

DONEGAL GROUP INC
Form 424B3
September 12, 2003

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

DONEGAL GROUP INC.

2001 AGENCY STOCK PURCHASE PLAN

PROSPECTUS SUPPLEMENT
TO PROSPECTUS DATED APRIL 12, 2002

On August 14, 2003, Donegal Group Inc. (the "Company") filed with the Securities and Exchange Commission a Form 10-Q Quarterly Report for the quarter ended June 30, 2003, a copy of which, without exhibits, is attached to this Prospectus Supplement.

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

The date of this Prospectus Supplement is September 12, 2003.

FORM 10-Q
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

(Mark One)

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2003

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

Edgar Filing: DONEGAL GROUP INC - Form 424B3

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)

N/A

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 6,303,749 shares of Class A Common Stock, \$0.01 par value, and 3,000,119 shares of Class B Common Stock, \$0.01 par value, outstanding on July 31, 2003.

Part 1. Financial Information

Item 1. Financial Statements.

DONEGAL GROUP INC. AND SUBSIDIARIES
 CONSOLIDATED BALANCE SHEETS

JUNE 30, 2003

 UNAUDITED)

ASSETS

Investments

Fixed maturities

Held to maturity, at amortized cost	\$106,780,904
Available for sale, at market value	186,684,612
Equity securities, available for sale, at market	22,638,130
Short-term investments, at cost, which approximates market	45,352,263

 Total investments 361,455,909

Cash	2,325,997
Accrued investment income	3,598,588
Premiums receivable	29,153,913
Reinsurance receivable	78,865,210

Edgar Filing: DONEGAL GROUP INC - Form 424B3

Deferred policy acquisition costs	15,520,953
Federal income tax receivable	227,921
Deferred federal income taxes	6,510,732
Prepaid reinsurance premiums	31,803,291
Property and equipment, net	4,263,789
Accounts receivable-- securities	--
Due from affiliate	1,776,477
Other	930,174

Total assets	\$536,432,954
	=====

LIABILITIES AND STOCKHOLDERS' EQUITY

LIABILITIES

Losses and loss expenses	\$209,649,451
Unearned premiums	132,113,381
Accrued expenses	6,195,006
Reinsurance balances payable	1,460,688
Federal income taxes payable	--
Cash dividend declared to stockholders	--
Borrowings under line of credit	12,800,000
Subordinate debt	15,000,000
Accounts payable-- securities	9,009,113
Due to affiliate	4,441,311
Other	1,892,204

Total liabilities	392,561,154

STOCKHOLDERS' EQUITY

Preferred stock, \$1.00 par value, authorized 2,000,000 shares; none issued	
Class A common stock, \$.01 par value, authorized 30,000,000 shares, issued 6,369,829 and 6,269,093 shares and outstanding 6,288,305 and 6,187,569 shares	63,698
Class B common stock, \$.01 par value, authorized 10,000,000 shares, issued 3,037,549 and 3,024,742 shares and outstanding 2,996,787 and 2,983,980 shares	30,375
Additional paid-in capital	62,748,296
Accumulated other comprehensive income	6,321,664
Retained earnings	75,599,515
Treasury stock	(891,748)

Total stockholders' equity	143,871,800

Total liabilities and stockholders' equity	\$536,432,954
	=====

See accompanying notes to consolidated financial statements.

Edgar Filing: DONEGAL GROUP INC - Form 424B3

	SIX MONTHS ENDED
	2003

REVENUES	
Net premiums earned	\$ 96,362,570
Investment income, net of investment expenses	6,680,228
Realized investment gains	85,890
Lease income	413,732
Service charge income	1,263,967
Other income	205,850

Total revenues	105,012,237

EXPENSES	
Net losses and loss expenses	61,508,981
Amortization of deferred policy acquisition costs	14,987,000
Other underwriting expenses	14,292,423
Policy dividends	469,157
Interest	521,531
Other expenses	675,228

Total expenses	92,454,320

Income before income taxes	12,557,917
Income taxes	3,444,532

Net income	\$ 9,113,385
	=====
Earnings per common share	
Basic	\$ 0.99
	=====
Diluted	\$ 0.97
	=====

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

	SIX MONTHS ENDED J
	2003

Net income	\$9,113,385
Other comprehensive income, net of tax	
Unrealized gains on securities:	
Unrealized holding gain during the period,	
net of income tax	1,465,540
Reclassification adjustment, net of income tax	(55,829)

Other comprehensive income	1,409,711

Comprehensive income	\$10,523,096
	=====

See accompanying notes to consolidated financial statements.

