DONEGAL GROUP INC
Form 10-Q
May 08, 2006

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

(Mark One)

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

For the quarterly period ended March 31, 2006

OR

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

For the transition period from __________ to __________.

Commission file number 0-15341

Donegal Group Inc.

(Exact name of registrant as specified in its charter)

Delaware	23-2424711
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1195 River Road, P.O. Box 302, Marietta, PA	17547-0302
(Address of principal executive offices)	(Zip code)

(717) 426-1931
(Registrant s telephone number, including area code)
Not applicable
(Former name, former address and former fiscal year, if changed since last report)

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

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

Large accelerated filer o   Accelerated filer þ   Non-accelerated filer o.

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 19,294,813 shares of Class A Common Stock, par value $0.01 per share, and 5,576,912 shares of Class B Common Stock, par value $0.01 per share, outstanding on April 28, 2006.

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Part I. Financial Information

Item 1. Financial Statements.

Donegal Group Inc. and Subsidiaries
Consolidated Balance Sheets

	March 31, 2006 (Unaudited)	December 31, 2005
Assets		
Investments		
Fixed maturities		
Held to maturity, at amortized cost	$ 179,383,140	$ 180,182,305
Available for sale, at fair value	293,568,415	295,097,235
Equity securities, available for sale, at fair value	40,964,727	33,371,360
Investments in affiliates	8,248,375	8,441,546
Short-term investments, at cost, which approximates fair value	27,996,551	30,653,668
Total investments	550,161,208	547,746,114
Cash	3,879,087	3,811,011
Accrued investment income	5,139,035	5,521,335
Premiums receivable	47,644,185	47,124,106
Reinsurance receivable	104,525,453	94,137,096
Deferred policy acquisition costs	23,557,086	23,476,593
Deferred tax asset, net	12,107,562	11,532,834
Prepaid reinsurance premiums	41,278,362	40,063,138
Property and equipment, net	5,211,731	5,234,423
Accounts receivable securities	3,382,991	411,149
Federal income taxes recoverable		901,341
Due from affiliate	4,306,037	
Other	1,645,762	1,462,448
Total assets	$ 802,838,499	$ 781,421,588
Liabilities and Stockholders Equity		
Liabilities		
Losses and loss expenses	$ 275,977,730	$ 265,729,527
Unearned premiums	189,540,158	186,660,050
Accrued expenses	9,310,292	12,706,485
Reinsurance balances payable	1,952,635	1,814,292
Federal income taxes payable	2,599,806	
Cash dividends declared to stockholders		1,781,393
Subordinated debentures	30,929,000	30,929,000
Accounts payable securities	1,195,052	896,893
Due to affiliate		728,486
Drafts payable	419,275	703,912
Other	2,482,357	1,575,364

Total liabilities	514,406,305	503,525,402
Stockholders Equity		
Preferred stock, $1.00 par value, authorized 2,000,000 shares; none issued		
Class A common stock, $.01 par value, authorized 30,000,000 shares, issued 19,400,411 and 19,156,459 shares and outstanding 19,255,480 and 19,011,528 shares	194,004	191,565
Class B common stock, $.01 par value, authorized 10,000,000 shares, issued 5,649,377 shares and outstanding 5,576,912 shares	56,494	56,494
Additional paid-in capital	144,700,435	141,932,954
Accumulated other comprehensive income	1,208,604	2,532,073
Retained earnings	143,164,405	134,074,848
Treasury stock	(891,748)	(891,748)
Total stockholders equity	288,432,194	277,896,186
Total liabilities and stockholders equity	$ 802,838,499	$ 781,421,588

All capital accounts and share information have been restated for 4-for-3 stock split as discussed in footnote 1.

See accompanying notes to consolidated financial statements.

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

	Three Months Ended March 31,	
	2006	**2005**
Revenues:		
Net premiums earned	$ 74,513,849	$ 71,762,523
Investment income, net of investment expenses	4,984,528	4,407,468
Net realized investment gains	474,799	690,291
Lease income	242,239	229,216
Installment payment fees	1,067,480	989,560
Total revenues	81,282,895	78,079,058
Expenses:		
Net losses and loss expenses	43,288,512	41,537,896
Amortization of deferred policy acquisition costs	11,886,000	11,486,000
Other underwriting expenses	11,901,257	11,654,117
Policy dividends	371,772	351,597
Interest	644,378	498,763
Other expenses	392,895	429,681
Total expenses	68,484,814	65,958,054
Income before income tax expense	12,798,081	12,121,004
Income tax expense	3,667,894	3,703,916
Net income	$ 9,130,187	$ 8,417,088
Net income per common share:		
Basic	$ 0.37	$ 0.35
Diluted	$ 0.36	$ 0.34

