

DONEGAL GROUP INC
Form 10-Q
November 06, 2008

**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 September 30, 2008

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, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 19,931,165 shares of Class A Common Stock, par value \$0.01 per share, and 5,576,775 shares of

Class B Common Stock, par value \$0.01 per share, outstanding on October 31, 2008.

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

| | September 30, 2008 | December 31, 2007 |
|--|-------------------------------|------------------------------|
| | (Unaudited) | |
| Assets | | |
| Investments | | |
| Fixed maturities | | |
| Held to maturity, at amortized cost | \$ 104,156,450 | \$ 154,290,119 |
| Available for sale, at fair value | 414,295,734 | 336,317,901 |
| Equity securities, available for sale, at fair value | 14,757,866 | 36,360,526 |
| Investments in affiliates | 8,120,101 | 8,648,818 |
| Short-term investments, at cost, which approximates fair value | 82,813,995 | 70,252,223 |
| | | |
| Total investments | 624,144,146 | 605,869,587 |
| Cash | 6,466,577 | 4,289,365 |
| Accrued investment income | 5,898,583 | 5,874,908 |
| Premiums receivable | 59,259,420 | 51,038,253 |
| Reinsurance receivable | 86,509,297 | 78,897,154 |
| Deferred policy acquisition costs | 30,871,669 | 26,235,072 |
| Deferred tax asset, net | 16,235,985 | 7,026,441 |
| Prepaid reinsurance premiums | 54,902,541 | 47,286,336 |
| Property and equipment, net | 5,773,667 | 5,608,129 |
| Accounts receivable securities | 2,897,164 | 602,191 |
| Other | 1,111,712 | 1,368,320 |
| | | |
| Total assets | \$ 894,070,761 | \$ 834,095,756 |
| | | |
| Liabilities and Stockholders Equity | | |
| Liabilities | | |
| Losses and loss expenses | \$ 242,148,416 | \$ 226,432,402 |
| Unearned premiums | 239,879,899 | 203,430,560 |
| Accrued expenses | 11,247,454 | 12,313,428 |
| Reinsurance balances payable | 1,993,082 | 2,105,501 |
| Federal income taxes payable | 986,979 | 375,736 |
| Cash dividends declared to stockholders | | 2,210,298 |
| Subordinated debentures | 15,465,000 | 30,929,000 |
| Accounts payable securities | 24,070,695 | 1,820,016 |
| Due to affiliate | 458,788 | 241,918 |
| Drafts payable | 1,035,400 | 717,540 |
| Other | 1,127,832 | 829,166 |

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| | | |
|---|----------------|----------------|
| Total liabilities | 538,413,545 | 481,405,565 |
| Stockholders Equity | | |
| Preferred stock, \$1.00 par value, authorized 2,000,000 shares; none issued | | |
| Class A common stock, \$.01 par value, authorized 30,000,000 shares, issued 20,470,242 and 20,167,999 shares and outstanding 19,914,643 and 19,756,643 shares | 204,702 | 201,680 |
| 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 | 162,632,023 | 156,850,666 |
| Accumulated other comprehensive income (loss) | (7,278,331) | 6,974,411 |
| Retained earnings | 207,691,691 | 193,806,855 |
| Treasury stock | (7,649,361) | (5,199,913) |
| Total stockholders equity | 355,657,216 | 352,690,191 |
| Total liabilities and stockholders equity | \$ 894,070,761 | \$ 834,095,756 |

See accompanying notes to consolidated financial statements.

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

| | Three Months Ended September | |
|---|-------------------------------------|-------------------|
| | 2008 | 2007 |
| | 30, | |
| Revenues: | | |
| Net premiums earned | \$ 88,170,757 | \$ 77,609,940 |
| Investment income, net of investment expenses | 5,801,750 | 5,812,669 |
| Net realized investment gains (losses) | (2,811,264) | 488,226 |
| Lease income | 230,903 | 267,741 |
| Installment payment fees | 1,316,429 | 1,262,255 |
| Total revenues | 92,708,575 | 85,440,831 |
| Expenses: | | |
| Net losses and loss expenses | 53,234,686 | 41,011,053 |
| Amortization of deferred policy acquisition costs | 14,818,000 | 12,940,000 |
| Other underwriting expenses | 14,240,659 | 14,218,116 |
| Policy dividends | 437,470 | 360,885 |
| Interest | 398,855 | 733,558 |
| Other expenses | 314,642 | 484,168 |
| Total expenses | 83,444,312 | 69,747,780 |
| Income before income tax expense | 9,264,263 | 15,693,051 |
| Income tax expense | 2,041,183 | 4,480,623 |
| Net income | \$ 7,223,080 | \$ 11,212,428 |
| Earnings per common share: | | |
| Class A common stock basic | \$ 0.29 | \$ 0.45 |
| Class A common stock diluted | \$ 0.29 | \$ 0.45 |
| Class B common stock basic and diluted | \$ 0.26 | \$ 0.41 |

Consolidated Statements of Comprehensive Income
(Unaudited)

Three Months Ended September
30,
2008 **2007**

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| | | |
|---|--------------|---------------|
| Net income | \$ 7,223,080 | \$ 11,212,428 |
| Other comprehensive income (loss), net of tax | | |
| Unrealized income (loss) on securities: | | |
| Unrealized holding income (loss) during the period, net of income tax (benefit) | (9,172,698) | 3,553,723 |
| Reclassification adjustment, net of income tax | 1,827,322 | (317,346) |
| Other comprehensive income (loss) | (7,345,376) | 3,236,377 |
| Comprehensive income (loss) | \$ (122,296) | \$ 14,448,805 |

See accompanying notes to consolidated financial statements.

