DONEGAL GROUP INC
Form S-2/A
November 21, 2003

As filed with the Securities and Exchange Commission on November 21, 2003

Registration No. 333-110175

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

AMENDMENT NO. 3
TO

FORM S-2

REGISTRATION STATEMENT
UNDER
THE SECURITIES ACT OF 1933

Donegal Group Inc.

(Exact name of registrant as specified in its charter)

Delaware	23-02424711
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1195 River Road
Marietta, Pennsylvania 17547
717-426-1931

(Address, including zip code, and telephone number, including area code, of registrant s principal executive offices)
Donald H. Nikolaus
President and Chief Executive Officer
Donegal Group Inc.
1195 River Road
Marietta, Pennsylvania 17547
717-426-1931

(Name, address, including zip code, and telephone number, including area code, of agent for service)
Copies to:

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215-979-1234	202-756-3303

Approximate date of commencement of proposed sale to public: As soon as practicable after this registration statement becomes effective.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act, check the following box. o

If the registrant elects to deliver its latest annual report to security holders, or a complete and legible facsimile thereof pursuant to Item 11(a)(1) of this Form, check the following box. o

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o ____

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o ____

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o ____

If delivery of the prospectus is expected to be made pursuant to Rule 434, check the following box. o

The information in this preliminary prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This preliminary prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any jurisdiction where the offer or sale is not permitted.

Subject to Completion. Dated November 21, 2003.

3,000,000 Shares

Donegal Group Inc.

Class A Common Stock

We are offering shares of our Class A common stock, which have one-tenth of a vote per share. Our Class A common stock is quoted on the Nasdaq National Market[SM] under the symbol DGICA. The last reported sale price of our Class A common stock on November 20, 2003 was $18.88 per share.

See Risk Factors beginning on page 8 to read about factors you should consider before buying shares of our Class A common stock.

Neither the Securities and Exchange Commission nor any other regulatory body has approved or disapproved of these securities or passed upon the adequacy or accuracy of this prospectus. Any representation to the contrary is a criminal offense.

	Per Share	Total
Initial price to public	$	$
Underwriting discount	$	$
Proceeds, before expenses, to Donegal Group Inc.	$	$

To the extent the underwriters sell more than 3,000,000 shares of Class A common stock, the underwriters have the option to purchase up to an additional 450,000 shares of Class A common stock from us at the public offering price, less the per share underwriting discount.

The underwriters expect to deliver the shares against payment on or about , 2003, subject to customary closing conditions.

SunTrust Robinson Humphrey	**Legg Mason Wood Walker Incorporated**
Advest, Inc.	**Cochran, Caronia & Co.**

Prospectus dated , 2003.

No dealer, salesperson or other person is authorized to give any information or to represent anything not contained in this prospectus. You must not rely on any unauthorized information or representations. This prospectus is an offer to sell only the shares of Class A common stock offered hereby, but only under circumstances and in jurisdictions where it is lawful to do so. The information contained in this prospectus is current as of its date.

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PROSPECTUS SUMMARY

This summary highlights information contained elsewhere, or incorporated by reference, in this prospectus that we believe is the most important regarding us and this offering. You should read the entire prospectus carefully, including the Risk Factors section and the information incorporated by reference, which is described under Where to Find More Information/ Incorporation by Reference, before investing in our Class A common stock. All financial information, operating statistics and ratios in this prospectus are based on generally accepted accounting principles as applied in the United States, which we also refer to as GAAP, unless otherwise noted. Unless the context indicates otherwise, all references in this prospectus to we, us, our or the Company include Donegal Group Inc. and its wholly owned insurance subsidiaries, Atlantic States Insurance Company (Atlantic States) and Southern Insurance Company of Virginia (Southern). As used in this prospectus, the Mutual Company refers to Donegal Mutual Insurance Company, and Donegal Insurance Group refers to the Company s insurance subsidiaries and the Mutual Company.

Our Company

Who We Are

We are a property and casualty insurance holding company whose insurance subsidiaries offer personal and commercial lines of insurance to businesses and individuals in 14 Mid-Atlantic and Southeastern states. We provide our policyholders with a selection of insurance products at competitive rates, while pursuing profitability through adherence to a strict underwriting discipline. At September 30, 2003, we had total assets of $541.6 million and stockholders equity of $146.4 million. Our net income was $13.1 million for the nine months ended September 30, 2003 compared to $12.0 million for the year ended December 31, 2002.

We derive a substantial portion of our insurance business from smaller- to mid-sized regional communities. We believe this focus provides us with competitive advantages in terms of local market knowledge, marketing, underwriting, claims servicing and policyholder service. At the same time, we believe we have cost advantages over many regional insurers because of our centralized accounting, administrative, investment, data processing and other services.

We currently operate through two insurance subsidiaries, Atlantic States and Southern, in six Mid-Atlantic states (Connecticut, Delaware, Maryland, New York, Ohio and Pennsylvania) and eight Southeastern states (Alabama, Arkansas, Georgia, Louisiana, North Carolina, South Carolina, Tennessee and Virginia). In addition, we expect to expand our presence in our existing markets and to establish a presence in the Midwest through two pending acquisitions: Peninsula Insurance Group, which operates primarily in Maryland, Delaware and Virginia, and Le Mars Insurance Company, which operates in Iowa, Nebraska, Oklahoma and South Dakota. We refer to Peninsula Insurance Group in this prospectus as Peninsula and Le Mars Insurance Company as Le Mars.