Consolidated Statements of Comprehensive Income

	Three Months Ended March 31,	
	2006	**2005**
Net income	$ 9,130,187	$ 8,417,088
Other comprehensive loss, net of tax		
Unrealized loss on securities:		
Unrealized holding loss during the period, net of income tax	(1,014,850)	(2,951,019)

Reclassification adjustment, net of income tax	(308,619)	(448,689)
Other comprehensive loss	(1,323,469)	(3,399,708)
Comprehensive income	$ 7,806,718	$ 5,017,380

All per share information has been restated for 4-for-3 stock split as discussed in footnote 1.

See accompanying notes to consolidated financial statements.

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Donegal Group Inc. and Subsidiaries
Consolidated Statement of Stockholders Equity
(Unaudited)
Three Months Ended March 31, 2006

	Class A Shares	Class B Shares	Class A Amount	Class B Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Retained Earnings	Treasury Stock	Total Stockholders Equity
alance, ecember 31, 005	19,156,459	5,649,377	$ 191,565	$ 56,494	$ 141,932,954	$ 2,532,073	$ 134,074,848	$ (891,748)	$ 277,896,18
suance of mmon stock	14,180		142		186,115				186,25
et income							9,130,187		9,130,18
ash dividends							(1,804)		(1,80
xercise of ock options	229,772		2,297		1,673,674				1,675,97
rant of stock tions					38,826		(38,826)		
ax benefit on ercise of ock options					868,866				868,86
ther mprehensive ss						(1,323,469)			(1,323,46
alance, arch 31, 2006	19,400,411	5,649,377	$ 194,004	$ 56,494	$ 144,700,435	$ 1,208,604	$ 143,164,405	$ (891,748)	$ 288,432,19

All capital accounts and share information have been restated for 4-for-3 stock split as discussed in footnote 1.
See accompanying notes to consolidated financial statements.

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

	Three Months Ended March 31,	
	2006	**2005**
Cash Flows from Operating Activities:		
Net income	$ 9,130,187	$ 8,417,088
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	923,326	696,807
Realized investment gains	(474,799)	(690,291)
Changes in assets and liabilities:		
Losses and loss expenses	10,248,203	(1,347,758)
Unearned premiums	2,880,108	4,550,568
Premiums receivable	(520,079)	(1,708,430)
Deferred acquisition costs	(80,493)	(272,398)
Deferred income taxes	137,900	(96,361)
Reinsurance receivable	(10,388,357)	2,686,506
Prepaid reinsurance premiums	(1,215,224)	(1,814,771)
Accrued investment income	382,300	167,476
Due from affiliate	(5,034,523)	(148,809)
Reinsurance balances payable	138,343	149,564
Current income taxes	3,501,147	4,751,429
Accrued expenses	(3,396,193)	(2,502,030)
Drafts payable	(284,637)	(352,062)
Other, net	723,679	(367,483)
Net adjustments	(2,459,299)	3,701,957
Net cash provided by operating activities	6,670,888	12,119,045
Cash Flows from Investing Activities:		
Purchase of fixed maturities:		
Held to maturity		(9,747,396)
Available for sale	(21,518,161)	(49,853,143)
Purchase of equity securities, available for sale	(10,333,648)	(6,036,413)
Maturity of fixed maturities:		
Held to maturity	615,538	1,518,212
Available for sale	4,339,685	6,140,165
Sale of fixed maturities:		
Available for sale	15,432,558	19,864,324
Sale of equity securities, available for sale	1,640,474	5,320,535
Net decrease in investment in affiliates	20,057	35,956
Net purchases of property and equipment	(404,329)	(218,831)
Net sales of short-term investments	2,657,117	23,199,667

Net cash used in investing activities	(7,550,709)	(9,776,924)
Cash Flows from Financing Activities:		
Cash dividends paid	(1,783,197)	(1,581,261)
Issuance of common stock	1,862,228	220,192
Tax benefit on exercise of stock options	868,866	
Net cash provided by (used in) financing activities	947,897	(1,361,069)
Net increase in cash	68,076	981,052
Cash at beginning of period	3,811,011	7,350,330
Cash at end of period	$ 3,879,087	$ 8,331,382
Cash paid during period Interest	$ 648,522	$ 503,137
Net cash received during period Taxes	$ (850,000)	$ (950,000)

See accompanying notes to consolidated financial statements.

