				

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U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 78,590	\$ 1,009	\$ 441	\$ 79,158
Obligations of states and political subdivisions	369,378	25,760	202	394,936
Corporate securities	70,137	2,259	457	71,939
Residential mortgage-backed securities	122,206	3,509	58	125,657
Fixed maturities	640,311	32,537	1,158	671,690
Equity securities	4,630	170	408	4,392
Totals	\$ 644,941	\$ 32,707	\$ 1,566	\$ 676,082

At March 31, 2012, our holdings of obligations of states and political subdivisions included general obligation bonds with an aggregate fair value of \$358.7 million and an amortized cost of \$336.3 million. Our holdings also included special revenue bonds with an aggregate fair value of \$93.5 million and an amortized cost of \$88.0 million. With respect to both categories, we held no securities of any issuer that comprised more than 10% of the category at March 31, 2012. Education bonds and water and sewer utility bonds represented 56% and 16%, respectively, of our total investments in special revenue bonds based on

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their carrying values at March 31, 2012. Many of the issuers of the special revenue bonds we held at March 31, 2012 have the authority to impose ad valorem taxes. In that respect, many of the special revenue bonds we held were similar to general obligation bonds.

The amortized cost and estimated fair values of our fixed maturities and equity securities at December 31, 2011 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
Held to Maturity				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 1,000	\$ 54	\$	\$ 1,054
Obligations of states and political subdivisions	56,966	2,857		59,823
Corporate securities	250	3		253
Residential mortgage-backed securities	274	19	1	292
				&nb