We seek to control our insurance risk by carefully selecting the business we underwrite. For our personal lines products, we focus on standard and preferred risks, primarily in private passenger automobile and homeowners lines of insurance. For our commercial lines products, we generally target small-and mid-sized businesses. We generally do not underwrite industrial accounts. We have no exposure to asbestos liabilities and have limited exposure to other environmental liabilities. In both our personal and commercial lines products, we seek to underwrite more than one type of policy per customer, and we seek to minimize our exposure to catastrophe-prone areas. We believe these underwriting practices are key factors in our ability to maintain a combined ratio that has consistently been more favorable than the combined ratio of our industry.

The following table provides information about our net premiums written and our combined ratio in relation to that of the industry:

	Year Ended December 31,						Nine Months Ended September 30,			
	2000		2001		2002		2002		2003	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
	(Amounts in thousands)									
Net premiums written:										
Personal lines	$100,517	62.8%	$111,623	63.1%	$125,777	64.7%	$ 95,407	64.1%	$ 98,641	63.0%
Commercial lines	59,605	37.2	65,405	36.9	68,727	35.3	53,391	35.9	57,892	37.0
Total business	$160,122	100.0%	$177,028	100.0%	$194,504	100.0%	$148,798	100.0%	$156,533	100.0%
Donegal GAAP combined ratio(1)	101.8%		103.8%		99.6%		100.2%		95.4%	
Industry SAP combined ratio(2)(3)	110.4		115.9		107.4		104.9		N/A(4)	

(1) The combined ratio is the ratio of losses and loss expenses, acquisition and other underwriting expenses and policy dividends to premiums earned.

(2) Presented on the basis of statutory accounting principles prescribed or permitted by state insurance regulatory authorities, which we refer to in this prospectus as SAP.

(3) As reported by A.M. Best & Company, Inc., which we also refer to as A.M. Best.

(4) Not yet reported by A.M. Best.

We distribute our insurance products through approximately 1,200 independent insurance agencies with approximately 6,800 agents in the states where we operate. We believe our relationships with our agents are valuable in identifying, obtaining and retaining our policyholders. We believe we have strong relations with our agents as a result of the consistent availability of our product offerings, competitive agency compensation and agent and policyholder support programs. The Donegal Insurance Group s top 30 agencies by direct written premiums have been writing business for it for an average of approximately 27 years. No single agency accounts for more than 1.0% of the direct written premiums of the Donegal Insurance Group.

Our insurance subsidiaries and the Mutual Company are rated A (Excellent) by A.M. Best.

Our Strategy

Our premiums earned have increased from $117.5 million in 1998 to $185.8 million in 2002, a compound annual growth rate of 12.2%. Over the same time period, our combined ratio has consistently been more favorable than that of the industry. We seek to grow our business and enhance our profitability by:

Achieving underwriting profitability. We are focused on achieving a combined ratio of less than 100% and believe that underwriting profitability is a fundamental component of our long-term financial strength.

Pursuing profitable growth by organic expansion. We will continue to grow our business by maintaining an effective and growing network of independent agents and providing a consistent, competitive and stable market for the product lines we write.

Acquiring property and casualty insurance companies. We will continue the selective acquisition of property and casualty insurers to augment our organic growth in our existing markets and expand into selected geographic regions.

Focusing on expense controls and the utilization of technology to increase operating efficiencies. We maintain stringent expense controls with direct involvement by our senior management, and we have increased our operating efficiency through significant commitments to the utilization of technology.

Providing responsive and friendly customer and agent service. We provide high-quality service in claims, underwriting and customer support to enable us to attract new policyholders and achieve strong policyholder retention.

Maintaining rate adequacy. We strive to maintain adequate premium rates to enhance our underwriting results, while maintaining our existing book of business and preserving our ability to write new business in the future.

Our Organizational Structure

The Mutual Company owns approximately 65% of our Class A common stock and approximately 62% of our Class B common stock, or approximately 64% of our combined Class A common stock and Class B common stock. Our insurance operations are interrelated with the insurance operations of the Mutual Company and, while maintaining the separate corporate existence of each company, we conduct our insurance business together with the other entities comprising the Donegal Insurance Group. As such, we share the same business philosophy, management, employees and facilities as the Mutual Company and offer the same types of insurance products.

The following chart depicts our organizational structure, including our insurance subsidiaries.

Atlantic States, our largest insurance subsidiary, and the Mutual Company have a pooling agreement under which both companies are allocated a given percentage of their combined underwriting results, excluding certain intercompany reinsurance assumed by the Mutual Company from our insurance subsidiaries. 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.

The following chart depicts our underwriting pool:

We believe our relationship with the Mutual Company offers us a number of competitive advantages, including:

- Facilitating our stable management, consistent underwriting discipline, external growth and long-term profitability.
- Creating operational and expense synergies from the combined resources and operating efficiencies of the Mutual Company and us.
- Enhancing our ability to affiliate with and eventually acquire other mutual insurance companies.
- Producing more uniform and stable underwriting results from year to year than we could achieve on our own.
- Giving Atlantic States the benefit of the underwriting capacity of the entire pool, rather than being limited by the amount of its own capital and surplus.

Recent Developments

On October 30, 2003, we announced an agreement to purchase Peninsula from Folksamerica Holding Company, Inc. for approximately $23.0 million in cash. Peninsula does business primarily in Maryland, Delaware and Virginia. We expect this acquisition to be consummated on or about January 1, 2004. Peninsula s net premiums earned were $29.7 million in 2002 and $24.4 million for the nine months ended September 30, 2003. Peninsula s stockholders equity and total assets as of September 30, 2003 were $21.8 million and $61.4 million, respectively.

On October 15, 2003, we announced our results for the nine months and quarter ended September 30, 2003. For the nine months ended September 30, 2003, our net income was $13.1 million, or $1.37 per share on a diluted basis, compared to $8.4 million, or $0.91 per share on a diluted basis, for the nine months ended September 30, 2002. For the third quarter of 2003, we reported net income of $4.0 million, or $0.40 per share on a diluted basis, compared to net income of $3.0 million, or $0.33 per share on a diluted basis, for the third quarter of 2002. The impact of Hurricane Isabel in September 2003 reduced our net income for the third quarter by $650,000, or $0.07 per diluted share.