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

1 Organization

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

At March 31, 2006, the Mutual Company held approximately 41% of our outstanding Class A common stock and approximately 68% of our outstanding Class B common stock.

Atlantic States, our largest subsidiary, and the Mutual Company have a pooling agreement under which both companies proportionately share their combined underwriting results, excluding certain reinsurance assumed by the Mutual Company from our insurance subsidiaries. See Note 4 Reinsurance for more information regarding the pooling agreement.

On April 6, 2006, our board of directors declared a four-for-three stock split of our Class A common stock and our Class B common stock in the form of a 33-1/3% stock dividend with a record date of April 17, 2006 and a distribution date of April 26, 2006. The capital stock accounts, all share amounts and earnings per share amounts have been restated to reflect this stock split.

Effective as of September 21, 2005, certain members of the Donegal Insurance Group entered into an Acquisition Rights Agreement with The Shelby Insurance Company and Shelby Casualty Insurance Company (together, Shelby), part of Vesta Insurance Group, Inc. The agreement grants those members the right, effective January 1, 2006, at their discretion and subject to their traditional underwriting and agency appointment standards, to offer renewal or replacement policies to the holders of Shelby s personal lines policies in Pennsylvania, Tennessee and Alabama, in connection with Shelby s plans of withdrawal from those three states. As part of the agreement, the Donegal Insurance Group is paying specified amounts to Shelby based on the direct premiums written by the Donegal Insurance Group on the renewal and replacement policies it issues. Net premiums written related to this agreement amounted to $1.7 million in the first quarter of 2006.

2 Basis of Presentation

The financial information for the interim periods included herein is unaudited; however, such information reflects all adjustments, consisting only of normal recurring adjustments, that, in the opinion of management, are necessary for a fair presentation of our financial position, results of operations and cash flows for the interim periods included herein. Our results of operations for the three months ended March 31, 2006 are not necessarily indicative of our results of operations to be expected for the twelve months ending December 31, 2006.

These interim financial statements should be read in conjunction with the financial statements and notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2005.

Certain amounts in our 2005 consolidated financial statements have been reclassified to conform to the current year presentation.

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3 Earnings Per Share

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

Three Months Ended March 31:	Basic	Effect of Stock Options	Diluted
2006			
Net income	$ 9,130,187	$	$ 9,130,187
Weighted average shares outstanding	24,642,295	691,970	25,334,265
Earnings per common share:			
Net income	$ 0.37	$ (0.01)	$ 0.36
2005			
Net income	$ 8,417,088	$	$ 8,417,088
Weighted average shares outstanding	23,929,220	701,559	24,630,779
Earnings per common share:			
Net income	$ 0.35	$ (0.01)	$ 0.34

All outstanding options to purchase shares of Class A common stock were included in the computation of diluted earnings per share.

4 Reinsurance

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

Our insurance operations are interrelated with the insurance operations of the Mutual Company, and, while maintaining the separate corporate existence of each company, the Mutual Company and we conduct our insurance business together with our other insurance subsidiaries as the Donegal Insurance Group. As such, the Mutual Company and we share the same business philosophy, management, employees and facilities and offer the same types of insurance products. We do not anticipate any changes in the pooling agreement with the Mutual Company, including changes in Atlantic States pool participation level in the foreseeable future.

The risk profiles of the business written by Atlantic States and the Mutual Company historically have been, and continue to be, substantially similar. The products, classes of business underwritten, pricing practices and underwriting standards of both companies are determined and administered by the same management and underwriting personnel. Further, as the Donegal Insurance Group, the companies share a combined business plan to achieve market penetration and underwriting profitability objectives. The products marketed by Atlantic States and the Mutual Company 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 the respective companies generally relate to specific risk profiles targeted within similar classes of business, such as preferred tier versus standard tier products, but not all of the standard risk gradients are allocated to one company. Therefore, the underwriting profitability of the business directly written by the individual companies will vary. However, as the risk characteristics of all

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business written directly by both companies are homogenized within the pool and each company shares the results according to its participation level, we realize 70% of the underwriting profitability of the pool (because of our 70% participation in the pool), while the Mutual Company realizes 30% of the underwriting profitability of the pool (because of the Mutual Company s 30% participation in the pool). Pooled business represents the predominant percentage of the net underwriting activity of both participating companies.