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

| | Nine Months Ended September | |
|---|------------------------------------|-------------------|
| | 30, | |
| | 2008 | 2007 |
| Revenues: | | |
| Net premiums earned | \$ 257,507,718 | \$ 231,882,586 |
| Investment income, net of investment expenses | 17,287,476 | 16,878,913 |
| Net realized investment gains (losses) | (2,789,535) | 653,656 |
| Lease income | 705,198 | 791,159 |
| Installment payment fees | 3,760,768 | 3,521,709 |
| Total revenues | 276,471,625 | 253,728,023 |
| Expenses: | | |
| Net losses and loss expenses | 162,244,444 | 132,155,199 |
| Amortization of deferred policy acquisition costs | 43,109,000 | 37,890,000 |
| Other underwriting expenses | 40,711,661 | 41,329,592 |
| Policy dividends | 924,537 | 868,004 |
| Interest | 1,545,571 | 2,160,580 |
| Other expenses | 1,211,480 | 1,496,889 |
| Total expenses | 249,746,693 | 215,900,264 |
| Income before income tax expense | 26,724,932 | 37,827,759 |
| Income tax expense | 5,883,951 | 10,344,437 |
| Net income | \$ 20,840,981 | \$ 27,483,322 |
| Earnings per common share: | | |
| Class A common stock basic | \$ 0.84 | \$ 1.11 |
| Class A common stock diluted | \$ 0.83 | \$ 1.10 |
| Class B common stock basic and diluted | \$ 0.76 | \$ 1.00 |

Consolidated Statements of Comprehensive Income
(Unaudited)

Nine Months Ended September
30,
2008 **2007**

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| | | |
|---|---------------|---------------|
| Net income | \$ 20,840,981 | \$ 27,483,322 |
| Other comprehensive income (loss), net of tax | | |
| Unrealized income (loss) on securities: | | |
| Unrealized holding income (loss) during the period, net of income tax (benefit) | (16,065,940) | 1,217,759 |
| Reclassification adjustment, net of income tax | 1,813,198 | (424,876) |
| Other comprehensive income (loss) | (14,252,742) | 792,883 |
| Comprehensive income | \$ 6,588,239 | \$ 28,276,205 |

See accompanying notes to consolidated financial statements.

Donegal Group Inc. and Subsidiaries
Consolidated Statement of Stockholders' Equity
(Unaudited)
Nine Months Ended September 30, 2008

| | Class A Shares | Class B Shares | Class A Amount | Class B Amount | Additional Paid-In Capital | Accumulated Other Comprehensive Income (Loss) | Retained Earnings | Treasury Stock | Total Stockholders' Equity |
|--|-------------------|-------------------|-------------------|-------------------|----------------------------------|---|----------------------|-------------------|----------------------------------|
| Balance, September 30, 2007 | 20,167,999 | 5,649,240 | \$ 201,680 | \$ 56,492 | \$ 156,850,666 | \$ 6,974,411 | \$ 193,806,855 | \$ (5,199,913) | \$ 352,690,100 |
| Change of common stock price | | | | | | | | | |
| Compensation (expense) | 302,243 | | 3,022 | | 3,349,078 | | | | 3,352,100 |
| Income | | | | | | | 20,840,981 | | 20,840,981 |
| Dividends | | | | | | | (5,207,082) | | (5,207,082) |
| Net income | | | | | | | | | |
| Share-based payments | | | | | 1,749,063 | | (1,749,063) | | |
| Benefit on exercise of stock options | | | | | 683,216 | | | | 683,216 |
| Change of treasury stock | | | | | | | | (2,449,448) | (2,449,448) |
| Other comprehensive income | | | | | | (14,252,742) | | | (14,252,742) |
| Balance, September 30, 2008 | 20,470,242 | 5,649,240 | \$ 204,702 | \$ 56,492 | \$ 162,632,023 | \$ (7,278,331) | \$ 207,691,691 | \$ (7,649,361) | \$ 355,657,200 |

See accompanying notes to consolidated financial statements.

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

| | Nine Months Ended September | |
|---|------------------------------------|---------------|
| | 30, | |
| | 2008 | 2007 |
| Cash Flows from Operating Activities: | | |
| Net income | \$ 20,840,981 | \$ 27,483,322 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,786,722 | 1,884,993 |
| Net realized investment losses (gains) | 2,789,535 | (653,656) |
| Changes in assets and liabilities: | | |
| Losses and loss expenses | 15,716,014 | (17,022,130) |
| Unearned premiums | 36,449,339 | 16,426,291 |
| Premiums receivable | (8,221,167) | (3,622,905) |
| Deferred acquisition costs | (4,636,597) | (2,170,316) |
| Deferred income taxes | (1,534,983) | 420,310 |
| Reinsurance receivable | (7,612,143) | 7,124,852 |
| Prepaid reinsurance premiums | (7,616,205) | (5,399,617) |
| Accrued investment income | (23,675) | 123,853 |
| Due to affiliate | 216,870 | (1,081,628) |
| Reinsurance balances payable | (112,419) | 558,046 |
| Current income taxes | 611,243 | 1,711,262 |
| Accrued expenses | (1,065,974) | (1,037,049) |
| Other, net | 873,144 | 322,942 |
| Net adjustments | 27,619,704 | (2,414,752) |
| Net cash provided by operating activities | 48,460,685 | 25,068,570 |
| Cash Flows from Investing Activities: | | |
| Purchases of fixed maturities: | | |
| Available for sale | (149,742,022) | (38,785,682) |
| Purchases of equity securities, available for sale | (12,890,734) | (16,762,862) |
| Maturity of fixed maturities: | | |
| Held to maturity | 49,698,926 | 8,204,300 |
| Available for sale | 43,899,947 | 21,994,045 |
| Sales of fixed maturities: | | |
| Available for sale | 25,215,920 | |
| Sales of equity securities, available for sale | 31,922,932 | 10,086,892 |
| Net decrease in investment in affiliates | 401,828 | 160,057 |
| Net purchase of property and equipment | (932,986) | (1,100,093) |
| Net sale (purchase) of short-term investments | (12,561,772) | 2,434,026 |
| Net cash used in investing activities | (24,987,961) | (13,769,317) |

Cash Flows from Financing Activities:

| | | |
|--|--------------|--------------|
| Cash dividends paid | (7,417,380) | (6,422,588) |
| Redemption of subordinated debentures | (15,464,000) | |
| Issuance of common stock | 3,352,100 | 1,767,017 |
| Purchase of treasury stock | (2,449,448) | (2,560,481) |
| Tax benefit on exercise of stock options | 683,216 | 198,965 |
| Net cash used in financing activities | (21,295,512) | (7,017,087) |
| Net increase in cash | 2,177,212 | 4,282,166 |
| Cash at beginning of period | 4,289,365 | 531,756 |
| Cash at end of period | \$ 6,466,577 | \$ 4,813,922 |
| Cash paid during period Interest | \$ 1,772,648 | \$ 2,164,472 |
| Net cash paid during period Taxes | \$ 6,125,000 | \$ 8,000,000 |

See accompanying notes to consolidated financial statements.