Edgar Filing: DONEGAL GROUP INC - Form 424B3

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

	THREE MONTHS ENDED 2003

REVENUES:	
Net premiums earned	\$48,433,689
Investment income, net of investment expenses	3,315,710
Realized investment gains	216,370
Lease income	211,115
Service charge income	649,934

Total revenues	52,826,818

EXPENSES:	
Net losses and loss expenses	29,658,466
Amortization of deferred policy acquisition costs	7,545,000
Other underwriting expenses	7,269,206
Policy dividends	227,314
Interest	306,790
Other expenses	344,652

Total expenses	45,351,428

Income before income taxes	7,475,390
Income taxes	2,206,437

Net income	\$ 5,268,953
	=====
Earnings per common share	
Basic	\$0.57
	=====
Diluted	\$0.56
	=====

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

	THREE MONTHS ENDED 2003

Net income	\$5,268,953
Other comprehensive income, net of tax	
Unrealized gains on securities:	
Unrealized holding gain during the period, net of income tax	1,566,233
Reclassification adjustment, net of income tax	(140,641)

Other comprehensive income	1,425,592

Comprehensive income	\$ 6,694,545
	=====

Edgar Filing: DONEGAL GROUP INC - Form 424B3

See accompanying notes to consolidated financial statements.

3

DONEGAL GROUP INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(Unaudited)
SIX MONTHS ENDED JUNE 30, 2003

	CLASS A SHARES	CLASS B SHARES	CLASS C SHARES
Balance, December 31, 2002	6,269,093	3,024,742	
Issuance of common stock	100,736	12,807	
Net income			
Cash dividends			
Grant of stock options			
Exercise of stock options			
Other comprehensive income			
Balance, June 30, 2003	6,369,829	3,037,549	

	ADDITIONAL PAID-IN CAPITAL	ACCUMULATED OTHER COMPREHENSIVE INCOME	RETAINED EARNINGS
Balance, December 31, 2002	\$60,651,751	\$4,911,953	\$68,417,956
Issuance of common stock	1,077,286		
Net income			9,113,385
Cash dividends			(990,218)
Grant of stock options	941,608		(941,608)

Edgar Filing: DONEGAL GROUP INC - Form 424B3

Exercise of stock options	77,651		
Other comprehensive income		1,409,711	
Balance, June 30, 2003	\$62,748,296	\$6,321,664	\$75,599,515

See accompanying notes to consolidated financial statements

4

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

	SIX MONTHS END 2003

CASH FLOWS FROM OPERATING ACTIVITIES:	
Net income	\$ 9,113,385

Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	794,070
Realized investment gains	(85,890)
Changes in assets and liabilities:	
Losses and loss expenses	(1,042,301)
Unearned premiums	11,110,934
Premiums receivable	(2,867,431)
Deferred policy acquisition costs	(953,883)
Deferred income taxes	(386,069)
Reinsurance receivable	4,342,062
Prepaid reinsurance premiums	(3,949,295)
Accrued investment income	216,861
Due to affiliate	(1,415,581)
Reinsurance balances payable	360,245
Current income taxes	(585,468)
Accrued expenses	(388,819)
Other, net	83,668

Net adjustments	5,233,103

Net cash provided by operating activities	14,346,488

CASH FLOWS FROM INVESTING ACTIVITIES:	
Purchase of fixed maturities	
Held to maturity	(24,963,165)
Available for sale	(42,998,272)
Purchase of equity securities, available for sale	(8,240,320)
Maturity of fixed maturities	
Held to maturity	10,692,008
Available for sale	49,017,841
Sale of fixed maturities	
Held to maturity	--