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

excess of loss reinsurance, under which our losses are automatically reinsured, through a series of contracts, over a set retention ($400,000 for 2006), and

catastrophic reinsurance, under which we recover, through a series of contracts, between 95% and 100% of an accumulation of many losses resulting from a single event, including natural disasters ($3.0 million retention for 2006).

The amount of coverage provided under each of these types of reinsurance depends upon the amount, nature, size and location of the risk being reinsured. We and the Mutual Company also purchase facultative reinsurance to cover exposures from losses that exceed the limits provided by our respective treaty reinsurance.

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

There were no significant changes to the pooling agreement, third-party reinsurance or other reinsurance agreements with the Mutual Company during the three months ended March 31, 2006 and 2005.

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5 Segment Information

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

	Three Months Ended March 31,	
	2006	2005
	($ in thousands)	
Revenues:		
Premiums earned:		
Commercial lines	$ 28,880	$ 27,327
Personal lines	45,634	44,436
Net premiums earned	74,514	71,763
Net investment income	4,984	4,407
Realized investment gains	475	690
Other	1,310	1,219
Total revenues	$ 81,283	$ 78,079
Income before income taxes:		
Underwriting income:		
Commercial lines	$ 3,988	$ 3,653
Personal lines	2,380	2,702
SAP underwriting income	6,368	6,355
GAAP adjustments	698	378
GAAP underwriting income	7,066	6,733
Net investment income	4,984	4,407
Realized investment gains	475	690
Other	273	291
Income before income taxes	$ 12,798	$ 12,121

6 Subordinated Debentures

On May 15, 2003, we received $15.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 15, 2033 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 4.10%, which is adjustable quarterly. At March 31, 2006, the interest rate on the debentures was 8.85%.

On October 29, 2003, we received $10.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on October 29, 2033 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At March 31, 2006, the interest rate on the debentures was 8.51%.

On May 24, 2004, we received $5.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 24, 2034 and are callable at our option, at par, after five years. The debentures carry an

interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At March 31, 2006, the interest rate on the debentures was 8.63%.

7 Share Based Compensation

Effective January 1, 2006, we adopted Financial Accounting Standards Board (FASB) SFAS No. 123(R), Share-Based Payment, a revision of FAS No. 123 and superseding APB Opinion No. 25. FAS No. 123(R) requires the measurement of all employee share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in our consolidated statements of income.

FAS 123(R) does not set accounting requirements for share-based compensation to nonemployees. We continue to account for share-based compensation to nonemployees under the provisions of FASB Interpretation No. 44 (FIN No. 44), Accounting for Certain Transactions involving Stock Compensation, and Emerging Issues Task Force Issue No. 00-23 (EITF 00-23), Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25, Accounting for Stock Issued to Employees, and FIN No. 44, Accounting for Certain Transactions involving Stock Compensation. Pursuant to FIN No. 44, APB Opinion No. 25 did not apply in the separate financial statements of a subsidiary to the accounting for share-based compensation granted by the subsidiary to employees of the parent or another subsidiary. EITF 00-23 states that when employees of a controlling entity are granted share-based compensation, the entity granting the share-based compensation should measure the fair value of the award at the grant date and recognize the fair value as a dividend to the controlling entity. These provisions apply to us, because the Mutual Company is the employer of record for the majority of employees that provide services to us. As a result, the impact of the implementation of FAS 123(R) was immaterial to our results of operations for the three months ended March 31, 2006.

FAS No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under previous rules. Tax benefits realized upon the exercise of stock options of $868,866 and $15,708 for the three months ended March 31, 2006 and 2005, respectively, were classified as financing activities in our Consolidated Statement of Cash Flows.

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

The following information should be read in conjunction with the historical financial information and the notes thereto included in this Quarterly Report on Form 10-Q and Management s Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2005 as filed with the Securities and Exchange Commission on March 13, 2006.

Critical Accounting Policies and Estimates

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

We 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 our reserves for property and casualty insurance unpaid losses and loss expenses, valuation of investments and policy acquisition costs. While we believe our estimates are appropriate, the ultimate amounts may differ from the estimates provided. These estimates are regularly reviewed, and any adjustment considered necessary is reflected in our current results of operations.

Liability for Losses and Loss Expenses

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

We maintain liabilities for the payment of losses and loss expenses with respect to both reported and unreported claims. Liabilities for loss expenses are intended to cover the ultimate costs of settling all losses, including investigation and litigation costs from such losses. We base the amount of 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. We

determine the amount of our liability for unreported claims and loss expenses on the basis of historical information by line of insurance. We account for inflation in the reserving function through analysis of costs and trends, and reviews of historical reserving results. We closely monitor our liabilities and recompute them periodically using new information on reported claims and a variety of statistical techniques. Our liabilities for losses are not discounted.