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

1 Organization

Donegal Mutual Insurance Company (Donegal Mutual) organized us as 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) 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 September 30, 2008, Donegal Mutual held approximately 42% of our outstanding Class A common stock and approximately 74% of our outstanding Class B common stock.

Atlantic States and Donegal Mutual are parties to a pooling agreement under which each company places all of its direct written business in the pool and both companies proportionately share the underwriting results of the pool, excluding certain reinsurance assumed by Donegal Mutual from our other insurance subsidiaries. From July 1, 2000 through February 29, 2008, Atlantic States had a 70% share of the results of the pool, and Donegal Mutual had a 30% share of the results of the pool. Effective March 1, 2008, Donegal Mutual and Atlantic States amended the pooling agreement to increase Atlantic States' share of the results of the pool to 80%. In connection with this amendment to the pooling agreement, Donegal Mutual transferred approximately \$11.9 million in cash and net liabilities to Atlantic States. 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 prices prevailing from time to time in the open market subject to the provisions of Securities and Exchange Commission (SEC) Rule 10b-18 and in privately negotiated transactions. We purchased 4,000 and 32,000 shares of our Class A common stock under this program during the three months ended September 30, 2008 and 2007, respectively. We purchased 144,243 and 165,727 shares of our Class A common stock under this program during the nine months ended September 30, 2008 and 2007, respectively. We have purchased a total of 410,669 shares of our Class A common stock under this program through September 30, 2008.

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 the interim periods included in this Form 10-Q Report. Our results of operations for the nine months ended September 30, 2008 are not necessarily indicative of our results of operations to be expected for the twelve months ending December 31, 2008.

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, 2007.

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. Holders of our Class A common stock are entitled to be paid cash dividends that are at least 10% higher than those declared and paid on our Class B common stock at the same time we

pay dividends 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 (SFAS) 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:

For the Three Months Ended September 30:

| | (dollars in thousands, except per share data) | | | |
|---|---|-----------|------------|-----------|
| | 2008 | | 2007 | |
| | Class A | Class B | Class A | Class B |
| Basic net income per share: | | | | |
| Numerator: | | | | |
| Allocation of net income | \$ 5,768 | \$ 1,455 | \$ 8,930 | \$ 2,282 |
| Denominator: | | | | |
| Weighted-average shares outstanding | 19,882,405 | 5,576,775 | 19,628,405 | 5,576,775 |
| Basic net income per share | \$ 0.29 | \$ 0.26 | \$ 0.45 | \$ 0.41 |
| Diluted net income per share: | | | | |
| Numerator: | | | | |
| Allocation of net income | \$ 5,768 | \$ 1,455 | \$ 8,930 | \$ 2,282 |
| Denominator: | | | | |
| Number of shares used in basic computation | 19,882,405 | 5,576,775 | 19,628,405 | 5,576,775 |
| Weighted-average effect of dilutive securities | | | | |
| Director and employee stock options | 132,787 | | 221,611 | |
| Number of shares used in per share computations | 20,015,192 | 5,576,775 | 19,850,016 | 5,576,775 |
| Diluted net income per share | \$ 0.29 | \$ 0.26 | \$ 0.45 | \$ 0.41 |

For the Nine Months Ended September 30:

| | (dollars in thousands, except per share data) | | | |
|-------------------------------------|---|-----------|------------|-----------|
| | 2008 | | 2007 | |
| | Class A | Class B | Class A | Class B |
| Basic net income per share: | | | | |
| Numerator: | | | | |
| Allocation of net income | \$ 16,629 | \$ 4,212 | \$ 21,886 | \$ 5,597 |
| Denominator: | | | | |
| Weighted-average shares outstanding | 19,849,971 | 5,576,775 | 19,674,869 | 5,576,775 |

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| | | | | | | | | |
|---|----|------------|----|-----------|----|------------|----|-----------|
| Basic net income per share | \$ | 0.84 | \$ | 0.76 | \$ | 1.11 | \$ | 1.00 |
| Diluted net income per share: | | | | | | | | |
| Numerator: | | | | | | | | |
| Allocation of net income | \$ | 16,629 | \$ | 4,212 | \$ | 21,886 | \$ | 5,597 |
| Denominator: | | | | | | | | |
| Number of shares used in basic computation | | 19,849,971 | | 5,576,775 | | 19,674,869 | | 5,576,775 |
| Weighted-average effect of dilutive securities | | | | | | | | |
| Director and employee stock options | | 176,458 | | | | 292,257 | | |
| Number of shares used in per share computations | | 20,026,429 | | 5,576,775 | | 19,967,126 | | 5,576,775 |
| Diluted net income per share | \$ | 0.83 | \$ | 0.76 | \$ | 1.10 | \$ | 1.00 |

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:

| | Nine Months Ended September 30, | | Three Months Ended September 30, | |
|------------------|------------------------------------|-----------|-------------------------------------|-----------|
| | 2008 | 2007 | 2008 | 2007 |
| Number of shares | 1,031,500 | 1,051,667 | 1,028,500 | 1,032,500 |

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. From July 1, 2000 through February 29, 2008, Atlantic States had a 70% share of the results of the pool, and Donegal Mutual had a 30% share of the results of the pool. Effective March 1, 2008, Donegal Mutual and Atlantic States amended the pooling agreement to increase Atlantic States' share of the results of the pool to 80%. In connection with this amendment to the pooling agreement, Donegal Mutual transferred approximately \$11.9 million of cash and net liabilities to Atlantic States. Net liabilities transferred as of March 1, 2008 consisted of the following:

| | |
|--|---------------------------|
| | (dollars in thousands) |
| Unearned premiums (net of reinsurance) | \$ 13,626 |
| Less: Ceding commissions | (1,709) |
| Net liabilities transferred | \$ 11,917 |

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 have in place during 2008:

excess of loss reinsurance, under which losses are automatically reinsured, through a series of contracts, over a set retention (\$600,000 for 2008), and

catastrophe 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 2008).

