

DONEGAL GROUP INC  
Form 10-Q  
May 08, 2014  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended March 31, 2014**

**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** **(I.R.S. Employer**  
**incorporation or organization)** **Identification No.)**  
**1195 River Road, P.O. Box 302, Marietta, PA 17547**  
**(Address of principal executive offices) (Zip code)**  
**(717) 426-1931**  
**(Registrant's telephone number, including area code)**  
**Not applicable**  
**(Former name, former address and former fiscal year, if changed since last report)**

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

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 20,937,567 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 May 1, 2014.



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DONEGAL GROUP INC.

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Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements.****Donegal Group Inc. and Subsidiaries****Consolidated Balance Sheets**

|  | <b>March 31,<br/>2014</b> | <b>December 31,<br/>2013</b> |
|--|---------------------------|------------------------------|
|  | (Unaudited)               |                              |
| <b><u>Assets</u></b>   |                           |                              |
| Investments  |                           |                              |
| Fixed maturities   |                           |                              |
| Held to maturity, at amortized cost                            | \$ 296,360,179            | \$ 240,370,277               |
| Available for sale, at fair value                              | 431,527,749               | 403,651,965                  |
| Equity securities, available for sale, at fair value           | 22,297,723                | 12,422,837                   |
| Investments in affiliates                                      | 37,117,118                | 35,685,433                   |
| Short-term investments, at cost, which approximates fair value | 16,367,589                | 99,677,795                   |
| Total investments  | 803,670,358               | 791,808,307                  |
| Cash   | 17,153,044                | 27,636,416                   |
| Accrued investment income                                      | 6,498,123                 | 5,423,531                    |
| Premiums receivable  | 133,342,894               | 123,904,629                  |
| Reinsurance receivable   | 252,079,827               | 244,239,113                  |
| Deferred policy acquisition costs                              | 45,407,383                | 43,627,510                   |
| Deferred tax asset, net  | 17,886,321                | 20,310,558                   |
| Prepaid reinsurance premiums                                   | 116,693,136               | 112,663,942                  |
| Property and equipment, net                                    | 7,053,122                 | 6,424,703                    |
| Accounts receivable - securities                               |                           | 1,187,866                    |
| Federal income taxes recoverable                               | 731,983                   | 420,952                      |
| Goodwill   | 5,625,354                 | 5,625,354                    |
| Other intangible assets  | 958,010                   | 958,010                      |
| Other  | 1,225,194                 | 1,179,611                    |
| Total assets   | \$ 1,408,324,749          | \$ 1,385,410,502             |
| <b><u>Liabilities and Stockholders Equity</u></b>              |                           |                              |
| <b><u>Liabilities</u></b>                                      |                           |                              |
| Unpaid losses and loss expenses                                | \$ 510,122,359            | \$ 495,619,269               |
| Unearned premiums  | 397,797,596               | 382,734,642                  |
| Accrued expenses   | 14,621,812                | 19,265,097                   |
| Reinsurance balances payable                                   | 12,510,502                | 17,948,808                   |
| Borrowings under lines of credit                               | 61,000,000                | 58,000,000                   |
| Cash dividends declared to stockholders                        |                           | 3,299,182                    |

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|   |                         |                         |
|---|-------------------------|-------------------------|
| Subordinated debentures   | 5,000,000               | 5,000,000               |
| Accounts payable - securities   |                         | 751,641                 |
| Due to affiliate  | 1,662,166               | 2,170,225               |
| Drafts payable  | 1,083,987               | 1,386,285               |
| Other   | 2,940,998               | 2,358,242               |
| <b>Total liabilities</b>  | <b>1,006,739,420</b>    | <b>988,533,391</b>      |
| <b>Stockholders Equity</b>  |                         |                         |
| Preferred stock, \$.01 par value, authorized 2,000,000 shares; none issued  |                         |                         |
| Class A common stock, \$.01 par value, authorized 40,000,000 shares, issued 21,825,877 and 21,786,765 shares and outstanding 20,884,169 and 20,845,903 shares | 218,259                 | 217,868                 |
| 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  | 190,342,555             | 189,116,410             |
| Accumulated other comprehensive income (loss)   | 1,936,592               | (2,312,890)             |
| Retained earnings   | 222,133,113             | 222,888,887             |
| Treasury stock  | (13,101,682)            | (13,089,656)            |
| <b>Total stockholders equity</b>  | <b>401,585,329</b>      | <b>396,877,111</b>      |
| <b>Total liabilities and stockholders equity</b>  | <b>\$ 1,408,324,749</b> | <b>\$ 1,385,410,502</b> |

See accompanying notes to consolidated financial statements.

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

(Unaudited)

|  | <b>Three Months Ended<br/>March 31,</b> |                     |
|--|---|---------------------|
|  | <b>2014</b>                             | <b>2013</b>         |
| <b>Revenues:</b>   |   |                     |
| Net premiums earned  | \$ 133,548,261                          | \$ 124,702,041      |
| Investment income, net of investment expenses  | 4,615,776                               | 4,815,443           |
| Net realized investment (losses) gains (includes (\$88,532) and \$1,340,564 accumulated other comprehensive (loss) income reclassifications) | (88,532)                                | 1,340,564           |
| Lease income   | 212,790                                 | 215,397             |
| Installment payment fees   | 1,641,550                               | 1,710,241           |
| Equity in earnings of Donegal Financial Services Corporation   | 409,242                                 | 1,088,906           |
| <b>Total revenues</b>  | <b>140,339,087</b>                      | <b>133,872,592</b>  |
| <b>Expenses:</b>   |   |                     |
| Net losses and loss expenses   | 97,632,392                              | 85,533,016          |
| Amortization of deferred policy acquisition costs  | 21,319,000                              | 19,560,000          |
| Other underwriting expenses  | 20,458,719                              | 18,751,511          |
| Policyholder dividends   | 394,503                                 | 475,273             |
| Interest   | 365,482                                 | 487,149             |
| Other expenses   | 962,207                                 | 982,354             |
| <b>Total expenses</b>  | <b>141,132,303</b>                      | <b>125,789,303</b>  |
| (Loss) income before income tax (benefit) expense  | (793,216)                               | 8,083,289           |
| Income tax (benefit) expense (includes (\$30,101) and \$455,792 income tax (benefit) expense from reclassification items)                    | (158,802)                               | 1,607,853           |
| <b>Net (loss) income</b>   | <b>\$ (634,414)</b>                     | <b>\$ 6,475,436</b> |
| <b>(Loss) earnings per common share:</b>   |   |                     |
| Class A common stock - basic   | \$ (0.02)                               | \$ 0.26             |
| Class A common stock - diluted   | \$ (0.02)                               | \$ 0.25             |
| Class B common stock - basic and diluted   | \$ (0.02)                               | \$ 0.23             |

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

(Unaudited)

|  | <b>Three Months Ended<br/>March 31,</b> |              |
|--|---|--------------|
|  | <b>2014</b>                             | <b>2013</b>  |
| Net (loss) income  | \$ (634,414)                            | \$ 6,475,436 |
| Other comprehensive income (loss), net of tax  |   |              |
| Unrealized gain (loss) on securities:  |   |              |
| Unrealized holding income (loss) during the period, net of income tax (benefit) expense of \$2,258,082 and (\$1,725,094)               | 4,191,051                               | (3,165,445)  |
| Reclassification adjustment for (losses) gains included in net income, net of income tax (benefit) expense of (\$30,101) and \$455,792 | 58,431                                  | (884,772)    |
| Other comprehensive income (loss)  | 4,249,482                               | (4,050,217)  |
| Comprehensive income   | \$ 3,615,068                            | \$ 2,425,219 |

See accompanying notes to consolidated financial statements.



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

(Unaudited)

**Three Months Ended March 31, 2014**

|  | Class A<br>Shares | Class B<br>Shares | Class A<br>Amount | Class B<br>Amount | Additional<br>Paid-In<br>Capital | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Retained<br>Earnings | Treasury<br>Stock | Total<br>Stockholders'<br>Equity |
|--|-------------------|-------------------|-------------------|-------------------|----------------------------------|---|----------------------|-------------------|----------------------------------|
| Balance,<br>December 31,                                     | 21,786,765        | 5,649,240         | \$ 217,868        | \$ 56,492         | \$ 189,116,410                   | \$ (2,312,890)  | \$ 222,888,887       | \$ (13,089,656)   | \$ 396,877,917                   |
| Issuance of<br>common stock                                  |                   |                   |                   |                   |                                  |   |                      |                   |                                  |
| Repurchase of<br>common stock                                | 39,112            |                   | 391               |                   | 1,096,374                        |   | (634,414)            |                   | 1,096,374                        |
| Dividends<br>paid  |                   |                   |                   |                   |                                  |   | (3,104)              |                   | (3,104)                          |
| Change in<br>value of stock<br>options                       |                   |                   |                   |                   | 118,256                          |   | (118,256)            |                   |                                  |
| Benefit on<br>exercise of<br>stock options                   |                   |                   |                   |                   | 11,515                           |   |                      |                   | 11,515                           |
| Change in<br>value of<br>treasury shares                     |                   |                   |                   |                   |                                  |   |                      | (12,026)          | (12,026)                         |
| Change in<br>Accumulated<br>Other<br>Comprehensive<br>Income |                   |                   |                   |                   |                                  | 4,249,482   |                      |                   | 4,249,482                        |
| Balance,<br>March 31, 2014                                   | 21,825,877        | 5,649,240         | \$ 218,259        | \$ 56,492         | \$ 190,342,555                   | \$ 1,936,592  | \$ 222,133,113       | \$ (13,101,682)   | \$ 401,585,224                   |

See accompanying notes to consolidated financial statements.