Reserve estimates can change over time because of unexpected changes in assumptions related to our external environment and, to a lesser extent, assumptions as to our internal operations. Assumptions related to our external environment include the absence of significant changes in tort law and the legal environment that increase liability exposure, consistency in judicial interpretations of insurance coverage and policy provisions and stability in economic conditions and the rate of loss cost inflation. For example, we have experienced a decrease in claims frequency on bodily injury liability claims during the past several years while claims severity has gradually increased. These trend changes give rise to greater uncertainty as to the pattern of future loss settlements on bodily injury claims. Related uncertainties regarding future trends include the cost of medical technologies and procedures and changes in the utilization of medical procedures. Internal assumptions include accurate measurement of the impact of rate changes and changes in policy provisions and consistency in the quality and characteristics of business written within a given line of business, among other items. To the extent we determine that underlying factors impacting our assumptions have changed, we attempt to make appropriate adjustments for such changes in our reserves. Accordingly, our ultimate liability for unpaid losses and loss expenses will likely differ from the amount recorded at March 31, 2006. For every 1% change in our estimate for loss and loss expense reserves, net of reinsurance recoverable, the effect on our pre-tax results of operations would be approximately $1.7 million.

The establishment of appropriate liabilities is an inherently uncertain process, and there can be no assurance that our ultimate liability will not exceed our loss and loss expense reserves and have an adverse effect on our results of operations and financial condition. Furthermore, the timing, frequency and extent of adjustments to our estimated future liabilities cannot be predicted, since the historical conditions and events that serve as a basis for our estimates of ultimate claim costs may change. As is the case for substantially all property and casualty insurance companies, we have found it necessary in the past to increase our estimated future liabilities for losses and loss expenses in certain periods, and in other periods our estimates have exceeded our actual liabilities. Further adjustments could be required in the future. However, on the basis of our internal procedures, which analyze, among other things, our prior assumptions, our 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 we have made adequate provision for our liability for losses and loss expenses.

Because of our participation in the pool with the Mutual Company, we are exposed to adverse loss development on the business of the Mutual Company included in the pool. However, pooled business represents the predominant percentage of the net underwriting activity of both companies, and the Mutual Company and we would proportionately share any adverse risk development of the pooled business. The business in the pool is homogenous (i.e., we have a 70% share of the entire pool and the Mutual Company has a 30% share of the entire pool). Since substantially all of the business of Atlantic States and the Mutual Company is pooled and the results shared by each company according to its participation level under the terms of the pooling agreement, the underwriting pool is intended to produce a more uniform and stable underwriting result from year to year for each company than they would experience individually and to spread the risk of loss among each company.

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Our liability for losses and loss expenses by major line of business as of March 31, 2006 and December 31, 2005 consisted of the following:

(dollars in thousands)	March 31, 2006	December 31, 2005
Commercial lines:		
Automobile	$ 22,769	$ 23,532
Workers compensation	41,274	40,962
Commercial multi-peril	29,736	29,448
Other	3,174	3,088
Total commercial lines	96,953	97,030
Personal lines:		
Automobile	63,600	63,254
Homeowners	10,770	10,900
Other	1,713	1,825
Total personal lines	76,083	75,979
Total commercial and personal lines	173,036	173,009
Plus reinsurance recoverable	102,942	92,721
Total liability for losses and loss expenses	$ 275,978	$ 265,730

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

Change in Loss and Loss Expense Reserves Net of Reinsurance	Adjusted Loss and Loss Expense Reserves Net of Reinsurance as of March 31, 2006	Percentage Change in Equity as of March 31, 2006(1)	Adjusted Loss and Loss Expense Reserves Net of Reinsurance as of December 31, 2005	Percentage Change in Equity as of December 31, 2005(1)
		(dollars in thousands)		
(10.0)%	$155,732	3.9%	$155,708	4.0%
(7.5)	160,058	2.9	160,033	3.0
(5.0)	164,384	1.9	164,359	2.0
(2.5)	168,710	1.0	168,684	1.0
Base	173,036		173,009	
2.5	177,362	-1.0	177,334	-1.0

5.0	181,688	-1.9	181,659	-2.0
7.5	186,014	-2.9	185,985	-3.0
10.0	190,340	-3.9	190,310	-4.0

(1) Net of income tax effect.