Edgar Filing: DONEGAL GROUP INC - Form 424B3

Available for sale	4,297,187
Sale of equity securities, available for sale	8,261,206
Net purchase of property and equipment	(167,274)
Net sale (purchase) of short-term investments	(16,322,845)

Net cash used in investing activities	(20,423,634)

CASH FLOWS FROM FINANCING ACTIVITIES:	
Cash dividends paid	(1,877,533)
Issuance of common stock	1,156,072
Issuance of subordinate debt	15,000,000
Line of credit, net	(7,000,000)

Net cash provided by (used in) financing activities	7,278,539

Net increase (decrease) in cash	1,201,393
Cash at beginning of period	1,124,604

Cash at end of period	\$ 2,325,997
	=====
Cash paid during period--Interest	\$ 368,581
Net cash paid during period--Taxes	\$ 4,330,000

See accompanying notes to consolidated financial statements.

5

DONEGAL GROUP INC. AND SUBSIDIARIES (UNAUDITED) SUMMARY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1 - ORGANIZATION

Donegal Group Inc. (the "Company") was organized as a regional insurance holding company by Donegal Mutual Insurance Company (the "Mutual Company") on August 26, 1986 and operates in the Mid-Atlantic and Southern states through its wholly owned insurance subsidiaries, Atlantic States Insurance Company ("Atlantic States") and Southern Insurance Company of Virginia ("Southern") (collectively, the "Insurance Subsidiaries"). The Company has three operating segments: the investment function, the personal lines of insurance and the commercial lines of insurance. Products offered in the personal lines of insurance consist primarily of homeowners and private passenger automobile policies. Products offered in the commercial lines of insurance consist primarily of commercial automobile, commercial multiple peril and workers' compensation policies. The Insurance Subsidiaries are subject to regulation by Insurance Departments in those states in which they operate and undergo periodic examinations by those departments. The Insurance Subsidiaries are also subject to competition from other insurance companies in their operating areas. Atlantic States participates in an inter-company pooling arrangement with the Mutual Company and assumes 70% of the pooled business. At June 30, 2003, the Mutual Company held approximately 66% of the outstanding Class A and approximately 62% of the outstanding Class B common stock of the Company.

Prior to 2002, Southern ceded 50% of its business to the Mutual Company. On January 1, 2002, the Mutual Company and Southern terminated their quota share agreement, under which Southern ceded 50% of its direct business, less reinsurance, to the Mutual Company. As a result of this termination, the Company's prepaid reinsurance premiums decreased \$7,310,471, unearned premiums decreased \$5,117,330, and deferred policy acquisition costs increased \$714,853.

Edgar Filing: DONEGAL GROUP INC - Form 424B3

The Mutual Company transferred \$1,478,288 in cash to the Company related to this termination. The Company did not recognize a gain or loss on this transaction.

As of June 30, 2003 the Company owns 47.5% of the outstanding stock of Donegal Financial Services Corporation ("DFSC"), a thrift holding company, which it acquired for \$3,042,000 in cash during 2000 and \$3,500,000 of cash in June of 2003. The remaining 52.5% of the outstanding stock of DFSC is owned by the Mutual Company.

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

Southern has (and Delaware, Pioneer-Ohio, Southern Heritage and Pioneer-New York had prior to their mergers) an agreement with the Mutual Company under which it cedes, and then reassumes back, 100% of its business net of reinsurance. The primary purpose of these agreements is to assist Southern and the former subsidiaries in maintaining the same A.M. Best rating (currently "A") as the Mutual Company. These agreements do not transfer insurance risk. While these subsidiaries ceded and reassumed amounts received from policyholders of \$23,178,704 and \$25,183,072 and claims of \$14,632,880 and \$15,270,392 under these agreements in the six months ended June 30, 2003 and 2002, respectively, the amounts are not reflected in the consolidated financial statements. The aggregate liabilities ceded and reassumed under these agreements were \$44,167,212 and \$43,541,766 at June 30, 2003 and December 31, 2002, respectively.