For the nine months ended September 30, 2003, our combined ratio was 95.4%, compared to 100.2% for the nine months ended September 30, 2002. For the third quarter of 2003, our combined ratio was 96.8% and our loss ratio was 65.9%, compared to 99.5% and 69.3%, respectively, for the third quarter of 2002. Our loss ratio for the third quarter of 2003 includes approximately two percentage points attributable to Hurricane Isabel.

On September 4, 2003, we announced our intention to acquire Le Mars. The Insurance Commissioner of Iowa approved the acquisition on November 6, 2003. We expect the Le Mars acquisition to be completed on or about January 1, 2004. We will invest approximately $12.5 million in cash to fund the acquisition of Le Mars. The acquisition of Le Mars will represent the first step in our plan to expand our operations in the Midwest. Le Mars had net premiums earned of $20.5 million in 2002 and $13.3 million for the nine months ended September 30, 2003. Le Mars statutory surplus and total admitted assets as of September 30, 2003 were $11.6 million and $37.7 million, respectively.

Corporate Information

We are a Delaware corporation with our principal executive offices at 1195 River Road, Marietta, Pennsylvania 17547, and our telephone number is (888) 877-0600. The address of our website is *www.donegalgroup.com*. The information contained on our website is not a part of this prospectus.

The Offering

Class A common stock offered	3,000,000 shares, which are entitled to one-tenth of a vote per share.
Class A common stock outstanding after this offering	9,321,818 shares, approximately 43.3% of which will be owned by the Mutual Company after this offering.
Nasdaq National Market[SM] symbol	DGICA
Class B common stock outstanding after this offering	3,011,049 shares, which are entitled to one vote per share, of which approximately 62% is currently owned by the Mutual Company and will continue to be owned by the Mutual Company after this offering.
Nasdaq National Market[SM] symbol	DGICB
Voting power held by the Mutual Company	The Mutual Company currently has the right to cast approximately 62% of the votes of holders of our Class A common stock and Class B common stock that may be cast at any meeting of stockholders and, after this offering, will be able to cast approximately 57.2% of the total Class A and Class B votes that may be cast at any meeting of stockholders.
Dividends	We paid cash dividends on our Class A common stock at the rate of $0.10 per share in the first quarter of 2003, $0.11 per share in both the second and third quarters of 2003 and have declared a dividend of $0.11 per share for the fourth quarter of 2003. We paid cash dividends on our Class B common stock of $0.09 per share in the first quarter of 2003, $0.10 per share in both the second and third quarters of 2003 and have declared a dividend of $0.10 per share for the fourth quarter of 2003.
Use of proceeds	We will receive net proceeds from this offering, before our expenses, of approximately $54.4 million, assuming an offering price of $19.23, equal to the closing price of our Class A common stock on November 7, 2003. We will use approximately $12.5 million of the proceeds of this offering to fund the acquisition of Le Mars and approximately $23.0 million to fund the acquisition of Peninsula. We expect to complete the Le Mars and the Peninsula acquisitions on or about January 1, 2004. We also expect to invest approximately $10.0 million of the proceeds over time to increase the capitalization of our insurance subsidiaries and use the remaining proceeds for working capital purposes.
Risk Factors	See Risk Factors beginning on page 8 of this prospectus for a discussion of factors that you should carefully consider before making an investment in our Class A common stock.

The above information is based on the number of shares outstanding at September 30, 2003 and assumes that the option covering an additional 450,000 shares we have granted to the underwriters will not be exercised. The information does not include 1,361,462 shares of Class A common stock reserved for issuance for outstanding options at a weighted average exercise price of $12.01 per share under our stock option and purchase plans and 575,975 shares, 247,113 shares and 250,563 shares, respectively, of Class A common stock reserved for future issuance under our stock option plans, our employee stock purchase plan and our agency stock purchase plan.

Summary Consolidated Financial Information

Our summary consolidated financial information presented below as of or for the years ended December 31, 1998 through 2002 is derived from our audited consolidated financial statements. Our consolidated financial statements as of December 31, 2001 and 2002 and for each of the years in the three-year period ended December 31, 2002, and our independent auditors report thereon, are included elsewhere in this prospectus. The summary consolidated financial data presented below as of or for the nine-month periods ended September 30, 2002 and 2003 is derived from our unaudited consolidated financial statements included elsewhere in this prospectus. Our results of operations for the nine months ended September 30, 2003 are not necessarily indicative of our results of operations that may be expected for the year ending December 31, 2003. In the opinion of our management, all adjustments, consisting only of normal recurring accruals, considered necessary for a fair presentation have been included. The financial data set forth below is only a summary and should be read in conjunction with our consolidated financial statements and related notes and Management s Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this prospectus.