Investments

We make estimates concerning the valuation of our investments and the recognition of other than temporary declines in the value of our investments. When we consider the decline in value of an individual investment to be other than temporary, we write down the investment to its estimated net realizable value, and the amount of the write-down is reflected as a realized loss in our statement of income. We individually monitor all investments for other than temporary declines in value. Generally, if an individual equity security

has depreciated in value by more than 20% of original cost, and has been in an unrealized loss position for more than six months, we assume there has been an other than temporary decline in value. With respect to debt securities, we assume there has been an other than temporary decline in value if it is probable that contractual payments will not be received. In addition, we may write down securities in an unrealized loss position based on a number of other factors, including the fair value of the investment being significantly below its cost, the deteriorating financial condition of the issuer of a security and the occurrence of industry, company and geographic events that have negatively impacted the value of a security or rating agency downgrades. We determined that certain investments trading below cost had declined on an other than temporary basis during the first quarter of 2006. Losses of $47,538 and $139,849 were included in net realized investment gains for these investments in the first quarter of 2006 and 2005, respectively.

Our investments in available-for-sale fixed maturity and equity securities are presented at estimated fair value, which generally represents quoted market prices.

Policy Acquisition Costs

Policy acquisition costs, consisting primarily of commissions, premium taxes and certain other underwriting costs that vary with and are directly related to the production of business, are deferred and amortized over the period in which the premiums are earned. The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value, which gives effect to the premium to be earned, related investment income, losses and loss expenses and certain other costs expected to be incurred as the premium is earned. Estimates in the calculation of policy acquisition costs have not shown material variability because of uncertainties in applying accounting principles or as a result of sensitivities to changes in key assumptions.

Results of Operations Three Months Ended March 31, 2006 Compared to Three Months Ended March 31, 2005

Net Premiums Written. Net premiums written for the three months ended March 31, 2006 were $76.2 million, an increase of $1.7 million, or 2.3%, over the comparable period in 2005. Commercial lines net premiums written decreased $400,000, or 1.3%, in the first quarter of 2006 compared to the comparable period in 2005. Personal lines net premiums written increased $2.1 million, or 4.9%, in the first quarter of 2006 compared to the comparable period in 2005. We have benefited during the first quarter of 2006 from the addition of the personal lines new business related to the Shelby Insurance Company acquisition rights agreement. Net premiums written related to this agreement amounted to $1.7 million.

Net Premiums Earned. Net premiums earned increased to $74.5 million for the first quarter of 2006, an increase of $2.7 million, or 3.8%, over the first quarter of 2005. Premiums are earned, or recognized as revenue, over the terms of our policies, which are one year or less in duration. Therefore, increases or decreases in net premiums earned generally reflect increases or decreases in net premiums written in the preceding twelve-month period compared to the comparable period one year earlier.

Investment Income. For the three months ended March 31, 2006, our net investment income increased 13.0% to $5.0 million, compared to $4.4 million for the comparable period one year ago. An increase in average invested assets from $501.6 million in the first quarter of 2005 to $549.0 million in the first quarter of 2006 and an increase in the annualized average return on investments from 3.5% for the first quarter of 2005 to 3.6% for the first quarter of 2006 accounted for the increase in net investment income. The increase in our annualized average return reflects a shift from short-term investments to higher yielding fixed maturities in our investment portfolio as well as higher short-term interest rates during the first quarter of 2006 compared to the comparable period a year earlier. These increases were offset in part by decreases in our annualized average return on increased holdings of tax-exempt fixed maturities in our investment portfolio during the first quarter of 2006 compared to the comparable period a year earlier. The increased holdings of tax-exempt fixed maturities in 2006 resulted from a shift from taxable to tax-exempt fixed maturities in order to obtain more favorable after-tax yields.

Net Realized Investment Gains. Net realized investment gains in the first quarter of 2006 were $474,799, compared to $690,291 for the comparable period in 2005. During the first quarter of 2006 and 2005, impairment losses of $47,538 and $139,849, respectively, were included in net realized investment gains. The remaining net realized investment gains in both periods resulted from normal turnover within our investment portfolio.

Losses and Loss Expenses. Our loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, in the first quarter of 2006 was 58.1%, compared to 57.9% in the first quarter of 2005. Our commercial lines loss ratio increased to 52.8% in the first quarter of 2006, compared to 52.0% in the first quarter of 2005, primarily due to an increase in our commercial automobile loss ratio as a result of an increase in claim severity in that line of business. Our personal lines loss ratio increased from 61.8% in the first quarter of 2005 to 62.0% in the first quarter of 2006 due to an increase in our homeowners loss ratio primarily related to increased weather-related claim frequency in that line of business.