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

(Unaudited)

|   | <b>Three Months Ended<br/>March 31,</b> |              |
|---|---|--------------|
|   | <b>2014</b>                             | <b>2013</b>  |
| <b>Cash Flows from Operating Activities:</b>                                      |   |              |
| Net (loss) income   | \$ (634,414)                            | \$ 6,475,436 |
| Adjustments to reconcile net income to net cash provided by operating activities: |   |              |
| Depreciation and amortization   | 793,240                                 | 901,111      |
| Net realized investment losses (gains)  | 88,532                                  | (1,340,564)  |
| Equity in earnings of Donegal Financial Services Corporation                      | (409,242)                               | (1,088,906)  |
| Changes in assets and liabilities:  |   |              |
| Losses and loss expenses  | 14,503,090                              | 11,728,371   |
| Unearned premiums   | 15,062,954                              | 11,296,320   |
| Premiums receivable   | (9,438,265)                             | (10,425,418) |
| Deferred acquisition costs  | (1,779,873)                             | (1,064,350)  |
| Deferred income taxes   | 136,054                                 | 1,631,380    |
| Reinsurance receivable  | (7,840,714)                             | (4,659,893)  |
| Prepaid reinsurance premiums  | (4,029,194)                             | (3,532,303)  |
| Accrued investment income   | (1,074,592)                             | (224,912)    |
| Due to affiliate  | (508,059)                               | (5,061,688)  |
| Reinsurance balances payable  | (5,438,306)                             | 1,035,868    |
| Current income taxes  | (311,031)                               | (774,316)    |
| Accrued expenses  | (4,643,285)                             | (2,689,827)  |
| Other, net  | 234,873                                 | (288,302)    |
| Net adjustments   | (4,653,818)                             | (4,557,429)  |
| Net cash (used in) provided by operating activities                               | (5,288,232)                             | 1,918,007    |
| <b>Cash Flows from Investing Activities:</b>                                      |   |              |
| Purchases of fixed maturities, held to maturity                                   | (69,863,688)                            |              |
| Purchases of fixed maturities, available for sale                                 | (34,438,401)                            | (37,561,696) |
| Purchases of equity securities, available for sale                                | (10,837,100)                            | (3,497,597)  |
| Maturity of fixed maturities:   |   |              |
| Held to maturity  | 13,941,822                              | 1,610,591    |
| Available for sale  | 9,197,730                               | 14,853,225   |
| Sales of fixed maturities, available for sale                                     | 1,235,464                               | 17,791,110   |
| Sales of equity securities, available for sale                                    | 2,329,866                               | 2,829,224    |
| Net purchases of property and equipment   | (832,686)                               | (48,498)     |
| Net decrease in investment in affiliates  |   | 465,000      |

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|   |               |               |
|---|---------------|---------------|
| Net sales of short-term investments                 | 83,310,206    | 12,562,837    |
| Net cash (used in) provided by investing activities | (5,956,787)   | 9,004,196     |
| <b>Cash Flows from Financing Activities:</b>        |               |               |
| Cash dividends paid                                 | (3,302,286)   | (3,069,386)   |
| Issuance of common stock                            | 1,075,959     | 2,239,693     |
| Purchase of treasury stock                          | (12,026)      |               |
| Payments on subordinated debentures                 |               | (15,465,000)  |
| Payments on line of credit                          |               | (9,000,000)   |
| Borrowings under lines of credit                    | 3,000,000     | 18,500,000    |
| Net cash provided by (used in) financing activities | 761,647       | (6,794,693)   |
| Net (decrease) increase in cash                     | (10,483,372)  | 4,127,510     |
| Cash at beginning of period                         | 27,636,416    | 19,801,290    |
| Cash at end of period                               | \$ 17,153,044 | \$ 23,928,800 |
| Cash paid during period - Interest                  | \$ 299,614    | \$ 517,823    |
| Net cash paid during period - Taxes                 | \$            | \$ 650,000    |

See accompanying notes to consolidated financial statements.

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**DONEGAL GROUP INC. AND SUBSIDIARIES**

**(Unaudited)**

**Notes to Consolidated Financial Statements**

**1 - Organization**

Donegal Mutual Insurance Company ( Donegal Mutual ) organized us as an insurance holding company on August 26, 1986. Our insurance subsidiaries, Atlantic States Insurance Company ( Atlantic States ), Southern Insurance Company of Virginia ( Southern ), Le Mars Insurance Company ( Le Mars ), the Peninsula Insurance Group ( Peninsula ), which consists of Peninsula Indemnity Company and The Peninsula Insurance Company, Sheboygan Falls Insurance Company ( Sheboygan ) and Michigan Insurance Company ( MICO ), write personal and commercial lines of property and casualty coverages exclusively through a network of independent insurance agents in certain Mid-Atlantic, Midwestern, New England and Southern states. We also own 48.2% of the outstanding stock of Donegal Financial Services Corporation ( DFSC ), a grandfathered unitary savings and loan holding company that owns Union Community Bank ( UCB ), a state savings bank. UCB has 13 banking offices, all of which are located in Lancaster County, Pennsylvania. Donegal Mutual owns the remaining 51.8% of the outstanding stock of DFSC.

We have four segments: our investment function, our personal lines of insurance, our commercial lines of insurance and our investment in DFSC. The personal lines products of our insurance subsidiaries consist primarily of homeowners and private passenger automobile policies. The commercial lines products of our insurance subsidiaries consist primarily of commercial automobile, commercial multi-peril and workers' compensation policies.

At March 31, 2014, Donegal Mutual held approximately 37% of our outstanding Class A common stock and approximately 76% of our outstanding Class B common stock. This ownership provides Donegal Mutual with approximately 65% of the total voting power of our common stock. Our insurance subsidiaries and Donegal Mutual have interrelated operations due to a pooling agreement and other intercompany agreements and transactions. While each company maintains its separate corporate existence, our insurance subsidiaries and Donegal Mutual conduct business together as the Donegal Insurance Group. As such, Donegal Mutual and our insurance subsidiaries share the same business philosophy, the same management, the same employees and the same facilities and offer the same types of insurance products.

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

The same executive management and underwriting personnel administer products, classes of business underwritten, pricing practices and underwriting standards of Donegal Mutual and our insurance subsidiaries. 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 our insurance subsidiaries and Donegal Mutual market are generally complementary, thereby allowing the Donegal Insurance Group to offer a broader range of products to a given market and to expand the Donegal Insurance Group's ability to service an entire personal lines or commercial lines account. Distinctions within the products of Donegal Mutual and our insurance subsidiaries generally relate to specific risk profiles targeted within similar classes of business, such as preferred tier versus standard tier products, but we do not allocate all of the standard risk gradients to one company. Therefore, the

underwriting profitability of the business the individual companies write directly will vary. However, as the risk characteristics of all business Donegal Mutual and Atlantic States write directly are homogenized within the underwriting pool, Donegal Mutual and Atlantic States share the underwriting results in proportion to their respective participation in the pool. Pooled business represents the predominant percentage of the net underwriting activity of both Donegal Mutual and Atlantic States.

On February 23, 2009, our board of directors authorized a share repurchase program pursuant to which we may purchase up to 300,000 shares of our Class A common stock at prices prevailing from time to time in the open market subject to the provisions of applicable rules of the Securities and Exchange Commission (the SEC ) and in privately negotiated transactions. We purchased 846 shares of our Class A common stock under this program during the three months ended March 31, 2014. We did not purchase any shares under this program during the three-month period ended March 31, 2013. We have purchased a total of 296,778 shares of our Class A common stock under this program from its inception through March 31, 2014.

On July 18, 2013, our board of directors authorized a share repurchase program pursuant to which we have the authority to purchase up to 500,000 additional shares of our Class A common stock at prices prevailing from time to time in the open market subject to the provisions of applicable rules of the SEC and in privately negotiated transactions. We did not purchase any shares of our Class A common stock under this program during the three-month period ended March 31, 2014.

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Our financial information for the interim periods included in this Form 10-Q Report is unaudited; however, such information reflects all adjustments, consisting only of normal recurring adjustments that, in the opinion of our management, are necessary for a fair presentation of our financial position, results of operations and cash flows for those interim periods. Our results of operations for the three months ended March 31, 2014 are not necessarily indicative of the results of operations we expect for the year ending December 31, 2014.

You should read these interim financial statements in conjunction with the financial statements and the notes to our financial statements contained in our Annual Report on Form 10-K for the year ended December 31, 2013.