	Year Ended December 31,					Nine Months Ended September 30,	
	1998	1999	2000	2001	2002	2002	2003
						(Unaudited)	
	(Amounts in thousands, except per share data)						
Statement of Operations Data:							
Net premiums earned	$117,454	$145,517	$151,646	$167,770	$185,841	$138,356	$146,082
Investment income, net	12,344	13,591	16,395	15,886	14,581	11,064	10,007
Realized investment gains (losses)	(14)	(39)	171	(880)	144	(14)	495
Total revenues	132,232	161,739	170,582	185,164	203,804	151,856	159,298
Income before income taxes	11,698	3,845	11,743	7,092	16,495	11,497	18,061
Income taxes (benefit)	2,675	(2,950)	2,906	1,274	4,492	3,122	4,946
Net income	9,023	6,795	8,837	5,818	12,003	8,375	13,115
Balance Sheet Data:							
Total investments	$261,507	$268,011	$289,345	$300,633	$332,299	$319,444	$358,320
Total assets	376,742	389,689	426,009	456,632	501,218	488,770	541,598
Debt obligations	37,500	37,000	40,000	27,600	19,800	19,800	27,800
Stockholders equity	100,915	103,792	114,130	120,928	133,183	131,029	146,399
Per Share Data:							
Basic earnings	$ 1.11	$ 0.82	$ 1.01	$ 0.65	$ 1.32	$ 0.92	$ 1.42
Diluted earnings	1.09	0.82	1.01	0.64	1.31	0.91	1.37
Dividends declared (Class A)				0.40	0.40	0.20	0.22
Dividends declared (Class B)				0.36	0.36	0.18	0.20
Dividends declared (common stock)(1)	0.34	0.36	0.36				
Stockholders equity	12.30	12.28	12.88	13.44	14.52	14.37	15.69

(1) Represents dividends declared prior to our April 2001 recapitalization.

RISK FACTORS

An investment in shares of our Class A common stock involves various risks. You should consider carefully the following risk factors in conjunction with the other information in this prospectus, including our consolidated financial statements and related notes, before deciding to invest in shares of our Class A common stock. If any of the following risks or uncertainties actually occurs, our business, financial condition and operating results would likely suffer. In that event, the market price of our Class A common stock could decline and you could lose all or part of your investment. The risk factors described below are not the only risks that may affect us. Additional risks and uncertainties not presently known to us also may adversely affect our business, financial condition and results of operations.

Risks Relating to Us and Our Business

Our operations are interrelated with those of the Mutual Company, which is our largest stockholder, and potential conflicts exist between the best interests of our stockholders and the best interests of the policyholders of the Mutual Company.

The Mutual Company, which currently owns shares of our common stock generally entitling it to cast approximately 62% of the aggregate votes eligible to be cast by our stockholders at any meeting of stockholders, controls the election of the members of our board of directors, and four of the six members of our board of directors are also members of the board of directors of the Mutual Company. These directors have a fiduciary duty to our stockholders, and also have a fiduciary duty to the policyholders of the Mutual Company. Our executive officers have the same positions with both the Mutual Company and us, and therefore have competing fiduciary duties. Certain potential and actual conflicts of interest arise from these separate fiduciary duties. Among these conflicts of interest are:

- We and the Mutual Company periodically review the percentage participation rate of Atlantic States in the underwriting pool.

- We and the Mutual Company must annually establish the terms of certain inter-company reinsurance agreements.

- We and the Mutual Company must make judgments about the allocation of shared expenses between the Mutual Company and us in accordance with various inter-company expense-sharing agreements.

- We may enter into other transactions and contractual relationships with the Mutual Company and its subsidiaries.

As a consequence, we and the Mutual Company have established a coordinating committee that consists of two of our directors who are not directors of the Mutual Company and two directors of the Mutual Company who are not members of the Company s board of directors. Under our by-laws and those of the Mutual Company, any new agreement or transaction between the Mutual Company and us, as well as any proposed change to an existing agreement between the Mutual Company and us, must first be submitted to the Mutual Company s and our boards of directors for approval. If approved by both boards of directors, the proposed agreement or transaction, or the change in an existing agreement, must receive the approval of the coordinating committee. Coordinating committee approval is granted only if both of our coordinating committee members conclude that the new agreement or transaction or proposed change in an existing agreement is fair and equitable to us and our stockholders and both of the Mutual Company s coordinating committee members conclude that the new agreement or transaction or proposed change in an existing agreement is fair and equitable to the Mutual Company and its policyholders.

The Mutual Company has the ability to determine the outcome of all matters submitted for approval by our stockholders. The price of our Class A common stock may be adversely affected because of the Mutual Company s ownership of our Class A common stock and Class B common stock or by the difference in voting power between our Class A common stock and Class B common stock.

Each share of our Class A common stock has one-tenth of a vote per share and generally can vote as a separate class only on matters pertaining to the rights of holders of Class A common stock. Voting control of the Company is vested in the Mutual Company. Following this offering, the Mutual Company will own approximately 43.3% of our outstanding Class A common stock and approximately 62% of our outstanding Class B common stock and will control 57.2% of the votes that may be cast on any matter submitted to a vote of our stockholders. The Mutual Company has sufficient voting control to:

elect our entire board of directors, who in turn determines our management and policies; and

control the outcome of any corporate transaction or other matter submitted to our stockholders for approval, including mergers, consolidations and the sale of all or substantially all of our assets.

The Mutual Company has and will continue to have after this offering sufficient voting power to prevent or cause a change in control and to amend our organizational documents. The interests of the Mutual Company may conflict with the interests of our other stockholders. In addition, the voting power of the Mutual Company may have a negative effect on the price of our Class A common stock.

Our results of operations could suffer if the Mutual Company were to experience unusually severe or frequent losses or were not able to price its premiums adequately.

Our insurance subsidiary, Atlantic States, participates in a pooling agreement with the Mutual Company, under which the parties share the underwriting results on substantially all of the property and casualty insurance business written by both companies. Under 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. The allocation of pool participation percentages between the Mutual Company and Atlantic States has been established based on the pool participants relative amounts of capital and surplus, expectations of future relative amounts of capital and surplus and our ability to raise capital for Atlantic States. We do not expect the allocation to change in the foreseeable future.

Because of the pooled business we are allocated, our insurance operations are interrelated with the insurance operations of the Mutual Company, and our results of operations are dependent, in part, upon the underwriting results of the Mutual Company. Although the underwriting pool is intended to produce a more uniform and stable underwriting result from year to year for the participants in the pool than they would experience individually and to spread the risk of loss among the participants, if the Mutual Company experiences unusually severe or frequent losses or does not adequately price its premiums, our business, financial condition and results of operations could suffer.