Underwriting Expenses. Our expense ratio, which is the ratio of policy acquisition costs and other underwriting expenses to premiums earned, for the first quarter of 2006 was 31.9%, compared to 32.2% in the first quarter of 2005. The slight decrease in the first quarter of 2006 expense ratio reflects decreased underwriting-based incentive compensation.

Combined Ratio. The combined ratio was 90.5% and 90.6% for the three months ended March 31, 2006 and 2005, respectively. The combined ratio represents the sum of the loss ratio, expense ratio and dividend ratio, which is the ratio of workers compensation policy dividends incurred to premiums earned. The slight improvement in the combined ratio was largely attributable to the decrease in the expense ratio for the 2006 period compared to the 2005 period.

Interest Expense. Interest expense for the first quarter of 2006 was $644,378, compared to $498,763 for the first quarter of 2005, and reflected an increase in average interest rates on our subordinated debentures in the first quarter of 2006 compared to the comparable period in 2005.

Income Taxes. Income tax expense was $3.7 million for the first quarter of 2006, representing an effective tax rate of 28.6%, compared to $3.7 million for the first quarter of 2005, representing an effective tax rate of 30.6%. The change in effective tax rates is primarily due to tax-exempt interest income representing a larger proportion of income before income tax expense in the 2006 period compared to the 2005 period.

Net Income and Earnings Per Share. Our net income for the first quarter of 2006 was $9.1 million, or $.36 per share on a diluted basis, an increase of 8.5% over the net income of $8.4 million, or $.34 per share on a diluted basis, reported for the first quarter of 2005. Our fully diluted shares outstanding for the first quarter of 2006 increased to 25.3 million, compared to 24.6 million for the first quarter of 2005.

Liquidity and Capital Resources

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

We have historically generated sufficient net positive cash flow from our operations to fund our commitments and build our investment portfolio, thereby increasing future investment returns. The impact of the pooling agreement with the Mutual Company historically has been cash flow positive because of the historical underwriting profitability of the pool. The pool is settled monthly, thereby resulting in cash flows substantially similar to cash flows that would result from the underwriting of direct business. We have not experienced any unusual variations in the timing of claim payments associated with our loss reserves. We maintain a high degree of liquidity in our investment portfolio in the form of readily marketable fixed maturities, equity securities and short-term investments. Our fixed-maturity investment portfolio is structured following a laddering approach, so that projected cash flows from investment income and principal maturities are evenly distributed from a timing perspective, thereby providing an additional measure of liquidity to meet our obligations should an unexpected variation occur in the future. Net cash flows provided by operating activities in the first three months of 2006 and 2005 were $6.7 million and $12.1 million, respectively.

On November 25, 2003, we entered into a credit agreement with Manufacturers and Traders Trust Company (M&T) relating to a four-year $35.0 million unsecured, revolving line of credit. As of March 31, 2006, we have the ability to borrow $35.0 million at interest rates equal to M&T s current prime rate or the then current LIBOR rate plus between 1.50% and 1.75%, depending on our leverage ratio. In addition, we pay a fee of 0.15% per annum on the loan commitment amount, regardless of usage. The agreement requires our compliance with certain covenants, which include minimum levels of our net worth, leverage ratio and statutory surplus and A.M. Best ratings of our insurance

subsidiaries. During the nine months

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ended March 31, 2006, we had no borrowings outstanding under the credit agreement, and we were in compliance with all requirements of the credit agreement.

The following table shows our expected payments for significant contractual obligations as of March 31, 2006.

($ in thousands)	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Net liability for unpaid losses and loss expenses	$ 173,036	$ 77,265	$ 79,452	$ 7,922	$ 8,397
Subordinated debentures	30,929				30,929
Total contractual obligations	$ 203,965	$ 77,265	$ 79,452	$ 7,922	$ 39,326

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

On April 6, 2006, our board of directors declared a four-for-three stock split of our Class A common stock and our Class B common stock in the form of a 33-1/3% stock dividend with a record date of April 17, 2006 and a distribution date of April 26, 2006.