**3 - Earnings Per Share**

We have two classes of common stock, which we refer to as our Class A common stock and our Class B common stock. Our certificate of incorporation provides that whenever our board of directors declares a dividend on our Class B common stock, our board of directors must also declare a dividend on our Class A common stock that is payable to the holders of our Class A common stock at the same time and as of the same record date at a rate that is at least 10% greater than the rate at which our board of directors declared a dividend on our Class B common stock. Accordingly, we use the two-class method to compute our earnings per common share. The two-class method is an earnings allocation formula that determines earnings per share separately for each class of common stock based on dividends we have declared and an allocation of our remaining undistributed earnings using a participation percentage that reflects the dividend rights of each class. The table below presents for the periods indicated a reconciliation of the numerators and denominators we used to compute basic and diluted net income per share for each class of our common stock:

|   | Three Months Ended March 31,<br>2014  |           | 2013       |           |
|---|---------------------------------------|-----------|------------|-----------|
|   | Class A                               | Class B   | Class A    | Class B   |
|   | (in thousands, except per share data) |           |            |           |
| <b>Basic and diluted net (loss) income per share:</b> |                                       |           |            |           |
| <b>Numerator:</b>                                     |                                       |           |            |           |
| Allocation of net (loss) income                       | \$ (510)                              | \$ (124)  | \$ 5,170   | \$ 1,305  |
| <b>Denominator:</b>                                   |                                       |           |            |           |
| Weighted-average shares outstanding                   | 20,873,043                            | 5,576,775 | 20,066,755 | 5,576,775 |
| Basic net (loss) income per share                     | \$ (0.02)                             | \$ (0.02) | \$ 0.26    | \$ 0.23   |
| <b>Diluted net (loss) income per share:</b>           |                                       |           |            |           |
| <b>Numerator:</b>                                     |                                       |           |            |           |
| Allocation of net (loss) income                       | \$ (510)                              | \$ (124)  | \$ 5,170   | \$ 1,305  |
| <b>Denominator:</b>                                   |                                       |           |            |           |
|   | 20,873,043                            | 5,576,775 | 20,066,755 | 5,576,775 |

|   |            |           |            |           |
|---|------------|-----------|------------|-----------|
| Number of shares used in basic computation            |            |           |            |           |
| Weighted-average shares effect of dilutive securities |            |           |            |           |
| Add: Director and employee stock options              | 380,186    |           | 291,477    |           |
| Number of shares used in per share computations       | 21,253,229 | 5,576,775 | 20,358,232 | 5,576,775 |
| Diluted net (loss) income per share                   | \$ (0.02)  | \$ (0.02) | \$ 0.25    | \$ 0.23   |

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

|   | <b>Three Months Ended<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2014</b>                             | <b>2013</b> |
| Number of options to purchase Class A shares excluded | 2,548,500                               | 1,212,000   |

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**4 - Reinsurance**

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

Our insurance subsidiaries and Donegal Mutual purchase certain third-party reinsurance on a combined basis. Le Mars, MICO, Peninsula and Sheboygan also purchase separate third-party reinsurance that provides coverage that is commensurate with their relative size and exposures. Our insurance subsidiaries use several different reinsurers, all of which, consistent with requirements of our insurance subsidiaries and Donegal Mutual, have an A.M. Best rating of A- (Excellent) or better or, with respect to foreign reinsurers, have a financial condition that, in the opinion of our management, is equivalent to a company with at least an A- rating from A.M. Best. The following information describes the external reinsurance our insurance subsidiaries have in place at March 31, 2014:

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

catastrophe reinsurance, under which Donegal Mutual, Atlantic States and Southern recover, through a series of reinsurance agreements, 100% of an accumulation of many losses resulting from a single event, including natural disasters, over a set retention (generally \$5.0 million) and after exceeding an annual aggregate deductible (generally \$1.5 million) up to aggregate losses of \$145.0 million per occurrence.

Our insurance subsidiaries and Donegal Mutual also purchase facultative reinsurance to cover exposures from losses that exceed the limits their third-party reinsurance agreements provide.

MICO maintains a quota-share reinsurance agreement with third-party reinsurers to reduce its net exposures. Effective January 1, 2014, the quota-share reinsurance percentage was 20%.

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

Other than the changes we discuss above, we have made no significant changes to our third-party reinsurance or the reinsurance agreements between our insurance subsidiaries and Donegal Mutual during the three months ended March 31, 2014.



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The amortized cost and estimated fair values of our fixed maturities and equity securities at March 31, 2014 were as follows:

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|----------------------------|
|   | (in thousands)    |                              |                               |                            |
| <b>Held to Maturity</b>   |                   |                              |                               |                            |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 48,379         | \$ 193                       | \$ 77                         | \$ 48,495                  |
| Obligations of states and political subdivisions                                      | 96,477            | 4,638                        |                               | \$ 101,115                 |
| Corporate securities  | 51,570            | 287                          | 152                           | \$ 51,705                  |
| Mortgage-backed securities  | 99,934            | 337                          | 261                           | 100,010                    |
| Totals  | \$ 296,360        | \$ 5,455                     | \$ 490                        | \$ 301,325                 |

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|----------------------------|
|   | (in thousands)    |                              |                               |                            |
| <b>Available for Sale</b>   |                   |                              |                               |                            |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 12,888         | \$ 128                       | \$ 29                         | \$ 12,987                  |
| Obligations of states and political subdivisions                                      | 262,754           | 15,960                       | 5                             | 278,709                    |
| Corporate securities  | 61,521            | 1,150                        | 54                            | 62,617                     |
| Mortgage-backed securities  | 76,018            | 1,235                        | 38                            | 77,215                     |
| Fixed maturities  | 413,181           | 18,473                       | 126                           | 431,528                    |
| Equity securities   | 21,752            | 592                          | 46                            | 22,298                     |
| Totals  | \$ 434,933        | \$ 19,065                    | \$ 172                        | \$ 453,826                 |

At March 31, 2014, our holdings of obligations of states and political subdivisions included general obligation bonds with an aggregate fair value of \$285.2 million and an amortized cost of \$270.3 million. Our holdings at March 31, 2014 also included special revenue bonds with an aggregate fair value of \$94.6 million and an amortized cost of \$88.9 million. With respect to both categories of these bonds, we held no securities of any issuer that comprised more than 10% of the category at March 31, 2014. Education bonds and water and sewer utility bonds represented 57% and 21%, respectively, of our total investments in special revenue bonds based on their carrying values at March 31, 2014. Many of the issuers of the special revenue bonds we held at March 31, 2014 have the authority to impose ad valorem taxes. In that respect, many of the special revenue bonds we held are similar to general obligation bonds.

The amortized cost and estimated fair values of our fixed maturities and equity securities at December 31, 2013 were as follows:

|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|----------------------------|
|  |                   | (in thousands)               |                               |                            |
| <b>Held to Maturity</b>  |                   |                              |                               |                            |
| U.S. Treasury securities and obligations of U.S.<br>government corporations and agencies | \$ 47,946         | \$                           | \$ 870                        | \$ 47,076                  |
| Obligations of states and political subdivisions   | 108,435           | 465                          | 446                           | 108,454                    |
| Corporate securities   | 14,875            | 17                           | 112                           | 14,780                     |
| Mortgage-backed securities   | 69,114            | 33                           | 667                           | 68,480                     |
| Totals   | \$ 240,370        | \$ 515                       | \$ 2,095                      | \$ 238,790                 |

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|   | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair<br/>Value</b> |
|---|---------------------------|---------------------------------------|--|-------------------------------------|
|   |                           | (in thousands)                        |  |                                     |
| <b>Available for Sale</b>   |                           |                                       |  |                                     |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies |                           |                                       |  |                                     |
|   | \$ 14,272                 | \$ 118                                | \$ 57                                  | \$ 14,333                           |
| Obligations of states and political subdivisions                                      | 265,783                   | 11,779                                | 15                                     | 277,547                             |
| Corporate securities  | 39,940                    | 775                                   | 43                                     | 40,672                              |
| Mortgage-backed securities  | 70,259                    | 923                                   | 82                                     | 71,100                              |
| Fixed maturities  | 390,254                   | 13,595                                | 197                                    | 403,652                             |
| Equity securities   | 12,168                    | 348                                   | 93                                     | 12,423                              |
| Totals  | \$ 402,422                | \$ 13,943                             | \$ 290                                 | \$ 416,075                          |

At December 31, 2013, our holdings of obligations of states and political subdivisions included general obligation bonds with an aggregate fair value of \$294.1 million and an amortized cost of \$284.9 million. Our holdings also included special revenue bonds with an aggregate fair value of \$91.9 million and an amortized cost of \$89.3 million. With respect to both categories, we held no securities of any issuer that comprised more than 10% of the category at December 31, 2013. Education bonds and water and sewer utility bonds represented 56% and 23%, respectively, of our total investments in special revenue bonds based on their carrying values at December 31, 2013. Many of the issuers of the special revenue bonds we held at December 31, 2013 have the authority to impose ad valorem taxes. In that respect, many of the special revenue bonds we held are similar to general obligation bonds.

We made reclassifications from available for sale to held to maturity of fixed maturities at fair value on November 30, 2013. The following table summarizes the reclassifications by type of securities at November 30, 2013:

|   | <b>Amortized<br/>Cost</b> | <b>Estimated<br/>Fair<br/>Value</b> |
|---|---------------------------|-------------------------------------|
| U.S. Treasury securities and obligations of U.S. government corporations and agencies |                           |                                     |
|   | \$ 50,627,225             | \$ 47,914,311                       |
| Obligations of states and political subdivisions                                      | 88,456,842                | 79,866,801                          |
| Corporate securities  | 15,745,976                | 14,879,294                          |
| Mortgage-backed securities  | 72,465,250                | 69,567,883                          |
| Totals  | \$ 227,295,293            | \$ 212,228,289                      |

We have segregated within accumulated other comprehensive income the net unrealized losses of \$15.1 million arising prior to the November 30, 2013 reclassification date for fixed maturities reclassified from available for sale to held to maturity. We will amortize this balance over the remaining life of the related securities as an adjustment to yield in a manner consistent with the accretion of discount on the same fixed maturities. At March 31, 2014 and December 31, 2013, net unrealized losses of \$14.7 million and \$14.9 million, respectively, remained within accumulated other comprehensive income.