We currently conduct business in 14 states, with a concentration of business in Pennsylvania and Virginia. Any single catastrophe occurrence or other condition affecting losses in these states could adversely affect our results of operations.

We conduct business in 14 states located primarily in the Mid-Atlantic and Southeastern portions of the United States. A substantial portion of our business is private passenger and commercial automobile, homeowners and workers compensation insurance in Pennsylvania and Virginia. While we actively manage our exposure to catastrophes through our underwriting process and the purchase of reinsurance, a single catastrophe occurrence, destructive weather pattern, general economic trend, terrorist attack, regulatory development or other condition affecting one or more of the states in which we conduct substantial business could materially adversely affect our business, financial condition and results of operations. Common catastrophic events include hurricanes, earthquakes, tornadoes, wind and hail storms, fires, explosions and severe winter storms.

Our business, financial condition and results of operations may be adversely affected if the independent agents that market our products do not maintain their current levels of premium writing, fail to comply with established underwriting guidelines or otherwise improperly market our products.

We market our insurance products solely through a network of approximately 1,200 independent insurance agencies, with approximately 6,800 agents. Our agency force is one of the most important components of our competitive profile. As a result, we are materially dependent upon these independent agents, each of whom has the authority to bind us to insurance contracts. To the extent that these independent agents marketing efforts cannot be maintained at their current levels of volume and quality or they bind us to unacceptable insurance risks, fail to comply with our established underwriting guidelines or otherwise improperly market our products, our business, financial condition and results of operations will suffer.

Our business may not continue to grow and may be materially adversely affected if we cannot retain existing, and attract new, independent agents or if insurance consumers increase their use of other insurance delivery systems.

The continued growth of our business will depend materially upon our ability to retain existing, and attract new, independent agents. If independent agencies find it easier to do business with our competitors, it would be difficult for us to retain our existing business or attract new business. While we believe we maintain good relationships with our independent agents, we cannot be certain that these independent agents will continue to sell our products to the consumers they represent. Some of the factors that could adversely affect our ability to retain existing, and attract new, independent agents include:

- the significant competition among our competitors to attract independent agents;
- our intense and time-consuming process to select a new independent agent;
- our stringent criteria that require independent agents to adhere to consistent underwriting standards; and
- our ability to pay competitive and attractive commissions, bonuses and other incentives to independent agents as compensation for selling our products.

While we sell insurance solely through our network of independent agents, many of our competitors sell insurance through a variety of delivery methods, including independent agents, captive agencies, the Internet and direct sales. To the extent that individuals represented by our independent agents change their delivery system preference, our business, financial condition and results of operations may be adversely affected.

We are dependent on dividends from our insurance subsidiaries for the payment of our operating expenses, our debt service and dividends to stockholders; however, our insurance subsidiaries may be unable to pay dividends to us.

As a holding company, we rely primarily on dividends from our insurance subsidiaries as a source of funds to meet our corporate obligations. Payment of dividends by our insurance subsidiaries is subject to regulatory restrictions and depends on the surplus of our subsidiaries. From time to time, the National Association of Insurance Commissioners, which is commonly known as the NAIC, and various state insurance regulators consider modifying the method of determining the amount of dividends that may be paid by an insurance company without prior regulatory approval. The maximum amount of dividends that our insurance subsidiaries can pay us in the fourth quarter of 2003 without prior regulatory approval is approximately $4.7 million. In addition, state insurance regulators have broad discretion to limit the payment of dividends by our insurance subsidiaries in the future. The ability of our insurance subsidiaries to pay dividends to us may be further constrained by business and regulatory considerations, such as the impact of dividends on surplus, which could affect our ratings, competitive position, amount of premiums that can be written and ability to pay future dividends.

If the A.M. Best rating assigned to the Mutual Company or our insurance subsidiaries is significantly downgraded, our competitive position would be adversely affected.

Industry ratings are a factor in establishing the competitive position of insurance companies. Our insurance subsidiaries and the Mutual Company are rated by A.M. Best, an industry-accepted source of insurance company financial strength ratings. A.M. Best ratings are specifically designed to provide an independent opinion of an insurance company s financial health and its ability to meet ongoing obligations to policyholders. We believe that the financial strength rating of A.M. Best is material to our insurance operations. Currently, the Mutual Company and each of our insurance subsidiaries has an A (Excellent) rating from A.M. Best. If the Mutual Company or any of our insurance subsidiaries were to be downgraded by A.M. Best, it would adversely affect our competitive position and make it more difficult for us to market our products and retain our existing policyholders.

We may not obtain the regulatory approval required to consummate the acquisition of Peninsula or be able to realize expected benefits from the Le Mars or Penninsula acquisitions.

We cannot complete the proposed acquisition of Peninsula without the approval of the insurance commissioner of Maryland. Each of our proposed acquisitions is also subject to other customary terms and conditions that may prevent consummation of the acquisitions. If we do successfully consummate these acquisitions, we may not realize the financial benefits that we expect to realize from these acquisitions.

If we consummate the acquisitions of Le Mars and Peninsula, our results of operations could be adversely affected for numerous reasons. Acquisitions entail many risks and can result in difficulties in assimilating and integrating operations, personnel, technologies, products and information systems, may raise regulatory concerns and may require additional infusions of capital. Certain anticipated cost savings may or may not be realized. As a result, the acquisitions could have an adverse impact on our financial condition and results of operations.

Our strategy to grow in part through acquisitions of smaller insurance companies exposes us to a number of risks that could adversely affect our results of operations and financial condition.