2 - BASIS OF PRESENTATION

The financial information for the interim periods included herein are unaudited; however, such information reflects all adjustments, consisting only of normal recurring adjustments, that, in the opinion of management, are necessary to a fair presentation of the Company's financial position, results of operations and cash flows for the interim periods included herein. The Company's results of operations for the six months ended June 30, 2003 are not necessarily indicative of its results of operations for the twelve months ending December 31, 2003.

6

These financial statements should be read in conjunction with the financial statements and notes thereto contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2002

3 - EARNINGS PER SHARE

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

NET	WEIGHTED AVERAGE SHARES	EARNINGS PER SHARE
-----	-------------------------------	--------------------------

Edgar Filing: DONEGAL GROUP INC - Form 424B3

	INCOME -----	OUTSTANDING -----	SHARE -----
THREE MONTHS ENDED JUNE 30:			
2003			
Basic	\$5,268,953	9,269,029	\$.57
Effect of stock options	---	155,021	(.01)
	-----	-----	-----
Diluted	\$5,268,953	9,424,050	\$.56
	=====	=====	-----
2002			
Basic	\$3,178,834	9,059,477	\$.35
Effect of stock options	---	116,252	---
	-----	-----	-----
Diluted	\$3,178,834	9,175,729	\$.35
	=====	=====	-----
SIX MONTHS ENDED JUNE 30:			
2003			
Basic	\$9,113,385	9,239,878	\$.99
Effect of stock options	---	137,736	(.02)
	-----	-----	-----
Diluted	\$9,113,385	9,377,614	\$.97
	=====	=====	-----
2002			
Basic	\$5,359,550	9,044,899	\$.59
Effect of stock options	---	105,309	---
	-----	-----	-----
Diluted	\$5,359,550	9,150,208	\$.59
	=====	=====	-----

The following options to purchase shares of common stock were not included in the computation of diluted earnings per share because the exercise price of the options was greater than the average market price during the relevant period:

	FOR THE THREE MONTHS ENDED JUNE 30,		FOR THE SIX MONTHS ENDED JUNE 30,	
	2003	2002	2003	2002
	-----	-----	-----	-----
Number of Options	1,117,500	941,501	1,117,500	941,501
	=====	=====	=====	=====

4 - SEGMENT INFORMATION

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

Edgar Filing: DONEGAL GROUP INC - Form 424B3

7

	THREE MONTHS ENDED JUN 2003	
	----- (\$ in thousands)	
Revenues:		
Premiums earned:		
Commercial lines	\$ 17,338	\$
Personal lines	31,096	
	-----	-----
Total net premiums earned	48,434	
	-----	-----
Net investment income, net of investment expense	3,316	
Realized investment gain	216	
Other	861	
	-----	-----
Total revenues	\$ 52,827	\$
	=====	=====
Income before income taxes:		
Underwriting income (loss)		
Commercial lines	\$ 1,902	\$
Personal lines	1,329	
	-----	-----
SAP underwriting income (loss)	3,231	
GAAP adjustments	503	
	-----	-----
GAAP underwriting income	3,734	
Net investment income, net of investment expense	3,316	
Realized investment gain	216	
Other	209	
	-----	-----
Income before income taxes	\$ 7,475	\$
	=====	=====
	SIX MONTHS ENDED JUNE 2003	
	----- (\$ in thousands)	
Revenues:		
Premiums earned:		
Commercial lines	\$ 34,643	\$
Personal lines	61,720	
	-----	-----
Total net premiums earned	96,363	
	-----	-----
Net investment income, net of investment expense	6,680	
Realized investment gain	86	
Other	1,883	
	-----	-----
Total revenues	\$ 105,012	\$
	=====	=====
Income before income taxes:		
Underwriting income (loss)		
Commercial lines	\$ 4,255	\$