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We show below the amortized cost and estimated fair value of our fixed maturities at March 31, 2014 by contractual maturity. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

|  | <b>Amortized<br/>Cost</b> | <b>Estimated<br/>Fair<br/>Value</b> |
|--|---------------------------|-------------------------------------|
|  | (in thousands)            |                                     |
| <b>Held to maturity</b>                |                           |                                     |
| Due in one year or less                | \$ 3,659                  | \$ 3,693                            |
| Due after one year through five years  | 38,127                    | 38,340                              |
| Due after five years through ten years | 76,922                    | 77,392                              |
| Due after ten years                    | 77,718                    | 81,890                              |
| Mortgage-backed securities             | 99,934                    | 100,010                             |
| <b>Total held to maturity</b>          | <b>\$ 296,360</b>         | <b>\$ 301,325</b>                   |
| <b>Available for sale</b>              |                           |                                     |
| Due in one year or less                | \$ 14,415                 | \$ 14,541                           |
| Due after one year through five years  | 66,282                    | 68,033                              |
| Due after five years through ten years | 126,254                   | 133,077                             |
| Due after ten years                    | 130,212                   | 138,662                             |
| Mortgage-backed securities             | 76,018                    | 77,215                              |
| <b>Total available for sale</b>        | <b>\$ 413,181</b>         | <b>\$ 431,528</b>                   |

Gross realized gains and losses from investments before applicable income taxes were as follows:

|                               | <b>Three Months Ended<br/>March 31,</b> |             |
|-------------------------------|---|-------------|
|                               | <b>2014</b>                             | <b>2013</b> |
|                               | (in thousands)                          |             |
| <b>Gross realized gains:</b>  |   |             |
| Fixed maturities              | \$ 23                                   | \$ 951      |
| Equity securities             | 24                                      | 474         |
|                               | 47                                      | 1,425       |
| <b>Gross realized losses:</b> |   |             |
| Fixed maturities              | 1                                       | 14          |
| Equity securities             | 135                                     | 70          |
|                               | 136                                     | 84          |

|                             |         |          |
|-----------------------------|---------|----------|
| Net realized (losses) gains | \$ (89) | \$ 1,341 |
|-----------------------------|---------|----------|

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at March 31, 2014 as follows:

|   | Less Than 12 Months |                   | More Than 12 Months |                   |
|---|---------------------|-------------------|---------------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses |
|   | (in thousands)      |                   |                     |                   |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 15,647           | \$ 76             | \$ 4,973            | \$ 30             |
| Obligations of states and political subdivisions                                      | 1,588               | 5                 |                     |                   |
| Corporate securities  | 40,874              | 172               | 3,259               | 34                |
| Mortgage-backed securities  | 40,344              | 164               | 13,408              | 135               |
| Equity securities   | 1,536               | 46                |                     |                   |
| Totals  | \$ 99,989           | \$ 463            | \$ 21,640           | \$ 199            |

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We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at December 31, 2013 as follows:

|   | Less Than 12 Months |                   | More Than 12 Months |                   |
|---|---------------------|-------------------|---------------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses |
|   | (in thousands)      |                   |                     |                   |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 50,803           | \$ 822            | \$ 4,642            | \$ 104            |
| Obligations of states and political subdivisions                                      | 65,171              | 363               | 13,405              | 99                |
| Corporate securities  | 16,694              | 84                | 6,852               | 72                |
| Mortgage-backed securities  | 72,878              | 536               | 19,014              | 213               |
| Equity securities   | 1,629               | 93                |                     |                   |
| Totals  | \$ 207,175          | \$ 1,898          | \$ 43,913           | \$ 488            |

We make estimates concerning the valuation of our investments and the recognition of other-than-temporary declines in the value of our investments. For equity securities, 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 when we consider the decline in value of an individual investment to be other than temporary. We individually monitor all investments for other-than-temporary declines in value. Generally, we assume there has been an other-than-temporary decline in value 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 held two equity securities that were in an unrealized loss position at March 31, 2014. Based upon our analysis of general market conditions and underlying factors impacting these equity securities, we considered these declines in value to be temporary. With respect to a debt security that is in an unrealized loss position, we first assess if we intend to sell the debt security. If we determine we intend to sell the debt security, we recognize the impairment loss in our results of operations. If we do not intend to sell the debt security, we determine whether it is more likely than not that we will be required to sell the debt security prior to recovery. If we determine it is more likely than not that we will be required to sell the debt security prior to recovery, we recognize an impairment loss in our results of operations. If we determine it is more likely than not that we will not be required to sell the debt security prior to recovery, we then evaluate whether a credit loss has occurred. We determine whether a credit loss has occurred by comparing the amortized cost of the debt security to the present value of the cash flows we expect to collect. If we expect a cash flow shortfall, we consider that a credit loss has occurred. If we determine that a credit loss has occurred, we consider the impairment to be other than temporary. We then recognize the amount of the impairment loss related to the credit loss in our results of operations, and we recognize the remaining portion of the impairment loss in our other comprehensive income, net of applicable taxes. In addition, we may write down securities in an unrealized loss position based on a number of other factors, including when the fair value of an investment is significantly below its cost, when the financial condition of the issuer of a security has deteriorated, the occurrence of industry, company or geographic events that have negatively impacted the value of a security and rating agency downgrades. We held 128 debt securities that were in an unrealized loss position at March 31, 2014. Based upon our analysis of general market conditions and underlying factors impacting these debt securities, we considered these declines in value to be temporary.

We amortize premiums and discounts on debt securities over the life of the security as an adjustment to yield using the effective interest method. We compute realized investment gains and losses using the specific identification method.

We amortize premiums and discounts on mortgage-backed debt securities using anticipated prepayments.

We account for investments in our affiliates using the equity method of accounting. Under this method, we record our investment at cost, with adjustments for our share of our affiliates' earnings and losses as well as changes in the equity of our affiliates due to unrealized gains and losses. Our investments in affiliates include our 48.2% ownership interest in DFSC. We



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include our share of DFSC's net income in our results of operations. We have compiled the following summary financial information for DFSC at March 31, 2014 and December 31, 2013 and for the three months ended March 31, 2014 and 2013, respectively, from the financial statements of DFSC. The financial information of DFSC at March 31, 2014 and for the three months then ended is unaudited.

| Balance sheets:                            | <b>March 31,<br/>2014</b> | <b>December 31,<br/>2013</b> |
|--|---------------------------|------------------------------|
|  | (in thousands)            |                              |
| Total assets                               | \$ 511,062                | \$ 512,578                   |
| Total liabilities                          | \$ 434,163                | \$ 438,649                   |
| Stockholders' equity                       | 76,899                    | 73,929                       |
| Total liabilities and stockholders' equity | \$ 511,062                | \$ 512,578                   |

  

| Income statements: | <b>Three Months Ended<br/>March 31,</b> |             |
|--------------------|---|-------------|
|                    | <b>2014</b>                             | <b>2013</b> |
|                    | (in thousands)                          |             |
| Net income         | \$ 849                                  | \$ 2,258    |

**Table of Contents****6 - Segment Information**

We evaluate the performance of our personal lines and commercial lines segments based upon the underwriting results of our insurance subsidiaries using statutory accounting principles ( SAP ) that various state insurance departments prescribe or permit. Our management uses SAP to measure the performance of our insurance subsidiaries instead of United States generally accepted accounting principles ( GAAP ). Financial data by segment is as follows:

|   | <b>Three Months Ended</b> |             |
|---|---------------------------|-------------|
|   | <b>March 31,</b>          |             |
|   | <b>2014</b>               | <b>2013</b> |
|   | (in thousands)            |             |
| <b>Revenues:</b>                          |                           |             |
| Premiums earned                           |                           |             |
| Commercial lines                          | \$ 54,346                 | \$ 47,631   |
| Personal lines                            | 79,202                    | 77,071      |
| GAAP premiums earned                      | 133,548                   | 124,702     |
| Net investment income                     | 4,616                     | 4,815       |
| Realized investment (losses) gains        | (89)                      | 1,341       |
| Equity in earnings of DFSC                | 409                       | 1,089       |
| Other                                     | 1,855                     | 1,926       |
| Total revenues                            | \$ 140,339                | \$ 133,873  |
| <b>(Loss) income before income taxes:</b> |                           |             |
| <b>Underwriting (loss) income:</b>        |                           |             |
| Commercial lines                          | \$ (5,348)                | \$ (1,591)  |
| Personal lines                            | (3,833)                   | 223         |
| SAP underwriting loss                     | (9,181)                   | (1,368)     |
| GAAP adjustments                          | 2,925                     | 1,750       |
| GAAP underwriting (loss) income           | (6,256)                   | 382         |
| Net investment income                     | 4,616                     | 4,815       |
| Realized investment (losses) gains        | (89)                      | 1,341       |
| Equity in earnings of DFSC                | 409                       | 1,089       |
| Other                                     | 527                       | 456         |
| (Loss) income before income taxes         | \$ (793)                  | \$ 8,083    |

**7 - Borrowings****Lines of Credit**

In June 2013, we renewed our existing credit agreement with Manufacturers and Traders Trust Company ( M&T ) relating to a \$60.0 million unsecured, revolving line of credit. The line of credit expires in July 2016. We have the

right to request a one-year extension of the credit agreement as of each anniversary date of the agreement. At March 31, 2014, we had \$46.0 million in outstanding borrowings and had the ability to borrow an additional \$14.0 million at interest rates equal to M&T's current prime rate or the then current LIBOR rate plus 2.25%. The interest rate on our outstanding borrowings is adjustable quarterly. At March 31, 2014, the interest rate on our outstanding borrowings was 2.40%. We pay a fee of 0.2% per annum on the loan commitment amount regardless of usage. The credit agreement requires our compliance with certain covenants. These covenants include minimum levels of our net worth, leverage ratio, statutory surplus and the A.M. Best ratings of our insurance subsidiaries. We complied with all requirements of the credit agreement during the three months ended March 31, 2014.