The acquisition of smaller and undercapitalized insurance companies involves a number of risks that could adversely affect our results of operations and financial condition. These risks include:

the inadequacy of reserves for loss and loss expenses;

the need to supplement management with additional experienced personnel;

conditions imposed by regulatory agencies that make the realization of cost-savings through integration of operations more difficult;

a need for additional capital that was not anticipated at the time of the acquisition; and

the use of more of our management s time than was originally anticipated.

If we cannot obtain sufficient capital to fund our organic growth and acquisitions, we may not be able to expand our business.

Our strategy is to expand our business through organic growth and through strategic acquisitions of regional insurance companies. We will require additional capital in the future to support this objective. If we are unable to obtain sufficient capital on satisfactory terms and conditions, we may not be able to expand our business or make future acquisitions. Our ability to obtain additional financing will depend on a number of factors, many of which are beyond our control. For example, we may not be able to obtain additional financing because we may already have substantial debt at the time or because we do not have sufficient cash flow to service or repay our existing or additional debt. In addition, any equity capital we obtain in the future could be dilutive to our existing stockholders.

Many of our competitors are financially stronger than we are and may be able to offer lower-priced products with which we may be unable to compete.

The property and casualty insurance industry is intensely competitive. Competition is based on many factors, including the perceived financial strength of the insurer, premiums charged, policy terms and conditions, policyholder service, reputation and experience. We compete with many regional and national property and casualty insurance companies, including direct sellers of insurance products, insurers having their own agency organizations and other insurers represented by independent agents. Many of these insurers are better capitalized than we are, have substantially greater financial, technical and operating resources and have equal or higher ratings from A.M. Best. In addition, our competition may become increasingly better capitalized in the future as the traditional barriers between insurance companies, banks and other financial institutions erode and as the property and casualty insurance industry continues to consolidate.

The greater capitalization of many of our competitors enables them to operate with lower profit margins and, therefore, allows them to market their products more aggressively, more quickly take advantage of new marketing opportunities and offer lower premium rates. We may not be able to maintain our current competitive position in the markets in which we operate if our competitors offer prices on products that are lower than the prices we can offer. Moreover, if our competitors lower the price of their products and we meet their pricing, our profit margins and revenues may be reduced and our ratios of claims and expenses to premiums may increase, which may materially adversely affect our business, financial condition and results of operations.

Because our investment portfolio is made up primarily of fixed-income securities, our investment income and the fair value of our investment portfolio could suffer as a result of a number of factors.

We invest the premiums we receive from our policyholders and maintain an investment portfolio that consists primarily of fixed-income securities. The management of our investment portfolio is an important component of our profitability because a significant portion of our operating income is generated from the income we receive on our invested assets. The quality and/or yield of our portfolio may be affected by a number of factors, including the general economic and business environment, changes in the credit quality of the issuers of the fixed-income securities we own, changes in market conditions and regulatory changes. The fixed-income securities we own are issued primarily by domestic entities and are backed either by the credit or collateral of the underlying issuer. Factors such as an economic downturn, a regulatory change pertaining to a particular issuer s industry, a significant deterioration in the cash flows of the issuer or a change in the issuer s marketplace may adversely affect our ability to collect principal and interest from the issuer.

Our investments are also subject to risk resulting from interest rate fluctuations. Increasing interest rates or a widening in the spread between interest rates available on United States Treasury securities and corporate debt or asset-backed securities, for example, will typically have an adverse impact on the market values of the fixed-rate securities in our investment portfolio. If interest rates decline, we generally achieve a lower overall rate of return on investments of cash generated from our operations. In addition, in the event that investments are called or mature in a declining interest rate environment, we may be unable to reinvest the proceeds in securities with comparable interest rates. Changes in interest rates may reduce both our profitability and our return on invested capital.

We are dependent on our key personnel, and the loss of any member of our senior management could negatively affect the implementation of our business strategy and achievement of our growth objectives.

The loss of, or failure to attract, key personnel could significantly impede our financial plans, growth, marketing and other objectives. Our success depends to a substantial extent on the ability and experience of our senior management. We believe that our future success will depend in large part on our ability to attract and retain additional skilled and qualified personnel and to expand, train and manage our employees. We may not be successful in doing so, because the competition for experienced personnel in the insurance industry is intense. We do not have employment agreements with our key personnel, all of whom are employed by the Mutual Company.

Recently enacted and proposed changes in securities laws and regulations are likely to increase our costs.

The Sarbanes-Oxley Act of 2002 that became law in July 2002 required changes in our corporate governance, public disclosure and compliance practices. The act also required the Securities and Exchange Commission, which is commonly known as the SEC, to promulgate new rules on a variety of corporate governance and disclosure subjects. In addition to final rules and rule proposals already made, the Nasdaq National Market^{SM} has proposed revisions to its requirements for companies listed on the Nasdaq National Market^{SM}, like us. We expect these developments to increase our legal and financial compliance costs.

We also expect these developments to make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. These developments could make it more difficult for us to attract and retain additional members of our board of directors, particularly to serve on our audit committee, and additional executive officers.

The reinsurance agreements on which we rely do not relieve us from liability to our policyholders, and we face a risk of non-payment from our reinsurers and the non-availability of reinsurance in the future.

We rely on reinsurance agreements to limit our maximum net loss from large single risks or risks in concentrated areas, and to increase our capacity to write insurance. Although the reinsurance we maintain provides that the reinsurer is liable to us, our reinsurance does not relieve us from liability to our policyholders. To the extent that a reinsurer may be unable to pay losses for which it is liable to us under the terms of its reinsurance agreement with us, we remain liable for such losses. As of September 30, 2003, we had approximately $14.0 million of reinsurance receivables from third party reinsurers for paid and unpaid losses for which we believe we are entitled to reimbursement. The insolvency or inability to make timely payments by our reinsurers under the terms of our reinsurance agreements would adversely affect our results of operations.