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.

Our 2008 reinsurance program was renewed at lower rates compared to 2007, largely attributable to our decision to increase our excess of loss reinsurance retention from \$400,000 to \$600,000 effective January 1, 2008. We made no other significant changes to our third-party reinsurance or other reinsurance agreements between our insurance subsidiaries and Donegal Mutual during the nine months ended September 30, 2008.

5 Investments

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at September 30, 2008 as follows:

| | Less than 12 months Fair Value | Unrealized Losses (dollars in thousands) | 12 months or longer Fair Value | Unrealized Losses |
|---|--------------------------------------|--|--------------------------------------|----------------------|
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 6,076 | \$ 24 | \$ | \$ |
| Obligations of states and political subdivisions | 174,259 | 12,843 | 72,709 | 4,554 |
| Corporate securities | 19,483 | 1,360 | 2,644 | 1,128 |
| Mortgage-backed securities | 53,315 | 653 | 6,049 | 87 |
| Equity securities | 3,491 | 377 | | |
| Total | \$ 256,624 | \$ 15,257 | \$ 81,402 | \$ 5,769 |

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at December 31, 2007 as follows:

| | Less than 12 months Fair Value | Unrealized Losses (dollars in thousands) | 12 months or longer Fair Value | Unrealized Losses |
|---|--------------------------------------|--|--------------------------------------|----------------------|
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ | \$ | \$ 41,579 | \$ 181 |
| Obligations of states and political subdivisions | 19,732 | 95 | 15,400 | 101 |
| Corporate securities | 2,326 | 179 | 7,626 | 166 |
| Mortgage-backed securities | | | 23,924 | 267 |
| Equity securities | 8,458 | 1,340 | 2,193 | 870 |
| Total | \$ 30,516 | \$ 1,614 | \$ 90,722 | \$ 1,585 |

Of our total fixed maturity securities with an unrealized loss at September 30, 2008, we classified 251 securities with a fair value of \$288.7 million and an unrealized loss of \$18.5 million as available-for-sale and carried them at fair value on our balance sheet, while we classified 41 securities with a fair value of \$45.8 million and an unrealized loss of \$2.2 million as held-to-maturity on our balance sheet and carried them at amortized cost.

Of our total fixed maturity securities with an unrealized loss at December 31, 2007, we classified 56 securities with a fair value of \$45.5 million and an unrealized loss of \$448,418 as available-for-sale and carried them at fair value on our balance sheet, while we classified 50 securities with a fair value of \$65.1 million and an unrealized loss of \$541,049 as held-to-maturity on our balance sheet and carried them at amortized cost.

We have no direct exposure to sub-prime residential mortgage-backed securities and hold no collateralized debt obligations. Substantially all of the unrealized losses in our fixed maturity investment portfolio resulted from general market conditions and the related impact on our fixed maturity investment valuations. Increases in municipal bond market yields resulted in overall market value declines in our municipal bond holdings as of September 30, 2008. When determining possible impairment of the debt securities we own, we consider unrealized losses that are due to the impact of general market conditions to be temporary in nature because we have the ability and intent to hold the debt securities we own to maturity. We evaluated the near-term prospects of the issuers of those investments in relation to the severity and duration of the impairment. Based upon that evaluation and our ability and intent to hold

those investments for a reasonable period of time sufficient for a recovery of fair value, we did not consider those investments to be other than temporarily impaired at September 30, 2008. We determined that certain investments trading below cost had declined on an other than temporary basis during the third quarter of 2008 and 2007. We included losses of \$328,716 and \$197,500 in net realized investment gains (losses) for these investments in the third quarters of 2008 and 2007, respectively. We determined that certain investments trading below cost had declined on an other than temporary basis during the first nine months of 2008 and

2007. We included losses of \$1.2 million and \$295,500 in net realized investment gains (losses) for these investments in the first nine months of 2008 and 2007, respectively.

6 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 the performance of our insurance subsidiaries. Financial data by segment is as follows:

| | Three Months Ended September 30, 2008 2007 (dollars in thousands) | |
|------------------------------------|---|-----------|
| Revenues: | | |
| Premiums earned: | | |
| Commercial lines | \$ 30,781 | \$ 28,058 |
| Personal lines | 57,390 | 49,552 |
| Net premiums earned | 88,171 | 77,610 |
| Net investment income | 5,802 | 5,813 |
| Realized investment gains (losses) | (2,811) | 488 |
| Other | 1,547 | 1,530 |
| Total revenues | \$ 92,709 | \$ 85,441 |
| Income before income taxes: | | |
| Underwriting income: | | |
| Commercial lines | \$ 3,681 | \$ 4,417 |
| Personal lines | 1,181 | 3,604 |
| SAP underwriting income | 4,862 | 8,021 |
| GAAP adjustments | 578 | 1,059 |
| GAAP underwriting income | 5,440 | 9,080 |
| Net investment income | 5,802 | 5,813 |
| Realized investment gains (losses) | (2,811) | 488 |
| Other | 833 | 312 |
| Income before income taxes | \$ 9,264 | \$ 15,693 |
| | | |
| | Nine Months Ended September 30, 2008 2007 (dollars in thousands) | |
| Revenues: | | |
| Premiums earned: | | |
| Commercial lines | \$ 90,617 | \$ 85,610 |
| Personal lines | 166,891 | 146,273 |

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| | | |
|------------------------------------|------------|------------|
| Net premiums earned | 257,508 | 231,883 |
| Net investment income | 17,287 | 16,879 |
| Realized investment gains (losses) | (2,790) | 654 |
| Other | 4,467 | 4,312 |
| Total revenues | \$ 276,472 | \$ 253,728 |
| Income before income taxes: | | |
| Underwriting income (loss): | | |
| Commercial lines | \$ 10,446 | \$ 15,350 |
| Personal lines | (5,051) | 1,611 |
| SAP underwriting income | 5,395 | 16,961 |
| GAAP adjustments (1) | 5,124 | 2,679 |
| GAAP underwriting income | 10,519 | 19,640 |
| Net investment income | 17,287 | 16,879 |
| Realized investment gains (losses) | (2,790) | 654 |
| Other | 1,709 | 655 |
| Income before income taxes | \$ 26,725 | \$ 37,828 |

- (1) GAAP adjustments for the nine months ended September 30, 2008 included an increase in deferred acquisition costs, which offset the ceding commissions that were included in the transfer of net liabilities from Donegal Mutual discussed in Note 4 Reinsurance.