MICO is a member of the Federal Home Loan Bank ( FHLB ) of Indianapolis. Through its membership, MICO has the ability to issue debt to the FHLB of Indianapolis in exchange for cash advances. MICO had no outstanding borrowings with the FHLB of Indianapolis at December 31, 2013 or March 31, 2014. The table below presents the amount of FHLB of Indianapolis stock MICO purchased, collateral pledged and assets related to MICO's membership at March 31, 2014.

|   |            |
|---|------------|
| FHLB stock purchased and owned as part of the agreement | \$ 252,100 |
| Collateral pledged, at par (carrying value \$2,777,078) | 3,700,000  |
| Borrowing capacity currently available                  | 2,395,543  |

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Atlantic States is a member of the FHLB of Pittsburgh. Through its membership, Atlantic States has the ability to issue debt to the FHLB of Pittsburgh in exchange for cash advances. In the first quarter of 2013, Atlantic States issued secured debt in the principal amount of \$15.0 million to the FHLB of Pittsburgh in exchange for cash advances in the amount of \$15.0 million. The interest rate on the advances was .30% at March 31, 2014. The table below presents the amount of FHLB of Pittsburgh stock Atlantic States purchased, collateral pledged and assets related to Atlantic States membership in the FHLB of Pittsburgh at March 31, 2014.

|  |            |
|--|------------|
| FHLB stock purchased and owned as part of the agreement  | \$ 870,300 |
| Collateral pledged, at par (carrying value \$16,028,983) | 19,000,000 |
| Borrowing capacity currently available                   | 125,191    |

**Subordinated Debentures**

In January 2002, West Bend Mutual Insurance Company ( West Bend ), the prior owner of MICO, purchased a \$5.0 million surplus note from MICO at face value to increase MICO's statutory surplus. On December 1, 2010, Donegal Mutual purchased the surplus note from West Bend at face value. The surplus note carries an interest rate of 5.00%, and any repayment of principal or payment of interest on the surplus note requires prior approval of the Michigan Department of Insurance and Financial Services.

**8 - Share-Based Compensation**

We measure all share-based payments to employees, including grants of stock options, and use a fair-value-based method for the recording of such expense in our consolidated statements of income. In determining the expense we record for stock options granted to directors and employees of our subsidiaries and affiliates, we estimate the fair value of each option award 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, the expected term, the dividend yield and the expected volatility.

We charged compensation expense related to our stock compensation plans against income before income taxes of \$180,415 and \$172,305 for the three months ended March 31, 2014 and 2013, respectively, with a corresponding income tax benefit of \$63,145 and \$60,307, respectively. At March 31, 2014, we had \$931,181 of unrecognized compensation expense related to nonvested share-based compensation granted under our stock compensation plans. We expect to recognize this cost over a weighted average period of 1.8 years.

We received cash from option exercises under all stock compensation plans for the three months ended March 31, 2014 and 2013 of \$193,558 and \$1.7 million, respectively. We realized actual tax benefits for the tax deductions from option exercises of share-based compensation of \$11,515 and \$98,929 for the three months ended March 31, 2014 and 2013, respectively.

**9 - Fair Value Measurements**

We account for financial assets using a framework that establishes a hierarchy that ranks the quality and reliability of the inputs, or assumptions, we use in the determination of fair value, and we classify financial assets and liabilities carried at fair value 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; and

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 base fair values on quoted market prices of comparable instruments or price estimates we obtain from independent pricing services and include these investments in Level 2 of the fair value hierarchy. We classify our fixed maturity investments as Level 2. Our fixed maturity investments consist of U.S. Treasury securities and obligations of U.S. government corporations and agencies, obligations of states and political subdivisions, corporate securities and mortgage-backed securities.

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We present our investments in available-for-sale fixed maturity and equity securities at estimated fair value. The estimated fair value of a security may differ from the amount that could be realized if we sold the security in a forced transaction. In addition, the valuation of fixed maturity investments is more subjective when markets are less liquid, increasing the potential that the estimated fair value does not reflect the price at which an actual transaction would occur. We utilize nationally recognized independent pricing services to estimate fair values or obtain market quotations for substantially all of our fixed maturity and equity investments. These pricing services utilize market quotations for fixed maturity and equity securities that have quoted prices in active markets. For fixed maturity securities that generally do not trade on a daily basis, the pricing services prepare estimates of fair value measurements based predominantly on observable market inputs. The pricing services do not use broker quotes in determining the fair values of our investments. Our investment personnel review the estimates of fair value the pricing services provide to determine if the estimates we obtain are representative of fair values based upon our investment personnel's general knowledge of the market, their research findings related to unusual fluctuations in value and their comparison of such values to execution prices for similar securities. Our investment personnel regularly monitor the market, current trading ranges for similar securities and the pricing of specific investments. Our investment personnel review all pricing estimates that we receive from the pricing services against their expectations with respect to pricing based on fair market curves, security ratings, coupon rates, security type and recent trading activity. Our investment personnel review documentation with respect to the pricing services' pricing methodology that they obtain periodically to determine if the primary pricing sources, market inputs and pricing frequency for various security types are reasonable. At December 31, 2013, we received one estimate per security from the pricing services, and we priced substantially all of our Level 1 and Level 2 investments using those prices. At March 31, 2014, we received two estimates per security from the pricing services, and we priced substantially all of our Level 1 and Level 2 investments using those prices. In our review of the estimates the pricing services provided at March 31, 2014 and December 31, 2013, we did not identify any discrepancies, and we did not make any adjustments to the estimates the pricing services provided.

We present our cash and short-term investments at estimated fair value. We classify these items as Level 1.

The carrying values in the balance sheet for premium receivables and reinsurance receivables and payables for premiums and paid losses and loss expenses approximate their fair values. The carrying amounts reported in the balance sheet for our subordinated debentures and borrowings under lines of credit approximate their fair values. We classify these items as Level 3.

We evaluate our 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 at March 31, 2014:

| <b>Fair Value</b> | <b>Fair Value Measurements Using</b>  |  |  |
|-------------------|---|--|--|
|                   | <b>Quoted Prices<br/>in Active<br/>Markets<br/>for<br/>Identical Assets<br/>(Level<br/>1)</b> | <b>Significant<br/>Other<br/>Observable<br/>Inputs<br/>(Level 2)</b> | <b>Significant<br/>Unobservable<br/>Inputs<br/>(Level 3)</b> |

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(in thousands)

|   |            |           |            |    |
|---|------------|-----------|------------|----|
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 12,987  | \$        | \$ 12,987  | \$ |
| Obligations of states and political subdivisions                                      | 278,709    |           | 278,709    |    |
| Corporate securities  | 62,617     |           | 62,617     |    |
| Mortgage-backed securities  | 77,215     |           | 77,215     |    |
| Equity securities   | 22,298     | 13,405    | 8,893      |    |
| Totals  | \$ 453,826 | \$ 13,405 | \$ 440,421 | \$ |

We did not transfer any investments between Levels 1 and 2 during the three months ended March 31, 2014.





amounts to other disclosures GAAP requires that provide additional detail about those amounts. The guidance was effective for interim and annual reporting periods after December 15, 2012. We adopted this new guidance as of January 1, 2013. Our adoption of this new guidance did not impact our financial position, results of operations or cash flows.

In July 2013, the FASB issued a new standard that requires an entity to present an unrecognized tax benefit as a reduction of a deferred tax asset for a net operating loss carryforward or similar tax loss or tax credit carryforward, rather than as a liability, when the uncertain tax position would reduce the net operating loss or other carryforward under the tax law of the applicable jurisdiction and when the entity intends to use the deferred tax asset for that purpose. The new standard was effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. We adopted this new guidance as of January 1, 2014. Our adoption of this new standard did not impact our financial position, results of operations or cash flows.

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

We recommend that you read the following information in conjunction with the historical financial information and the footnotes to that financial information we include in this Quarterly Report on Form 10-Q. We also recommend you read Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2013.

#### **Critical Accounting Policies and Estimates**

We combine our financial statements with those of our insurance subsidiaries and present our financial statements 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 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 determination of other-than-temporary investment impairments and the policy acquisition costs of our insurance subsidiaries. While we believe our estimates and the estimates of our insurance subsidiaries are appropriate, the ultimate amounts may differ from the estimates we provided. We regularly review our methods for making these estimates and we reflect any adjustment we consider necessary in our current results of operations.

#### **Liability for Unpaid 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. At the time of establishing its estimates, an insurer recognizes that its ultimate liability for losses and loss expenses will exceed or be less than such estimates. Our insurance subsidiaries base their estimates of liabilities for losses and loss expenses on assumptions as to future loss trends, expected claims severity, judicial theories of liability and other factors. However, during the loss adjustment period, our insurance subsidiaries may learn additional facts regarding individual claims, and, consequently, it often becomes necessary for our insurance subsidiaries to refine and adjust their estimates of liability. We reflect any adjustments to our insurance subsidiaries' liabilities for losses and loss expenses in our consolidated results of operations in the period in which our insurance subsidiaries make the changes in estimates.