In addition, we face a risk of the non-availability of reinsurance or an increase in reinsurance costs that could adversely affect our ability to write business or our results of operations. Market conditions beyond our control, such as the amount of surplus in the reinsurance market and natural and man-made catastrophes, affect the availability and cost of the reinsurance we purchase. We cannot assure you that reinsurance will remain available to us to the same extent and on substantially the same terms and rates as it is currently available. If we are unable to maintain our current level of reinsurance or purchase new reinsurance protection in amounts that we consider sufficient, we would either have to be willing to accept an increase in our net retention or reduce our insurance writings, and our business, financial condition and results of operations could be adversely affected.

Risks Relating to the Property and Casualty Insurance Industry

We face significant exposure to terrorism.

As a result of the September 11, 2001 terrorist attacks, the insurance industry has been compelled to re-examine policy terms and conditions and to address the potential for future threats of terrorist attacks and resulting losses. Our personal and commercial property and casualty insurance policies are not priced to cover the risk of terrorist attacks and losses such as those suffered in the World Trade Center terrorist attack. Therefore, we have exposure to terrorism under the lines of insurance products that we offer. The recently enacted Terrorism Risk Insurance Act of 2002 may reduce the impact of future losses as a result of terrorism in connection with commercial insurance products we offer; however, because of the uncertainty regarding the application of the Terrorism Risk Insurance Act, the amount of losses we may be required to retain as a result of terrorism may result in a material adverse effect on our business, financial condition and results of operations. The Terrorism Risk Insurance Act is scheduled to expire on December 31, 2005, so it will not provide coverage beyond that time unless it is extended. The Terrorism

Risk Insurance Act does not cover the personal insurance products we offer, and state regulators have not approved exclusions for acts of terrorism in our personal insurance products. Therefore we could incur large unexpected losses from the personal insurance policies that we issue, which could have a material adverse effect on our business, financial condition and results of operations.

Industry trends, such as increased litigation against the insurance industry and individual insurers, the willingness of courts to expand covered causes of loss, rising jury awards, increasing medical costs and the escalation of loss severity may contribute to increased costs and to the deterioration of our reserves.

Loss severity in our industry has continued to increase in recent years, principally driven by larger court judgments and increasing medical costs. In addition, many legal actions and proceedings have been brought on behalf of classes of complainants, which can increase the size of judgments. The propensity of policyholders and third party claimants to litigate and the willingness of courts to expand causes of loss and the size of awards may render our loss reserves inadequate for current and future losses if we become subject to litigation.

Loss or significant restriction of the use of credit scoring in the pricing and underwriting of our personal insurance products could reduce our future profitability.

We use credit scoring as a factor in making risk selection and pricing decisions where allowed by state law for our personal insurance products. Recently, some consumer groups and regulators have questioned whether the use of credit scoring unfairly discriminates against people with low incomes, minority groups and the elderly. These consumer groups and regulators are calling for the prohibition or restriction on the use of credit scoring in underwriting and pricing. Laws or regulations enacted in a number of states that significantly curtail the use of credit scoring in the underwriting process could reduce our future profitability.

Changes in applicable insurance laws or regulations or changes in the way regulators administer those laws or regulations could materially adversely change our operating environment and increase our exposure to loss or put us at a competitive disadvantage.

Property and casualty insurers are subject to extensive supervision in the states in which they do business. This regulatory oversight includes, by way of example, matters relating to licensing and examination, rate setting, market conduct, policy forms, limitations on the nature and amount of certain investments, claims practices, mandated participation in involuntary markets and guaranty funds, reserve adequacy, insurer solvency, transactions between affiliates, the amount of dividends that may be paid and restrictions on underwriting standards. Such regulation and supervision are primarily for the benefit and protection of policyholders and not for the benefit of stockholders. For instance, we are subject to involuntary participation in specified markets in various states in which we operate, and the rate levels we are permitted to charge do not always correspond with our underlying costs associated with the coverage we have issued.

The NAIC and state insurance regulators are re-examining existing laws and regulations, specifically focusing on insurance company investments, issues relating to the solvency of insurance companies, risk-based capital guidelines, restrictions on terms and conditions included in insurance policies, certain methods of accounting, reserves for unearned premiums, losses and other purposes, interpretations of existing laws and the development of new laws. Changes in state laws and regulations, as well as changes in the way state regulators view related party transactions in particular, could materially change our operating environment and have an adverse effect on our business.

The state insurance regulatory framework recently has come under increased federal scrutiny. Congress is considering legislation that would create an optional federal charter for insurers. Federal chartering has the potential to create an uneven playing field for insurers by subjecting federally-chartered and state-chartered insurers to different regulatory requirements. Federal chartering also raises the specter of a matrix of regulation and costly duplicative, or conflicting, federal and state requirements. In addition, if federal legislation repeals the partial exemption for the insurance industry from federal antitrust laws, it would make it extremely difficult for insurers to compile and share loss data and predict future loss costs, which is an important part of cost-based pricing for insurers. If the ability to collect this data were removed, then the predictability of future loss costs, and hence, the reliability of our pricing, would be greatly undermined.

If certain state regulators, legislators and special interest groups are successful in attempts to reduce, freeze or set rates for insurance policies, especially automobile policies, at levels that do not, in our management s view, correspond with underlying costs, our results of operations will be adversely affected.