Edgar Filing: DONEGAL GROUP INC - Form 424B3

Personal lines	191	

SAP underwriting income (loss)	4,446	
GAAP adjustments	659	

GAAP underwriting income (loss)	5,105	
Net investment income, net of investment expense	6,680	
Realized investment gain	86	
Other	687	

Income before income taxes	\$ 12,558	\$
	=====	=====

5- SUBORDINATE DEBT

On May 15, 2003 the Company received \$15,000,000 as proceeds from the issuance of a floating rate junior subordinate debenture. The debenture matures on May 15, 2033 and is callable by the Company, at par, after five years. The debenture carries an interest rate equal to the three-month LIBOR rate plus 4.10% and is adjustable quarterly. At June 30, 2003 the interest rate on this debenture was 5.41%, which rate will first be subject to adjustment on August 15, 2003.

8

6- STOCK-BASED COMPENSATION PLANS

The Company accounts for Stock-based compensation plans under the provisions of Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. During 2001 the company adopted an Equity Incentive Plan for key employees that made 1,500,000 shares of Class A common stock available. The plan provides for the granting of awards by the Board of Directors in the form of stock options, stock appreciation rights, restricted stock or any combination of the above. During 2001 the Company also adopted an Equity incentive plan for Directors that made 200,000 shares of Class A common stock available. Awards may be made in the form of stock options, and the plan additionally provides for the issuance of 175 shares of restricted stock to each director on the first business day of January in each year. No stock-based employee compensation is reflected in income, except for expense associated with restricted stock issued, as all options granted under those plans had an exercise price equal to, or greater than, the market value of the underlying common stock on the date of the grant. The following table illustrates the effect on net income and earnings per share as if the Company had applied the provisions of statement of Financial Accounting Standards (SFAS) No. 123 (as amended by SFAS No. 148), "Accounting for Stock-Based Compensation."

	FOR THE THREE MONTHS ENDED JUNE 30,		
	2003	2002	2001
	-----	-----	-----
Net income, as reported	\$ 5,269	\$ 3,179	\$ 9,1

(in thousands, except per share)

Edgar Filing: DONEGAL GROUP INC - Form 424B3

Less:

Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(91)	(50)	(1)
	-----	-----	-----
Pro form net income	\$ 5,178	\$ 3,129	\$ 9,0
	=====	=====	=====
Basic earnings per share:			
As reported	\$.57	\$.35	\$.
Pro forma	\$.56	\$.35	\$.
Diluted earnings per share:			
As reported	\$.56	\$.35	\$.
Pro forma	\$.55	\$.34	\$.

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

RESULTS OF OPERATIONS -THREE MONTHS ENDED JUNE 30, 2003 COMPARED
TO THREE MONTHS ENDED JUNE 30, 2002

Total revenues for the three months ended June 30, 2003 were \$52,826,818, which were \$2,090,015, or 4.1%, greater than the same period in 2002. Net

9

premiums earned increased to \$48,433,689, an increase of \$2,323,177, or 5.0%, over the second quarter of 2002. Direct premiums written of the combined pool of Atlantic States and the Mutual Company increased \$3,877,494, or 6.3%, in the second quarter of 2003 compared to the second quarter of 2002. A 4.9% decrease in the direct written premiums of Southern accounted for a majority of the remaining change in premiums. The Company reported net realized investment gains of \$216,370 in the second quarter of 2003, compared to net realized investment gains of \$60,481 for the same period of 2002. The realized gain in 2003 was net of realized losses of \$14,225 that resulted from changes in the market value of securities that were determined to be other than temporary. The realized gain in 2002 was net of realized losses of \$92,440 that resulted from changes in the market value of securities that were determined to be other than temporary. Investment income was \$3,315,710, a decrease of \$394,572, or 10.6%, from the second quarter of 2002. An increase in average invested assets from \$306.3 million in the second quarter of 2002 to \$352.0 million in the second quarter of 2003 was more than offset by a decrease in the annualized average return on investments from 4.8% in the second quarter of 2002 to 3.8% in the second quarter of 2003, accounting for the decrease in investment income.