Our insurance subsidiaries maintain liabilities for the payment of losses and loss expenses with respect to both reported and unreported claims. Our insurance subsidiaries establish these liabilities for the purpose of covering the ultimate costs of settling all losses, including investigation and litigation costs. 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 the policyholder incurred. 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.

Reserve estimates can change over time because of unexpected changes in assumptions related to our insurance subsidiaries' external environment and, to a lesser extent, assumptions related to our insurance subsidiaries' internal operations. For example, our insurance subsidiaries have experienced a decrease in claims frequency on workers compensation 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 workers' compensation claims. Related

uncertainties regarding future trends include the cost of medical technologies and procedures and changes in the utilization of medical procedures. Assumptions related to our insurance subsidiaries' external environment include the absence of significant changes in tort law and the legal environment that increase liability exposure, consistency in judicial interpretations of insurance coverage and policy provisions and the rate of loss cost inflation. Internal assumptions include consistency in the recording of premium and loss statistics, consistency in the recording of claims, payment and case reserving methodology, accurate measurement of the impact of rate changes and changes in policy provisions, consistency in the quality and characteristics of business written within a given line of business and consistency in reinsurance coverage and collectability of reinsured losses, among other items. To the extent our insurance subsidiaries determine that underlying factors impacting their assumptions have changed, our insurance subsidiaries attempt to make appropriate adjustments for such changes in their reserves. Accordingly, our insurance subsidiaries' ultimate liability for unpaid losses and loss expenses will likely differ from the amount recorded at March 31, 2014. For every 1% change in our insurance subsidiaries' estimate for loss and loss expense reserves, net of reinsurance recoverable, the effect on our pre-tax results of operations would be approximately \$2.7 million.

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The establishment of appropriate liabilities is an inherently uncertain process and we can provide no assurance that our insurance subsidiaries' ultimate liability 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 of future liabilities have exceeded their actual liabilities. Changes in our insurance subsidiaries' estimate of their liability for losses and loss expenses generally reflect actual payments and their evaluation of information received since the prior reporting date.

Excluding the impact of severe weather events, our insurance subsidiaries have noted stable amounts in the number of claims incurred and a slight downward trend in 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 United States property and casualty insurance industry has experienced increased litigation trends and economic conditions that have extended the estimated length of disabilities and contributed to increased medical loss costs. We have also experienced a general slowing of settlement rates in litigated claims. Our insurance subsidiaries could have to make further adjustments to their estimates 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.

Atlantic States' participation in the pool with Donegal Mutual exposes it to adverse loss development on the business of Donegal Mutual that the pool includes. 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. The business in the pool is homogeneous and each company has a pro-rata share of the entire pool. Since substantially all of the business of Atlantic States and Donegal Mutual is pooled and the results shared by each company according to its participation level under the terms of the pooling agreement, the intent of the underwriting pool is 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 between the companies.

Donegal Mutual and our insurance subsidiaries operate together as the Donegal Insurance Group and share a combined business plan designed to achieve market penetration and underwriting profitability objectives. The products our insurance subsidiaries and Donegal Mutual offer 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

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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 the individual companies write directly will vary. However, because the pool homogenizes the risk characteristics of all business Donegal Mutual and Atlantic States write directly and each company shares the results according to each company's participation percentage, each company realizes its percentage share of the underwriting results of the pool. Our insurance subsidiaries' unpaid liability for losses and loss expenses by major line of business at March 31, 2014 and December 31, 2013 consisted of the following:

|  | <b>March 31,<br/>2014</b> | <b>December 31,<br/>2013</b> |
|--|---------------------------|------------------------------|
|  | (in thousands)            |                              |
| <b>Commercial lines:</b>                                   |                           |                              |
| Automobile   | \$ 36,295                 | \$ 36,017                    |
| Workers compensation                                       | 82,997                    | 79,932                       |
| Commercial multi-peril                                     | 43,219                    | 39,822                       |
| Other  | 2,678                     | 2,716                        |
| <b>Total commercial lines</b>                              | <b>165,189</b>            | <b>158,487</b>               |
| <b>Personal lines:</b>                                     |                           |                              |
| Automobile   | 88,272                    | 92,280                       |
| Homeowners   | 13,198                    | 13,367                       |
| Other  | 2,043                     | 1,471                        |
| <b>Total personal lines</b>                                | <b>103,513</b>            | <b>107,118</b>               |
| <b>Total commercial and personal lines</b>                 | <b>268,702</b>            | <b>265,605</b>               |
| <b>Plus reinsurance recoverable</b>                        | <b>241,420</b>            | <b>230,014</b>               |
| <b>Total liability for unpaid losses and loss expenses</b> | <b>\$ 510,122</b>         | <b>\$ 495,619</b>            |

We have evaluated the effect on our insurance subsidiaries' unpaid loss and loss expense reserves and our stockholders' equity in the event of reasonably likely changes in the variables we consider 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' unpaid loss and loss expense reserves and our stockholders' equity in the event of reasonably likely changes in the variables we considered in establishing the loss and loss expense reserves of our insurance subsidiaries:

| <b>Percentage<br/>Change in Loss<br/>and Loss Expense</b> | <b>Adjusted Loss and<br/>Loss Expense<br/>Reserves Net</b> | <b>Percentage<br/>Change<br/>in Stockholders</b> | <b>Adjusted Loss and<br/>Loss Expense<br/>Reserves Net</b> | <b>Percentage<br/>Change<br/>in Stockholders</b> |
|---|--|--|--|--|
|---|--|--|--|--|

| <b>Reserves<br/>Net<br/>of<br/>Reinsurance</b> | <b>of<br/>Reinsurance<br/>at<br/>March 31,<br/>2014</b> | <b>Equity at<br/>March 31, 2014(1)</b> | <b>of<br/>Reinsurance<br/>at<br/>December 31, 2013</b> | <b>Equity at<br/>December 31, 2013(1)</b> |
|--|---|--|--|---|
| (dollars in thousands)                         |   |  |  |   |
| (10.0)%  | \$ 241,832  | 4.3%                                   | \$ 239,045   | 4.4%                                      |
| (7.5)  | 248,549   | 3.3                                    | 245,685  | 3.3                                       |
| (5.0)  | 255,267   | 2.2                                    | 252,325  | 2.2                                       |
| (2.5)  | 261,984   | 1.1                                    | 258,965  | 1.1                                       |
| Base   | 268,702   |  | 265,605  |   |
| 2.5  | 275,420   | (1.1)                                  | 272,245  | (1.1)                                     |
| 5.0  | 282,137   | (2.2)                                  | 278,885  | (2.2)                                     |
| 7.5  | 288,855   | (3.3)                                  | 285,525  | (3.3)                                     |
| 10.0   | 295,572   | (4.3)                                  | 292,166  | (4.4)                                     |

(1) Net of income tax effect.

#### Statutory Combined Ratios

We evaluate our insurance operations by monitoring certain key measures of growth and profitability. In addition to using GAAP-based performance measurements, we also utilize certain non-GAAP financial measures that we believe are

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valuable in managing our business and for comparison to our peers. These non-GAAP measures are underwriting (loss) income, combined ratio and net premiums written. An insurance company's statutory combined ratio is a standard measure of underwriting profitability. This ratio is the sum of the ratio of calendar-year incurred losses and loss expenses to premiums earned; the ratio of expenses incurred for commissions, premium taxes and underwriting expenses to net premiums written and the ratio of dividends to policyholders to premiums earned. The combined ratio does not reflect investment income, federal income taxes or other non-operating income or expense. A combined ratio of less than 100 percent generally indicates underwriting profitability. The statutory combined ratio differs from the GAAP combined ratio. In calculating the GAAP combined ratio, we do not deduct installment payment fees from incurred expenses, and we base the expense ratio on premiums earned instead of premiums written. The following table sets forth our insurance subsidiaries' statutory combined ratios by major line of business for the three months ended March 31, 2014 and 2013:

|                                     | <b>Three Months Ended</b> |             |
|-------------------------------------|---------------------------|-------------|
|                                     | <b>March 31,</b>          |             |
|                                     | <b>2014</b>               | <b>2013</b> |
| <b>Commercial lines:</b>            |                           |             |
| Automobile                          | 100.0%                    | 102.7%      |
| Workers compensation                | 97.6                      | 101.6       |
| Commercial multi-peril              | 119.3                     | 98.5        |
| Other                               | NM <sup>1</sup>           | NM          |
| Total commercial lines              | 104.3                     | 98.4        |
| <b>Personal lines:</b>              |                           |             |
| Automobile                          | 97.9                      | 104.2       |
| Homeowners                          | 109.8                     | 89.1        |
| Other                               | 121.5                     | 82.5        |
| Total personal lines                | 102.7                     | 98.1        |
| Total commercial and personal lines | 103.2                     | 98.0        |

<sup>1</sup> Not meaningful  
Investments

We make estimates concerning the valuation of our investments and the recognition of other-than-temporary declines in the value of our investments. For equity securities, we write down an individual investment to its fair value and we reflect the amount of the write-down as a realized loss in our results of operations when we consider the decline in value of the individual investment to be other than temporary. We individually monitor all investments for other-than-temporary declines in value. Generally, we assume there has been an other-than-temporary decline in value if an individual equity security has depreciated in value by more than 20% of its original cost and has been in such an unrealized loss position for more than six months. We held two equity securities that were in an unrealized loss position at March 31, 2014. Based upon our analysis of general market conditions and underlying factors impacting these equity securities, we considered these declines in value to be temporary. With respect to a debt security that is in an unrealized loss position, we first assess if we intend to sell the debt security. If we determine we intend to sell the debt security, we recognize the impairment loss in our results of operations. If we do not intend to sell the debt security, we determine whether it is more likely than not that we will be required to sell the debt security prior to recovery. If we determine it is more likely than not that we will be required to sell the debt security prior to recovery, we recognize an impairment loss in our results of operations. If we determine it is more likely than not that we will not

be required to sell the debt security prior to recovery, we then evaluate whether a credit loss has occurred. We determine whether a credit loss has occurred by comparing the amortized cost of the debt security to the present value of the cash flows we expect to collect on the debt security. If we expect a cash flow shortfall, we consider that a credit loss has occurred. If we determine that a credit loss has occurred, we consider the impairment to be other than temporary. We then recognize the amount of the impairment loss related to the credit loss in our results of operations, and we recognize the remaining portion of the impairment loss in our other comprehensive income, net of applicable taxes. In addition, we may write down securities in an unrealized loss position based on a number of other factors, including when the fair value of an investment is significantly below its cost, when the financial condition of the issuer of a security has deteriorated, the occurrence of industry, company or geographic events that have negatively impacted the value of a security or rating agency downgrades. We held 128 debt securities that were in an unrealized loss position at March 31, 2014. Based upon our analysis of general market conditions and underlying factors impacting these debt securities, we considered these declines in value to be temporary. We did not recognize any impairment losses in the first three months of 2014 or 2013.