7 Subordinated Debentures

On May 15, 2003, we received \$15.0 million in net proceeds from the issuance of subordinated debentures. We redeemed these debentures on August 15, 2008.

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 October 29, 2008. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At September 30, 2008, the interest rate on the debentures was 6.64%.

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 May 24, 2009. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At September 30, 2008, the interest rate on the debentures was 6.66%.

8 Share-Based Compensation

Effective January 1, 2006, we adopted SFAS No. 123(R), Share-Based Payment which requires the measurement of all share-based payments to employees, including grants of 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 we utilize 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 we charged against income before income taxes was \$55,518 and \$94,655 for the three months ended September 30, 2008 and 2007, respectively, with a corresponding income tax benefit of \$19,431 and \$33,129, respectively. The compensation expense for our stock compensation plans that we charged against income before income taxes was \$142,214 and \$248,798 for the nine months ended September 30, 2008 and 2007, respectively, with a corresponding income tax benefit of \$49,775 and \$87,079, respectively. As of September 30, 2008, our total unrecognized compensation cost related to nonvested share-based compensation granted under our stock compensation plans was \$320,682. We expect to recognize this cost over a weighted average period of 2.7 years.

SFAS No. 123(R) does not establish 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 we grant share-based compensation to employees of a controlling entity, we 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 we granted to employees and directors of Donegal Mutual, the employer of a majority of the employees that provide services to us. We recorded implied dividends of \$1,709,099 and \$22,282 for the three months ended September 30, 2008 and 2007, respectively. We recorded implied dividends of \$1,749,063 and \$61,441 for the nine months ended September 30, 2008 and 2007, respectively.

We received cash from option exercises under all stock compensation plans for the three months ended September 30, 2008 and 2007 of \$877,773 and \$375,210, respectively. We realized tax benefits for the tax deductions from option exercises of share-based compensation of \$51,459 and \$161,230 for the three months ended September 30, 2008 and 2007, respectively. We received cash from option exercises under all stock compensation plans for the nine months ended September 30, 2008 and 2007 of \$2.3 million and \$504,380, respectively. We realized tax benefits for the tax deductions from option exercises of share-

based compensation of \$683,216 and \$198,965 for the nine months ended September 30, 2008 and 2007, respectively.

9 Fair Value Measurements

As of January 1, 2008, we adopted SFAS No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) and requires expanded disclosures about fair value measurements. SFAS No. 157 establishes a hierarchy that ranks the quality and reliability of inputs, or assumptions, used in the determination of fair value and requires financial assets and liabilities carried at fair value to be classified and disclosed in one of the following three categories:

- Level 1 quoted prices in active markets for identical assets and liabilities
- Level 2 directly or indirectly observable inputs other than Level 1 quoted prices
- Level 3 unobservable inputs not corroborated by market data

For investments that have quoted market prices in active markets, we use the quoted market price as fair value and include these investments in Level 1 of the fair value hierarchy. We classify publicly traded equity securities as Level 1. When quoted market prices in active markets are not available, we use various pricing services to determine fair value and include these investments in Level 2 of the fair value hierarchy. We classify our fixed maturity securities as Level 2. We had no investments classified as Level 3 at September 30, 2008.

We evaluate assets and liabilities on a recurring basis to determine the appropriate level at which to classify them for each reporting period. The following table presents our fair value measurements for our investments in available-for-sale fixed maturity and equity securities as of September 30, 2008:

| | Fair Value | Fair Value Measurements Using | | |
|-------------------------------------|------------|--|---|---|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Fixed maturities available for sale | \$ 414,296 | \$ | \$ 414,296 | \$ |
| Equity securities | 14,758 | 8,508 | 6,250 | |
| Total | \$ 429,054 | \$ 8,508 | \$ 420,546 | \$ |

We also adopted FASB Staff Position (FSP) No. 157-2, which allowed us to defer the effective date of SFAS No. 157 for certain nonfinancial assets and liabilities to January 1, 2009.

10 Impact of New Accounting Standards

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, which permits companies to choose to measure many financial instruments and certain other items at fair value at specified election dates. Upon adoption, an entity reports 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. Effective January 1, 2008, we adopted SFAS No. 159. The adoption of SFAS No. 159 had no effect on our results of operations, financial condition or liquidity.

On October 10, 2008, the FASB issued FSP No. 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active. FSP No. 157-3 clarifies the application of SFAS No. 157 in a market that is not

active. FSP No. 157-3 was effective upon issuance, including prior periods for which financial statements had not been issued. The Company adopted the provisions of FSP No. 157-3 effective September 30, 2008.

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

You should read the following information 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, 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 GAAP.

Our insurance subsidiaries make estimates and assumptions that can have a significant effect on amounts and disclosures that 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 amounts estimated. 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 those 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, including prevailing economic conditions. 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 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 we change our estimates.

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 those 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.

Our liability 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, 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 those changes in their liabilities. Accordingly, our insurance subsidiaries' ultimate liability for unpaid losses and loss expenses will

likely differ from the amount recorded at September

30, 2008. For every 1% change in our estimate of our insurance subsidiaries' liability for losses and loss expenses, 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, we cannot predict the timing, frequency and extent of adjustments to our insurance subsidiaries' estimated future liabilities, 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. We may have to make adjustments 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 proportionately share any adverse risk development of the pooled business. 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 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. The risk profiles of the business written by Atlantic States and Donegal Mutual historically have been, and continue to be, substantially similar. The same management and underwriting personnel determine and administer the products, classes of business underwritten, pricing practices and underwriting standards of both companies. 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 marketed 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 products compared to standard tier products, but we do not allocate all of the standard risk gradients to one company. Therefore, the underwriting profitability of the business directly written by the individual companies will vary. However, as 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 each company's participation level, each company realizes its pro rata share of the underwriting results of the pool.