The GAAP combined ratio of insurance operations in the second quarter of 2003 was 92.3% compared to 99.3% for the same period in 2002. The GAAP combined ratio is the sum of the ratios of incurred losses and loss adjusting expenses to premiums earned (loss ratio), policyholders' dividends to premiums earned (dividend ratio) and underwriting expenses to premiums earned (expense ratio). The Company's loss ratio in the second quarter of 2003 was 61.2% compared to 69.7% in the second quarter of 2002. The commercial loss ratio decreased

Edgar Filing: DONEGAL GROUP INC - Form 424B3

significantly to 57.2% in the second quarter of 2003 compared to 62.7% in the second quarter of 2002 with Commercial Multi-peril showing the largest improvement decreasing from 53.6% in the second quarter of 2002 to 41.0% in the second quarter of 2003. The personal lines loss ratio showed an improvement going from 74.0% in the second quarter of 2002 to 63.2% in the second quarter of 2003. The Company's expense ratio for the second quarter of 2003 was 30.6% compared to 29.4% for the second quarter of 2002. The dividend ratio increased slightly to 0.5% for the second quarter of 2003 compared to 0.2% in the second quarter of 2002.

Federal income taxes for the second quarter of 2003 represented 29.5% of income before income taxes compared to 28.6% for the same period of 2002. The increase in the effective tax rate was due to tax-exempt investment income representing a smaller portion of income before taxes in 2003 compared to 2002.

RESULTS OF OPERATIONS -SIX MONTHS ENDED JUNE 30, 2003 COMPARED TO SIX MONTHS ENDED JUNE 30, 2002

Total revenues for the six months ended June 30, 2003 were \$105,012,237, which were \$4,241,388, or 4.2%, greater than the same period in 2002. Net premiums earned increased to \$96,362,570, an increase of \$4,799,798, or 5.2%, over the first six months of 2002. The premiums written of the combined pool of Atlantic States and the Mutual Company increased \$10,860,551, or 9.4%, in the first half of 2003 compared to the first half of 2002. A 1.0% decrease in the direct written premiums of Southern accounted for a majority of the remaining change in premiums. The Company reported net realized investment gains of \$85,890 in the first six months of 2003, compared to net realized investment gains of \$187,259 for the same period of 2002. The realized gain in 2003 was net of realized losses of \$267,724 that resulted from changes in the market value of securities that were determined to be other than temporary. The realized gain in 2002 was net of realized losses of \$152,518 that resulted from changes in the market value of securities that were determined to be other than temporary. Investment income was \$6,680,228, a decrease of \$760,358, or 10.2%, from the first six months of 2002. An increase in average invested assets from \$302.9 million in the first half of 2002 to \$346.9 million in the first half of 2003 was more than offset by a decrease in the annualized average return on investments from 4.9% in the first six months of 2002 to 3.9% in the first half of 2003, accounting for the decrease in investment income.

The GAAP combined ratio of insurance operations in the six months ended June 30, 2003 was 94.7% compared to 100.5% for the same period in 2002. The GAAP combined ratio is the sum of the ratios of incurred losses and loss adjusting expenses to premiums earned (loss ratio), policyholders' dividends to premiums earned (dividend ratio) and underwriting expenses to premiums earned (expense ratio). The Company's loss ratio in the first half of 2003 was 63.8% compared to 69.3% in the first half of 2002. The commercial loss ratio decreased significantly to 54.9% in the first six months of 2003 compared to 60.2% in the first half of 2002 with Commercial Multi-peril showing the largest improvement decreasing from 57.4% in the first six months of 2002 to 49.1% in the first six months of 2003. The personal lines loss ratio showed an improvement going from 74.5% in the first half of 2002 to 68.7% in the first half of 2003. The Company's expense ratio for the first six months of 2003 was 30.4% compared to

30.6% for the first six months of 2002. The dividend ratio decreased slightly to 0.5% for the first two quarters of 2003 compared to 0.6% in the first two quarters of 2002.

Edgar Filing: DONEGAL GROUP INC - Form 424B3

Federal income taxes for the first half of 2003 represented 27.4% of income before income taxes compared to 27.6% for the same period of 2002.