On April 20, 2006, we declared regular quarterly cash dividends of 8.25 cents per share for our Class A common stock and 7.0 cents per share for our Class B common stock, payable May 15, 2006 to stockholders of record as of the close of business on May 1, 2006. There are no regulatory restrictions on the payment of dividends to our stockholders, although there are state law restrictions on the payment of dividends from our insurance subsidiaries to us. Our insurance subsidiaries are required by law to maintain certain minimum surplus on a statutory basis, and are subject to regulations under which payment of dividends from statutory surplus is restricted and may require prior approval of the applicable domiciliary insurance regulatory authorities. Our insurance subsidiaries are subject to risk-based capital (RBC) requirements. At December 31, 2005, our insurance subsidiaries capital levels were each substantially above RBC requirements. At January 1, 2006, amounts available for distribution as dividends to us from our insurance subsidiaries without prior approval of their domiciliary insurance regulatory authorities were $21.9 million from Atlantic States, $5.4 million from Southern, $2.1 million from Le Mars and $2.9 million from Peninsula, all of which remained available at March 31, 2006.

As of March 31, 2006, we had no material commitments for capital expenditures.

Equity Price Risk

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

Credit Risk

Our portfolio of fixed-maturity securities and, to a lesser extent, short-term investments is subject to credit risk. This risk is defined as the potential loss in market value resulting from adverse changes in the

borrower s ability to repay the debt. We manage this risk by performing an analysis of prospective investments and through regular reviews of our portfolio by our investment staff. We also limit the amount that any one security can constitute of our total investment portfolio.

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

Because the pooling agreement does not relieve Atlantic States of primary liability as the originating insurer, we are subject to a concentration of credit risk arising from business ceded to the Mutual Company. Our insurance subsidiaries maintain reinsurance agreements in place with the Mutual Company and with a number of other major unaffiliated authorized reinsurers.

Impact of Inflation

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

Risk Factors

The business, results of operations and financial condition, and therefore the value of our common stock, are subject to a number of risks. For a description of certain risks, reference is made to our 2005 annual report on Form 10-K, filed with the Securities and Exchange Commission on March 13, 2006.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

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

We have maintained approximately the same investment mix and duration of our investment portfolio to our liabilities from December 31, 2005 to March 31, 2006.

There have been no material changes to our quantitative or qualitative market risk exposure from December 31, 2005 through March 31, 2006.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

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

Changes in Internal Control Over Financial Reporting

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

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

Certain forward-looking statements contained herein involve risks and uncertainties. These statements include certain discussions relating to underwriting, premium and investment income volume, business strategies and our business activities during 2006 and beyond. In some cases, you can identify forward-looking statements by terms such as may, will, should, could, would, expect, plan, intend, anticipate, believe, estimate, project similar expressions. These forward-looking statements reflect our current views about future events, are based on assumptions that reflect current conditions and are subject to known and unknown risks and uncertainties that may cause our actual results to differ materially from those anticipated by these forward-looking statements. Many of the factors that will determine future events or our future results of operations are beyond our ability to control or predict.

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Part II. Other Information

Item 1. Legal Proceedings.

None.

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

Period	(a) Total Number of Shares (or Units) Purchased		(b) Average Price Paid per Share (or Unit)		(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs		(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
Month #1	Class A	None	Class A	None	Class A	None	
January 1-31, 2006	Class B	64,021	Class B	$17.38	Class B	64,021	(1)
Month #2	Class A	None	Class A	None	Class A	None	
Feb. 1-28, 2006	Class B	None	Class B	None	Class B	None	
Month #3	Class A	22,221	Class A	$17.58	Class A	22,221	
March 1-31, 2006	Class B	6,989	Class B	$16.93	Class B	6,989	(1)
	Class A	22,221	Class A	$17.58	Class A	22,221	
Total	Class B	71,010	Class B	$17.34	Class B	71,010	(1)

(1) These shares were purchased by the Mutual Company pursuant to its announcement on August 17, 2004 that it will, at its discretion, purchase shares of our Class A common stock and Class B common stock at market prices prevailing from time to time in the open market subject to the provisions of SEC Rule 10b-18 and in privately negotiated transactions. Such announcement did not stipulate a maximum number of shares that may be purchased under this program.

Item 3. Defaults upon Senior Securities.

None.

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

None.

Item 5. Other Information.

None.

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Item 6. Exhibits.

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

Signatures

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

	DONEGAL GROUP INC.
May 8, 2006	**By:** /s/ Donald H. Nikolaus
	Donald H. Nikolaus, President and Chief Executive Officer
May 8, 2006	**By:** /s/ Jeffrey D. Miller
	Jeffrey D. Miller, Senior Vice President and Chief Financial Officer