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Our insurance subsidiaries liability for losses and loss expenses by major line of business as of September 30, 2008 and December 31, 2007 consisted of the following:

| | September 30, 2008 | December 31, 2007 |
|--|--------------------------|-------------------------|
| | (dollars in thousands) | |
| Commercial lines: | | |
| Automobile | \$ 18,403 | \$ 20,274 |
| Workers compensation | 36,486 | 36,309 |
| Commercial multi-peril | 28,882 | 24,847 |
| Other | 1,585 | 1,780 |
| Total commercial lines | 85,356 | 83,210 |
| Personal lines: | | |
| Automobile | 58,567 | 55,796 |
| Homeowners | 11,291 | 10,121 |
| Other | 1,968 | 1,025 |
| Total personal lines | 71,826 | 66,942 |
| Total commercial and personal lines | 157,182 | 150,152 |
| Plus reinsurance recoverable | 84,966 | 76,280 |
| Total liability for losses and loss expenses | \$ 242,148 | \$ 226,432 |

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 the loss and loss expense reserves of our insurance subsidiaries. We established the range of reasonably likely changes based on a review of changes in accident year development by line of business and applied those changes 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 the most likely scenario. The following table sets forth the estimated 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 | | Adjusted Loss and Loss Expense Reserves Net of Reinsurance as of | |
|---|--|--|--|---|
| | September 30, | Percentage Change in Equity as of September 30, | September 30, | Percentage Change in Equity as of December 31, |
| | | | | |

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| Reinsurance | 2008 | 2008(1) | December 31, 2007 | 2007(1) |
|-------------|------------------------|---------|----------------------|---------|
| | (dollars in thousands) | | | |
| (10.0)% | \$ 141,464 | 2.9% | \$ 135,137 | 2.8% |
| (7.5) | 145,393 | 2.2 | 138,891 | 2.1 |
| (5.0) | 149,323 | 1.4 | 142,644 | 1.4 |
| (2.5) | 153,252 | 0.7 | 146,398 | 0.7 |
| Base | 157,182 | | 150,152 | |
| 2.5 | 161,112 | -0.7 | 153,906 | -0.7 |
| 5.0 | 165,041 | -1.4 | 157,660 | -1.4 |
| 7.5 | 168,971 | -2.2 | 161,413 | -2.1 |
| 10.0 | 172,900 | -2.9 | 165,167 | -2.8 |

(1) Net of income tax effect.

Investments

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 fair value, and we reflect the amount of the write-down 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 such an unrealized loss position for more than six months, we assume there has been an other than temporary decline in value. We held 14 equity securities that were in an unrealized loss position at September 30, 2008. A substantial number of these equity securities have declined in value by less than 20% of original cost or have been in an unrealized loss position for less than six months. Certain of these equity securities have declined in value by more than 20% of original cost but have traded at a value exceeding 80% of original cost within the past six months or have been in an unrealized loss position for more than six months but have declined in value by less than 20% of original cost. Based upon our analysis of general market conditions and underlying factors impacting these equity securities, we consider these declines in value to be temporary. 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 nine months of 2008 and 2007. We included losses of \$1.2 million and \$295,500 in net realized investment gains (losses) in our results of operations for these investments in the first nine months of 2008 and 2007, 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 primarily 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.

Results of Operations Three Months Ended September 30, 2008 Compared to Three Months Ended September 30, 2007

Net Premiums Written. Net premiums written for the three months ended September 30, 2008 were \$92.2 million, an increase of \$12.3 million, or 15.4%, over the \$79.9 million of net premiums written for the comparable period in 2007. Net premiums written in the third quarter of 2008 reflected the impact of the increased pooling allocation of approximately \$7.5 million. Net premiums written during the third quarter also benefited from the renewal of our 2008 reinsurance program at lower rates compared to 2007. The lower reinsurance rates were largely due to our decision to increase our per loss retention from \$400,000 to \$600,000 effective January 1, 2008. Personal lines net premiums written increased \$8.3 million, or 15.2%, in the third quarter of 2008 compared to the comparable period in 2007. Commercial lines net premiums written increased \$3.9 million, or 15.6%, in the third quarter of 2008 compared to the comparable period in 2007.

Net Premiums Earned. Net premiums earned increased to \$88.2 million for the third quarter of 2008, an increase of \$10.6 million, or 13.6%, over the third quarter of 2007. 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. Net premiums earned in the third quarter of 2008 reflected the impact of the increased pooling allocation of approximately \$7.5 million and benefited from the renewal of our 2008 reinsurance program at lower rates compared to 2007.

Investment Income. For the three months ended September 30, 2008 and 2007, our net investment income was \$5.8 million. Average invested assets increased from \$593.2 million in the third quarter of 2007 to \$621.2 million in the third quarter of 2008. The decrease in our annualized average rate of return on investments was primarily due to

increased short-term investments in lower yielding U.S. Treasury securities during the third quarter of 2008.

Net Realized Investment Gains (Losses). Net realized investment losses in the third quarter of 2008 were \$2.8 million, compared to net realized investment gains of \$488,226 for the comparable period in 2007. Realized investment losses in the third quarter of 2008 included \$1.4 million from the sale of fixed and equity securities, including all of our holdings of Fannie Mae and Freddie Mac preferred stocks, and an amount of \$1.1 million representing our pro rata share of investment losses in a limited partnership investment that is solely invested in equity securities. During the third quarter of 2008 and 2007, we included impairment losses of \$328,716 and \$197,500, respectively, in net realized investment gains (losses).

Losses and Loss Expenses. Our loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, for the third quarter of 2008 was 60.4%, an increase from our 52.8% loss ratio for the third quarter of 2007. We experienced increased weather-related claim activity and reduced favorable loss development in the third quarter of 2008 compared to the comparable period in 2007. Our commercial lines loss ratio increased to 55.7% for the third quarter of 2008, compared to 49.1% for the third quarter of 2007, primarily due to increases in our commercial multi-peril and workers' compensation loss ratios. Our personal lines loss ratio increased from 55.2% for the third quarter of 2007 to 62.6% for the third quarter of 2008 primarily due to increases in our homeowners and private passenger automobile loss ratios.