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We present our investments in available-for-sale fixed maturity and equity securities at estimated fair value. The estimated fair value of a security may differ from the amount we could realize if we sold the security in a forced transaction. In addition, the valuation of fixed maturity investments is more subjective when markets are less liquid, increasing the potential that the estimated fair value does not reflect the price at which an actual transaction would occur. We utilize nationally recognized independent pricing services to estimate fair values or obtain market quotations for substantially all of our fixed maturity and equity investments. The pricing services utilize market quotations for fixed maturity and equity securities that have quoted prices in active markets. For fixed maturity securities that generally do not trade on a daily basis, the pricing services prepare estimates of fair value measurements based predominantly on observable market inputs. The pricing services do not use broker quotes in determining the fair values of our investments. Our investment personnel review the estimates of fair value the pricing services provide to determine if the estimates we obtain are representative of fair values based upon their general knowledge of the market, their research findings related to unusual fluctuations in value and their comparison of such values to execution prices for similar securities. Our investment personnel monitor the market and are familiar with current trading ranges for similar securities and pricing of specific investments. Our investment personnel review all pricing estimates that we receive from the pricing services against their expectations with respect to pricing based on fair market curves, security ratings, coupon rates, security type and recent trading activity. Our investment personnel review documentation with respect to the pricing services pricing methodology that they obtain periodically to determine if the primary pricing sources, market inputs and pricing frequency for various security types are reasonable. At December 31, 2013, we received one estimate per security from the pricing services, and we priced substantially all of our Level 1 and Level 2 investments using those prices. At March 31, 2014, we received two estimates per security from the pricing services, and we priced substantially all of our Level 1 and Level 2 investments using those prices. In our review of the estimates the pricing services provided at March 31, 2014 and December 31, 2013, we did not identify any discrepancies and we did not make any adjustments to the estimates the pricing services provided.

**Policy Acquisition Costs**

Our insurance subsidiaries defer their policy acquisition costs, consisting primarily of commissions, premium taxes and certain other underwriting costs that relate directly to the successful acquisition of insurance policies. We amortize these costs over the period in which our insurance subsidiaries earn the related premiums. The method we follow in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value. This method 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.

**Results of Operations - Three Months Ended March 31, 2014 Compared to Three Months Ended March 31, 2013**

*Net Premiums Written.* Our insurance subsidiaries net premiums written for the three months ended March 31, 2014 were \$144.6 million, an increase of \$12.1 million, or 9.1%, from the \$132.5 million of net premiums written for the first quarter of 2013. We primarily attribute the increase to a reduction in MICO's external quota-share reinsurance, the impact of premium rate increases and an increase in the writing of commercial lines of business. Effective January 1, 2014, MICO reduced its external quota-share reinsurance percentage from 30% to 20%. Personal lines net premiums written increased \$3.4 million, or 4.6%, for the first quarter of 2014 compared to the first quarter of 2013. The increase included \$1.1 million related to the MICO reinsurance change, with the remainder of the increase attributable to premium rate increases our insurance subsidiaries implemented throughout 2013. Commercial lines net premiums written increased \$8.7 million, or 14.9%, for the first quarter of 2014 compared to the first quarter of 2013. The increase included \$1.7 million related to the MICO reinsurance change, with the remainder of the increase attributable to premium rate increases and increased writings of new accounts in the commercial automobile, commercial

multi-peril and workers compensation lines of business.

*Net Premiums Earned.* Our insurance subsidiaries net premiums earned for the first quarter of 2014 were \$133.5 million, an increase of \$8.8 million, or 7.1%, compared to \$124.7 million for the first quarter of 2013, reflecting increases in net premiums written during 2014 and 2013. 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 12-month period compared to the comparable period one year earlier.

*Investment Income.* Our net investment income was \$4.6 million for the first quarter of 2014, compared to \$4.8 million for the first quarter of 2013. We attribute the decrease primarily to lower average investment yields on our invested assets.

*Net Realized Investment (Losses) Gains.* Net realized investment losses for the first quarter of 2014 were \$88,532, compared to net realized investment gains of \$1.3 million for the first quarter of 2013. The net realized investment (losses) gains for the first quarters of 2014 and 2013 resulted primarily from strategic sales of fixed maturities within our investment portfolio. We did not recognize any impairment losses in our investment portfolio during the first quarter of 2014 or 2013.

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*Equity in Earnings of DFSC.* Our equity in the earnings of DFSC was \$409,242 for the first quarter of 2014, compared to \$1.1 million for the first quarter of 2013. The decrease in DFSC's earnings resulted from a lesser benefit from acquisition accounting adjustments during the first quarter of 2014 compared to the first quarter of 2013.

*Losses and Loss Expenses.* Our insurance subsidiaries' loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, for the first quarter of 2014 was 73.1%, an increase from our insurance subsidiaries' 68.6% loss ratio for the first quarter of 2013. Our insurance subsidiaries' commercial lines loss ratio increased to 75.6% for the first quarter of 2014 compared to 70.6% for the first quarter of 2013, primarily due to an increase in the commercial multi-peril loss ratio. The personal lines loss ratio increased to 72.2% for the first quarter of 2014 compared to 67.9% for the first quarter of 2013, primarily due to an increase in the homeowners loss ratios. We primarily attribute the increased loss ratios to an increase in weather-related losses to \$15.3 million for the first quarter of 2014, compared to \$5.6 million for the first quarter of 2013. Our insurance subsidiaries experienced favorable loss reserve development of approximately \$430,000 during the first quarter of 2014 in their reserves for prior accident years, compared to unfavorable loss reserve development of approximately \$1.8 million during the first quarter of 2013. The change in loss reserve development patterns occurred primarily within our insurance subsidiaries' commercial automobile, personal automobile and workers' compensation reserves.

*Underwriting Expenses.* The expense ratio for an insurance company is the ratio of policy acquisition costs and other underwriting expenses to premiums earned. The expense ratio of our insurance subsidiaries was 31.3% for the first quarter of 2014, compared to 30.7% for the first quarter of 2013.

*Combined Ratio.* The combined ratio represents the sum of the loss ratio, the expense ratio and the dividend ratio, which is the ratio of workers' compensation policy dividends incurred to premiums earned. Our insurance subsidiaries' combined ratio was 104.7% and 99.7% for the three months ended March 31, 2014 and 2013, respectively.

*Interest Expense.* Our interest expense for the first quarter of 2014 was \$365,482, compared to \$487,149 for the first quarter of 2013. The decrease was related to a lower average interest rate on borrowings during the first quarter of 2014 compared to the first quarter of 2013 due to the utilization of FHLB borrowings to prepay \$15.5 million of subordinated debentures during the first quarter of 2013.

*Income Taxes.* Income tax benefit was \$158,802 for the first quarter of 2014, representing an effective tax rate of 20.0%, compared to income tax expense of \$1.6 million for the first quarter of 2013, representing an effective tax rate of 19.9%. The effective tax rate in both periods represented an estimate based on projected annual taxable income.

*Net (Loss) Income and Earnings Per Share.* Our net loss for the first quarter of 2014 was \$634,414, or \$.02 per share of Class A common stock and \$.02 per share of Class B common stock, compared to net income of \$6.5 million, or \$.25 per share of Class A common stock on a diluted basis and \$.23 per share of Class B common stock, for the first quarter of 2013. We had 20.9 million and 20.2 million Class A shares outstanding at March 31, 2014 and 2013, respectively. We had 5.6 million Class B shares outstanding 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 such obligations and needs arise. Our major sources of funds from operations are the net cash flows we generate from our insurance subsidiaries' underwriting results, investment income and investment maturities.

We have historically generated sufficient net positive cash flow from our operations to fund our commitments and add to 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 consistent underwriting profitability of the pool. Donegal Mutual and Atlantic States settle their respective obligations to each other under the pool monthly, thereby resulting in cash flows substantially similar to the cash flows that would result from each company writing 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 significant liquidity in our investment portfolio in the form of readily marketable fixed maturities, equity securities and short-term investments. We structure our fixed-maturity investment portfolio 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. The net cash flows (used in) provided by our operating activities in the first three months of 2014 and 2013 were (\$5.3 million) and \$1.9 million, respectively, with the change in cash flows due primarily to our insurance subsidiaries increased claim payments during the first three months of 2014 compared to the prior-year period.