LIQUIDITY AND CAPITAL RESOURCES

The Company generates sufficient funds from its operations and maintains a high degree of liquidity in its investment portfolio. The primary source of funds to meet the demands of claim settlements and operating expenses are premium collections, investment income and maturing investments. The Company had no significant commitments for capital expenditures as of June 30, 2003.

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

On May 15, 2003 the Company received \$15,000,000 as proceeds from the issuance of a floating rate junior subordinate debenture. The debenture matures on May 15, 2033 and is callable by the Company, at par, after five years. The debenture carries an interest rate equal to the three-month LIBOR rate plus 4.10% and is adjustable quarterly. At June 30, 2003 the interest rate on this debenture was 5.41%, which rate will first be subject to adjustment on August 15, 2003.

As of June 30, 2003, under a credit agreement dated December 29, 1995, and amended as of July 27, 1998, with Fleet National Bank of Connecticut ("the Bank"), the Company had unsecured borrowings of \$12.8 million. Per the terms of the credit agreement, the Company may borrow up to \$24 million at interest rates equal to the Bank's then current prime rate or the then current London interbank eurodollar bank rate plus 1.70%. At June 30, 2003, the interest rate on the outstanding balances was 2.97% on an outstanding eurodollar balances of \$4.8 million and 2.69% on an outstanding eurodollar balances of \$8.0 million. In addition, the Company pays a non-use fee at a rate of 3/10 of 1% per annum on the average daily unused portion of the Bank's commitment. Each July 27th the credit line is reduced by \$8 million and is \$24 million as of June 30, 2003. Any outstanding loan in excess of the remaining credit line, after such reduction, will then be payable.

The Company's principal source of cash with which to pay stockholder dividends is dividends from Atlantic States and Southern. Atlantic States and Southern are required by law to maintain certain minimum surplus on a statutory basis, and are subject to regulations under which payment of dividends from statutory surplus is restricted and may require prior approval of their domiciliary insurance regulatory authorities. Atlantic States and Southern are subject to Risk-Based Capital (RBC) requirements. At December 31, 2002 each Atlantic States' and Southern's capital was substantially above the RBC requirements. In 2003 amounts available for distribution as dividends to the Company without prior approval of their domiciliary insurance regulatory authorities were \$10,646,804 from Atlantic States and \$2,493,398 from Southern.

CREDIT RISK

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

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

Edgar Filing: DONEGAL GROUP INC - Form 424B3

IMPACT OF INFLATION

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

11

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

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

The Company has maintained approximately the same duration of its investment portfolio to its liabilities from December 31, 2002 to June 30, 2003. In addition, the Company has maintained approximately the same investment mix during this period.

There have been no material changes to the Company's quantitative or qualitative market risk exposure from December 31, 2002 through June 30, 2003.

ITEM 4. CONTROL AND PROCEDURES

The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's controls and procedures pursuant to Rule 13a-15 under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this report. Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company (including the Company's consolidated subsidiaries) in the Company's periodic filings with the Securities and Exchange Commission is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. There has been no change in the Company's internal control over financial reporting during the quarter covered by this report that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

12

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

NONE.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS.

Edgar Filing: DONEGAL GROUP INC - Form 424B3

In April 2003, the Company formed a wholly owned Connecticut statutory trust, DGI Statutory Trust I (the "Trust"), which issued \$15 million aggregate principal amount of trust preferred securities on May 15, 2003. The Company owns all of the \$464,000 aggregate principal amount of the common securities of the Trust. The proceeds from the issuance of the common securities and the trust preferred securities were used by the Trust to purchase \$15.464 million of floating rate junior subordinated deferrable interest debentures of the Company, which pay interest at a floating rate adjustable quarterly equal to the three-month LIBOR plus 410 basis points. The interest rate for the initial period ending August 15, 2003 is 5.41125%. Prior to May 15, 2008, the interest rate may not exceed 12.5%. The proceeds are being used by the Company for working capital purposes, including potential acquisitions and to support the growth of the Company's insurance subsidiaries.