Underwriting Expenses. Our expense ratio, which is the ratio of policy acquisition costs and other underwriting expenses to premiums earned, for the third quarter of 2008 and 2007 was 33.0% and 35.0%, respectively. Our expense ratio reflected a higher premium base and decreased expenses incurred for underwriting-based incentive compensation costs as a result of higher loss ratios compared to the comparable period in 2007.

Combined Ratio. Our combined ratio was 93.8% and 88.3% for the three months ended September 30, 2008 and 2007, respectively. Our combined ratio represents the sum of our loss ratio, expense ratio and dividend ratio, which is the ratio of workers' compensation policy dividends incurred to premiums earned.

Interest Expense. Interest expense for the third quarter of 2008 was \$398,855 compared to \$733,558 for the third quarter of 2007. The lower interest expense reflected the redemption of \$15.5 million of subordinated debentures in August 2008 and a decrease in average interest rates on our subordinated debentures in the third quarter of 2008 compared to the comparable period in 2007.

Income Taxes. Income tax expense was \$2.0 million for the third quarter of 2008, representing an effective tax rate of 22.0%, compared to \$4.5 million for the third quarter of 2007, representing an effective tax rate of 28.6%. 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 2008 period compared to the 2007 period.

Net Income and Earnings Per Share. Our net income for the third quarter of 2008 was \$7.2 million, or \$.29 per share of Class A common stock on a diluted basis and \$.26 per share of Class B common stock, compared to net income of \$11.2 million, or \$.45 per share of Class A common stock on a diluted basis and \$.41 per share of Class B common stock, reported for the third quarter of 2007. Our diluted Class A shares outstanding for the third quarter of 2008 increased to 20.0 million, compared to 19.9 million for the third quarter of 2007. We had 5.6 million Class B shares outstanding for both periods.

Results of Operations – Nine Months Ended September 30, 2008 Compared to Nine Months Ended September 30, 2007

Net Premiums Written. Net premiums written for the nine months ended September 30, 2008 were \$286.3 million, an increase of \$43.4 million, or 17.9%, over the comparable period in 2007. Net premiums written for the first nine months of 2008 included a \$13.6 million transfer of unearned premiums related to the change in the pooling agreement between Atlantic States and Donegal Mutual effective March 1, 2008. Net premiums written in the first nine months of 2008 also reflected the impact of the increased pooling allocation of approximately \$18.0 million and benefited from the renewal of our 2008 reinsurance program at lower rates compared to 2007. The lower reinsurance rates were largely due to our decision to increase our per loss retention from \$400,000 to \$600,000 effective January 1, 2008. Commercial lines net premiums written increased \$13.7 million, or 15.6%, in the first nine months of 2008 compared to the comparable period in 2007. Personal lines net premiums written increased \$29.7 million, or 19.2%, in the first nine months of 2008 compared to the comparable period in 2007.

Net Premiums Earned. Net premiums earned increased to \$257.5 million for the first nine months of 2008, an increase of \$25.6 million, or 11.0%, over the first nine months of 2007. 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. Net premiums earned in the first nine months of 2008 reflected the impact of the increased pooling allocation of approximately \$17.0 million and benefited from the renewal of our 2008 reinsurance program at lower rates compared to 2007.

Investment Income. For the nine months ended September 30, 2008, our net investment income increased 2.4% to \$17.3 million, compared to \$16.9 million for the comparable period one year ago. An increase in average invested assets from \$594.1 million in the first nine months of 2007 to \$615.0 million in the first nine months of 2008 accounted for the increase in net investment income.

Net Realized Investment Gains (Losses). Net realized investment losses in the first nine months of 2008 were \$2.8 million, compared to net realized gains of \$653,656 for the comparable period in 2007. Realized investment losses in the first nine months of 2008 included \$1.4 million from the sale of fixed maturities and equity securities, including all of our holdings of Fannie Mae and Freddie Mac preferred stocks, and an amount of \$1.1 million representing our pro rata share of investment losses in a limited partnership investment that is solely invested in equity securities. We recognized impairment charges of \$1.2 million in the first nine months of 2008, compared to impairment charges of \$295,500 recognized in the first nine months of 2007. 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 of our investment portfolio.

Losses and Loss Expenses. Our loss ratio in the first nine months of 2008 was 62.9%, compared to 57.0% in the first nine months of 2007. Losses and loss expenses increased for the first nine months of 2008 as we experienced increased weather-related claim activity and reduced favorable loss reserve development compared to the comparable period in 2007. Our commercial lines loss ratio increased to 54.7% in the first nine months of 2008, compared to 47.8% in the first nine months of 2007, primarily due to increases in our workers' compensation and commercial multi-peril loss ratios. Our personal lines loss ratio increased from 62.5% in the first nine months of 2007 to 67.6% in the first nine months of 2008 primarily due to increases in our homeowners and private passenger automobile loss ratios.

Underwriting Expenses. Our expense ratio for the first nine months of 2008 was 32.6%, compared to 34.2% in the first nine months of 2007. Our expense ratio reflected decreased expenses incurred for underwriting-based incentive compensation costs as a result of higher loss ratios compared to the comparable period in 2007.

Combined Ratio. Our combined ratio was 95.9% and 91.5% for the nine months ended September 30, 2008 and 2007, respectively. Our combined ratio represents the sum of our loss ratio, expense ratio and dividend ratio. The increase in our combined ratio was largely attributable to the increase in our loss ratio for the 2008 period compared to the 2007 period.

Interest Expense. Interest expense for the first nine months of 2008 was \$1.5 million compared to \$2.2 million for the first nine months of 2007. The lower interest expense reflected the redemption of \$15.5 million of subordinated debentures in August 2008 and a decrease in average interest rates on our subordinated debentures in the first nine months of 2008 compared to the comparable period in 2007.

Income Taxes. Income tax expense was \$5.9 million for the first nine months of 2008, representing an effective tax rate of 22.0%, compared to \$10.3 million for the first nine months of 2007, representing an effective tax rate of 27.3%. 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 2008 period compared to the 2007 period.