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At March 31, 2014, we had \$46.0 million in outstanding borrowings under our line of credit with M&T and had the ability to borrow an additional \$14.0 million at interest rates equal to M&T's current prime rate or the then current LIBOR rate plus 2.25%. At March 31, 2014, Atlantic States had \$15.0 million in outstanding advances with the FHLB of Pittsburgh. The interest rate on these advances was .30% at March 31, 2014.

The following table shows our expected payments for significant contractual obligations at March 31, 2014:

|   | <b>Total</b>      | <b>Less than<br/>1 year</b> | <b>1-3 years</b>  | <b>4-5 years</b> | <b>After 5 years</b> |
|---|-------------------|-----------------------------|-------------------|------------------|----------------------|
|   |                   |                             | (in thousands)    |                  |                      |
| Net liability for unpaid losses and loss expenses of our insurance subsidiaries | \$ 268,702        | \$ 123,077                  | \$ 122,814        | \$ 10,537        | \$ 12,274            |
| Subordinated debentures   | 5,000             |                             |                   |                  | 5,000                |
| Borrowings under lines of credit  | 61,000            | 15,000                      | 46,000            |                  |                      |
| <b>Total contractual obligations</b>  | <b>\$ 334,702</b> | <b>\$ 138,077</b>           | <b>\$ 168,814</b> | <b>\$ 10,537</b> | <b>\$ 17,274</b>     |

We estimate the date of payment for the net liability for unpaid losses and loss expenses of our insurance subsidiaries based on historical experience and expectations of future payment patterns. We show the liability net of reinsurance recoverable on unpaid losses and loss expenses to reflect expected future cash flows related to such liability. Amounts Atlantic States assumes pursuant to the pooling agreement with Donegal Mutual represent a substantial portion of our insurance subsidiaries' gross liability for unpaid losses and loss expenses, and amounts Atlantic States cedes pursuant to the pooling agreement represent a substantial portion of our insurance subsidiaries' reinsurance recoverable on unpaid losses and loss expenses. We include cash settlement of Atlantic States' assumed liability from the pool 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 by Atlantic States for its percentage share of pooled losses occurring in periods prior to the effective date of such change.

We estimate the timing of the amounts for the borrowings under our lines of credit based on their contractual maturities we discuss in Note 7 – Borrowings. The borrowings under our lines of credit carry interest rates that vary as we discuss in Note 7 – Borrowings. Based upon the interest rates in effect at March 31, 2014, our annual interest cost associated with the borrowings under our lines of credit is approximately \$1.1 million. For every 1% change in the interest rate associated with the borrowings under our lines of credit, the effect on our annual interest cost would be approximately \$610,000.

We estimate the timing of the amounts for the subordinated debentures based on their contractual maturity we discuss in Note 7 – Borrowings. The subordinated debentures carry an interest rate of 5%, and any repayment of principal or payment of interest on the subordinated debentures requires prior regulatory approval of the Michigan Department of Insurance and Financial Services. Our annual interest cost associated with the subordinated debentures is approximately \$250,000.

On February 23, 2009, our board of directors authorized a share repurchase program pursuant to which we may purchase up to 300,000 shares of our Class A common stock at prices prevailing from time to time in the open market subject to the provisions of applicable rules of the Securities and Exchange Commission (the "SEC") and in privately negotiated transactions. We purchased 846 shares of our Class A common stock under this program during the three

months ended March 31, 2014. We did not purchase any shares under this program during the three-month period ended March 31, 2013. We have purchased a total of 296,778 shares of our Class A common stock under this program from its inception through March 31, 2014.

On July 18, 2013, our board of directors authorized a share repurchase program pursuant to which we have the authority to purchase up to 500,000 additional shares of our Class A common stock at prices prevailing from time to time in the open market subject to the provisions of applicable rules of the SEC and in privately negotiated transactions. We did not purchase any shares of our Class A common stock under this program during the three-month period ended March 31, 2014.

On April 17, 2014, our board of directors declared quarterly cash dividends of 13.15 cents per share of our Class A common stock and 11.60 cents per share of our Class B common stock, payable on May 15, 2014 to our stockholders of record as of the close of business on May 1, 2014. We are not subject to any restrictions on our payment of dividends to our stockholders, although there are state law restrictions on the payment of dividends by our insurance subsidiaries to us. Dividends from our insurance subsidiaries are our principal source of cash for payment of dividends to our stockholders. Our insurance subsidiaries are subject to regulations that restrict the payment of dividends from statutory surplus and may require prior approval of their domiciliary insurance regulatory authorities. Our insurance subsidiaries are also subject to risk based capital ( RBC ) requirements that may further impact their ability to pay dividends to us. Our insurance subsidiaries' statutory capital and surplus at December 31, 2013 exceeded the amount of statutory

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capital and surplus necessary to satisfy regulatory requirements, including the RBC requirements, by a significant margin. Amounts remaining available for distribution to us as dividends from our insurance subsidiaries without prior approval of their domiciliary insurance regulatory authorities in 2014 are \$18.7 million from Atlantic States, \$4.2 million from Southern, \$2.8 million from Le Mars, \$4.2 million from Peninsula, \$1.1 million from Sheboygan and \$4.1 million from MICO, or a total of approximately \$35.1 million.

At March 31, 2014, we had no material commitments for capital expenditures.

## **Equity Price Risk**

Our portfolio of marketable equity securities, which we carry 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 its 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 we invest in the securities of any one issuer.

Our insurance subsidiaries provide property and casualty insurance coverages through independent insurance agencies. We bill the majority of this business directly to the insured, although we bill a portion of our commercial business through licensed insurance 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 unpaid 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.

## **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 the securities we hold in our investment portfolio as a result of fluctuations in prices and interest rates and, to a lesser extent, our debt obligations. We 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 our debt obligations.

Our investment mix shifted slightly during the first three months of 2014. We reinvested funds we held in short-term investments at year-end 2013 into fixed maturities. The duration of our investment portfolio increased slightly due to this reinvestment activity.

There have been no material changes to our quantitative or qualitative market risk exposure from December 31, 2013 through March 31, 2014.

**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, at the end of the period this Quarterly Report on Form 10-Q covers. 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.



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**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 Quarterly Report on Form 10-Q 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**

We base all statements contained in this Quarterly Report on Form 10-Q that are not historic facts on our current expectations. Such statements are forward-looking in nature (as defined in the Private Securities Litigation Reform Act of 1995) and necessarily involve risks and uncertainties. Forward-looking statements we make may be identified by our use of words such as will, expects, intends, plans, anticipates, believes, seeks, estimates and similar expressions. Actual results could vary materially. The factors that could cause our actual results to vary materially from forward-looking statements we have previously made, include, but are not limited to, our ability to maintain profitable operations, the adequacy of the loss and loss expense reserves of our insurance subsidiaries, business and economic conditions in the areas in which we operate, interest rates, competition from various insurance and other financial businesses, terrorism, the availability and cost of reinsurance, adverse and catastrophic weather events, legal and judicial developments, changes in regulatory requirements, our ability to integrate and manage successfully the companies we may acquire from time to time and the other risks that we describe from time to time in our filings with the SEC. We disclaim any obligation to update such statements or to announce publicly the results of any revisions that we may make to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

**Item 4T. Controls and Procedures.**

Not applicable.

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

None.

**Item 1A. 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 Risk Factors in our 2013 Annual Report on Form 10-K filed with the SEC on March 14, 2014. There have been no material changes in the risk factors disclosed in that Form 10-K Report during the three months ended March 31, 2014.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

| 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 |
|---------------------|---|------|--|---------|---|---------|---|
|                     |   |      |  |         | Class A   | Class B | Class A   |
| Month #1            | Class A   | None | Class A                                    | None    | Class A   | None    |   |
| January 1-31, 2014  | Class B   | None | Class B                                    | None    | Class B   | None    |   |
| Month #2            | Class A   | None | Class A                                    | None    | Class A   | None    |   |
| February 1-28, 2014 | Class B   | None | Class B                                    | None    | Class B   | None    |   |
| Month #3            | Class A   | 846  | Class A                                    | \$14.22 | Class A   | 846     |   |
| March 1-31, 2014    | Class B   | None | Class B                                    | None    | Class B   | None    | (1)   |
| Total               | Class A   | 846  | Class A                                    | \$14.22 | Class A   | 846     |   |
|                     | Class B   | None | Class B                                    | None    | Class B   | None    |   |

- (1) We purchased these shares pursuant to our announcement on February 23, 2009 that we will purchase up to 300,000 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 3,222 additional shares of our Class A common stock under this stock repurchase program.

**Item 3. Defaults upon Senior Securities.**

None.

**Item 4. Removed and Reserved.**

**Item 5. Other Information.**

None.

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**Table of Contents****Item 6. Exhibits.**

| <b>Exhibit No.</b> | <b>Description</b>  |
|--------------------|---|
| 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 |
| Exhibit 101.INS    | XBRL Instance Document  |
| Exhibit 101.SCH    | XBRL Taxonomy Extension Schema Document   |
| Exhibit 101.PRE    | XBRL Taxonomy Presentation Linkbase Document  |
| Exhibit 101.CAL    | XBRL Taxonomy Calculation Linkbase Document   |
| Exhibit 101.LAB    | XBRL Taxonomy Label Linkbase Document   |
| Exhibit 101.DEF    | XBRL Taxonomy Extension Definition Linkbase Document  |

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**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.**

May 8, 2014

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

May 8, 2014

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