The trust preferred securities accrue and pay quarterly distributions based on the liquidation value of \$1,000 per capital security at a floating rate adjustable quarterly equal to the three-month LIBOR plus 410 basis points. The rate for determining distributions during the initial period ending August 15, 2003 is 5.41125%. Prior to May 15, 2008, the rate for determining distributions may not exceed 12.5%. The Company has entered into contractual arrangements which, taken collectively, constitute a full and unconditional guarantee on a subordinated basis by the Company of the obligations of the Trust under the trust preferred securities. The Company's guarantee, however, does not apply if the Company does not make payments on the debentures and, as a result, the Trust does not have sufficient funds to make payments. The debentures represent the sole asset of the Trust.

The trust preferred securities are redeemable upon maturity of the debentures on May 15, 2033, or upon earlier redemption of the debentures as provided in the indenture. The Company has the right to redeem the debentures purchased by the Trust in whole or in part, on or after May 15, 2008. As specified in the indenture, if the debentures are redeemed on or after May 15, 2008 and prior to maturity, the redemption price will be the principal amount and any accrued but unpaid interest. In addition, the Company may redeem, at any time (and possibly before May 15, 2008), within 120 days following the occurrence of a change in banking, tax, investment company or other laws or regulations that results in specified changes in the treatment of the trust preferred securities for tax or regulatory capital purposes or under the Investment Company Act of 1940. If the debentures are redeemed prior to May 15, 2008, the redemption price will be equal to 107.5% of the principal amount plus any accrued and unpaid interest.

FTN Financial Capital Markets and Keefe, Bruyette & Woods, Inc. served as placement agents in connection with the issuance of the trust preferred securities and debentures and each were compensated \$225,000 for their services. Since the trust preferred securities and debentures were issued to institutional investors, the securities were exempt from registration under Rule 506 of the Securities Act of 1933.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

NONE.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

Annual Stockholders meeting held April 17, 2003.

Directors elected at meeting:

Donald H. Nikolaus

Votes for

3,238,525

Edgar Filing: DONEGAL GROUP INC - Form 424B3

Votes withheld

20,099

ITEM 5. OTHER INFORMATION.

NONE.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K.

(a) Exhibits

Exhibit No. -----	Description -----
Exhibit 10 (DD)	Amended and Restated Declaration of Trust of DGI Statutory Trust I dated May 15, 2003 by and among Donegal Group Inc., as sponsor, U.S. Bank National Association, as institutional trustee, and Jeffrey D. Miller, Ralph G. Spontak and Daniel J. Wagner, as administrators
Exhibit 10 (EE)	Guarantee Agreement dated May 15, 2003 by and between Donegal Group Inc., as guarantor, and U.S. Bank National Association, as guarantee trustee
Exhibit 10 (FF)	Indenture dated May 15, 2003 between Donegal Group Inc., as issuer, and U.S. Bank National Association, as debenture trustee
Exhibit 10 (GG)	Placement Agreement dated April 25, 2003, among Donegal Group Inc. and its financing subsidiary, DGI Statutory Trust I, together as offerors, and FTN Financial Capital Markets and Keefe, Bruyette & Woods, Inc., as placement agents
Exhibit 10 (HH)	Subscription Agreement dated May 15, 2003 among Donegal Group Inc. and DGI Statutory Trust I, together as offerors, and I-Preferred Term Securities II, Ltd., as purchaser
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

(b) Reports on Form 8-K:

On April 16, 2003, the Company filed a report on form

Edgar Filing: DONEGAL GROUP INC - Form 424B3

8-K including as an exhibit the Company's first quarter 2003 earnings press release.

On July 22, 2003, the Company filed a report on form 8-K including as an exhibit the Company's second quarter 2003 earnings press release.

13

SIGNATURES

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

DONEGAL GROUP INC.

AUGUST , 2003

BY: _____
Donald H. Nikolaus, President
and Chief Executive Officer

AUGUST , 2003

BY: _____
Ralph G. Spontak, Senior Vice President,
Chief Financial Officer and Secretary

14