Net Income and Earnings Per Share. Our net income for the first nine months of 2008 was \$20.8 million, or \$.83 per share of Class A common stock on a diluted basis and \$.76 per share of Class B common stock, compared to our net income of \$27.5 million, or \$1.10 per share of Class A common stock on a diluted basis and \$1.00 per share of Class B common stock, for the first nine months of 2007. Our diluted Class A and Class B shares outstanding were 20.0 million and 5.6 million, respectively, for both periods.

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 between Donegal Mutual and Atlantic States has historically 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 nine months of 2008 and 2007 were \$48.5 million and \$25.1 million, respectively. The net cash flows provided by operating activities in the first nine months of 2008 included an \$11.9 million transfer of cash from Donegal Mutual discussed in Note 4 Reinsurance.

We maintain a credit agreement with Manufacturers and Traders Trust Company (M&T) relating to a \$35.0 million unsecured, revolving line of credit that will expire in July 2010. As of September 30, 2008, 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 credit 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 nine months ended September 30, 2008, 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 September 30, 2008.

| | Total | Less than 1 year | 1-3 years | 4-5 years | After 5 years |
|---|------------|------------------------|-----------|-----------|---------------|
| | | (dollars in thousands) | | | |
| Net liability for unpaid losses and loss expenses of our insurance subsidiaries | \$ 157,182 | \$ 71,497 | \$ 68,545 | \$ 7,667 | \$ 9,473 |
| Subordinated debentures | 15,465 | | | | 15,465 |
| Total contractual obligations | \$ 172,647 | \$ 71,497 | \$ 68,545 | \$ 7,667 | \$ 24,938 |

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. Cash settlement of Atlantic States' assumed liability from the pool is included in monthly settlements of pooled activity, as we net amounts ceded to and assumed from the pool. 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. Our subordinated debentures carry interest rates that vary based upon the three-month LIBOR rate and adjust quarterly. Based upon the interest rates in effect as of September 30, 2008, our annual interest cost associated with our subordinated debentures is approximately \$1.0 million. For every 1% change in the three-month LIBOR rate, the effect on our annual interest cost would be approximately \$150,000. We redeemed subordinated debentures in the amount of \$15,464,000 on August 15, 2008.

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. We purchased 4,000 and 32,000 shares of our Class A common stock under this program during the three months ended September 30, 2008 and 2007, respectively. We purchased 144,243 and 165,727 shares of our Class A common stock under this program during the nine months ended September 30, 2008 and 2007, respectively. We have purchased a total of 410,669 shares of our Class A common stock under this program through September 30, 2008.

On October 16, 2008, our board of directors declared quarterly cash dividends of 10.5 cents per share for our Class A common stock and 9.25 cents per share for our Class B common stock, payable November 17, 2008 to stockholders of record as of the close of business on November 3, 2008. There are no regulatory restrictions on the payment of dividends to our stockholders, although there are state law restrictions on the payment of annual dividends greater than 10% of statutory surplus from our insurance subsidiaries to us. Our insurance subsidiaries are required by law to maintain certain minimum surplus on a statutory basis and require prior approval of the applicable domiciliary insurance regulatory authorities for dividends in excess of 10% of statutory surplus. Our insurance subsidiaries are subject to risk-based capital (RBC) requirements. At December 31, 2007, our insurance subsidiaries capital levels were each substantially above the applicable RBC requirements. At January 1, 2008, amounts available for distribution as dividends to us from our insurance subsidiaries without prior approval of their domiciliary insurance regulatory authorities were \$24.1 million from Atlantic States, \$5.0 million from Southern, \$5.1 million from Le Mars and \$3.7 million from Peninsula. Atlantic States paid a \$10.0 million dividend to us on August 11, 2008. All other amounts remained available at September 30, 2008.

As of September 30, 2008, 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, which we define 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 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. We bill the majority of this business 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 with Donegal Mutual and with a number of other major unaffiliated authorized reinsurers.

Impact of Inflation

We establish property and casualty insurance premium rates before we know the amount of losses and loss expenses, or the extent to which inflation may impact such expenses. Consequently, our insurance subsidiaries attempt, in establishing rates, to anticipate the potential impact of inflation.

Risk Factors

Our business, results of operations and financial condition, and, therefore, the value of our Class A common stock and Class B common stock, are subject to a number of risks. For a description of certain risks, we refer to our 2007 Annual Report on Form 10-K filed with the SEC on March 13, 2008.

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 our liabilities, i.e., policy claims of our insurance subsidiaries and debt obligations.

Our investment mix has shifted slightly due to our continuing shift from taxable to tax-exempt fixed maturity investments and a shift from equity securities to short-term investments during 2008. We have maintained approximately the same duration of our investment portfolio to our liabilities from December 31, 2007 to September 30, 2008.

There have been no material changes to our quantitative or qualitative market risk exposure from December 31, 2007 through September 30, 2008.

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 SEC 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 SEC is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

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 Form 10-Q report that has materially affected, or is reasonably likely to affect materially, 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 2008 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, 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.

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 July 1-31, 2008 | Class A | None | Class A | None | Class A | None | |
| | Class B | None | Class B | None | Class B | None | |
| Month #2 August 1-31, 2008 | Class A | None | Class A | None | Class A | None | |
| | Class B | 1,001 | Class B | \$20.00 | Class B | 1,001 | (2) |
| Month #3 September 1-30, 2008 | Class A | 4,000 | Class A | \$18.00 | Class A | 4,000 | |
| | Class B | None | Class B | None | Class B | None | (1) |
| Total | Class A | 4,000 | Class A | \$18.00 | Class A | 4,000 | |
| | Class B | 1,001 | Class B | \$20.00 | Class B | 1,001 | |

(1) 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. We may purchase up to 89,331 additional shares of our Class A common stock under this stock repurchase program.

- (2) 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 stock repurchase program.

Item 3. Defaults upon Senior Securities.

None.

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

None.

Item 5. Other Information.

None.

Item 6. Exhibits.

| 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 |

Signatures

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

DONEGAL GROUP INC.

November 6, 2008

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

November 6, 2008

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