From time to time, the automobile insurance industry in particular has been under pressure from certain state regulators, legislators and special interest groups to reduce, freeze or set rates at levels that do not, in the view of our management, correspond with underlying costs, including initiatives to roll back automobile and other personal lines rates. This activity may in the future adversely affect the profitability of our automobile insurance line of business in various states because increasing costs of litigation and medical treatment, combined with rising automobile repair costs, continue to increase our cost of providing automobile insurance coverage that we may not be able to offset by increasing the rates for our automobile insurance products. Adverse legislative and regulatory activity constraining our ability to price automobile insurance coverage adequately may occur in the future. The impact of the automobile insurance regulatory environment on our results of operations in the future is not predictable.

We are subject to assessments, based on our market share in a given line of business, to assist in the payment of unpaid claims and related costs of insolvent insurance companies; these assessments could significantly affect our financial condition.

We are obligated to pay assessments under the guaranty fund laws of the various states in which we are licensed. Generally, under these laws, we are subject to assessment, depending upon our market share of a given line of insurance business, to assist in the payment of unpaid claims and related costs of insolvent insurance companies in those states. The number and magnitude of future insurance company failures in the states in which we conduct business cannot be predicted, but resulting assessments could significantly affect our business, financial condition and results of operations. We are currently being assessed at the maximum level permitted by Pennsylvania law for several of our lines of business, and we expect we will continue to be assessed by Pennsylvania at the maximum level for these business lines for a number of years.

We must establish premium rates and loss and loss expense reserves from forecasts of the ultimate costs expected to arise from risks underwritten during the policy period, and our profitability could be adversely affected to the extent our premium rates or reserves are too low.

One of the distinguishing features of the property and casualty insurance industry is that its products are priced before its costs are known, as premium rates are generally determined before losses are reported. Accordingly, we must establish premium rates from forecasts of the ultimate costs we expect to arise from risks we have underwritten during the policy period, and our premium rates may not be adequate to cover the ultimate losses incurred. Further, we must establish reserves for losses and loss expenses based upon estimates involving actuarial and statistical projections at a given time of what we expect to be our ultimate liability, and it is possible that our ultimate liability will exceed these estimates because of the future development of known losses, the existence of losses that have occurred but are currently unreported and larger than historical settlements on pending and unreported claims. The process of estimating reserves is inherently judgmental and can be influenced by factors that are subject to variation. If the premium rates or reserves we establish are not sufficient, our business, financial condition and results of operations may be adversely impacted.

The cyclical nature of the property and casualty insurance industry may reduce our revenues and profit margins.

The property and casualty insurance industry is highly cyclical, and individual lines of business experience their own cycles within the overall insurance industry cycle. Premium rate levels are related to the availability of insurance coverage, which varies according to the level of surplus in the insurance industry. The level of surplus in the industry varies with returns on invested capital and regulatory barriers to withdrawal of surplus. Increases in surplus have generally been accompanied by increased price competition among property and casualty insurers. If we find it necessary to reduce premiums or limit premium increases due to these competitive pressures on pricing, we may experience a reduction in our profit margins and revenues, an increase in our ratios of losses and expenses to premiums and, therefore, lower profitability.

Risks Relating to Our Class A Common Stock

The price of our Class A common stock may be adversely affected by its low trading volume.

Our Class A common stock has limited trading liquidity. Reported average daily trading volume in our Class A common stock for the nine-month period ended September 30, 2003, was approximately 7,400 shares. All of our 6,321,818 shares of Class A common stock outstanding at September 30, 2003 are available for public sale, with the majority held by the Mutual Company. This limited trading liquidity subjects our shares of Class A common stock to greater price volatility and may make it difficult for you to sell your shares of Class A common stock at a price that is attractive to you.

The market price of our Class A common stock may be adversely affected by future sales of a substantial number of shares of our Class A common stock or Class B common stock or the availability of such shares for sale.

The sale, or the availability for sale, of a significant number of shares of our Class A common stock or Class B common stock could adversely affect the prevailing market prices of our Class A common stock and could impair our ability to raise capital through future sales of our equity securities. Upon completion of this offering, we will have outstanding 9,321,818 shares of our Class A common stock and 3,011,049 shares of our Class B common stock. Apart from the shares held by the Mutual Company and our officers and directors that are subject to lock-up agreements with the underwriters for a period of 90 days following this offering, all of our outstanding shares of Class A common stock and Class B common stock are freely tradeable without restrictions under the Securities Act. Sales of a substantial number of shares of our Class A common stock or Class B common stock by the Mutual Company or our directors or officers after the expiration of the lock-up period could cause the price of our Class A common stock to fall.

The Mutual Company s ownership of our stock, provisions of our certificate of incorporation and by-laws and certain state laws make it unlikely anyone could acquire control of us unless the Mutual Company were in favor of the change of control.

The Mutual Company s ownership of our Class A common stock and Class B common stock, certain provisions of our certificate of incorporation and by-laws and the insurance laws and regulations of Pennsylvania and Virginia could delay or prevent the removal of members of our board of directors and could make more difficult a merger, tender offer or proxy contest involving us to succeed, even if such events were beneficial to the interest of our stockholders other than the Mutual Company. These factors could also discourage a third party from attempting to acquire control of us. The classification of our board of directors could also have the effect of delaying or preventing a change in control of us.

In addition, we have authorized 2,000,000 shares of series preferred stock that we could issue without further stockholder approval and upon such terms and conditions, and having such rights, privileges and preferences, as our board of directors may determine and that may make it difficult for a third party to acquire control of us. We have no current plans to issue any preferred stock. Moreover, the Delaware

General Corporation Law, which we also refer to as the DGCL, contains certain provisions that prohibit certain business combination transactions under certain circumstances. In addition, state insurance laws and regulations generally prohibit any persons from acquiring a 10% or greater interest in an insurance company without the prior approval of the state insurance commissioner of the state where the insurer is domiciled.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This prospectus and the documents incorporated by reference into this prospectus contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include certain discussions relating to underwriting, premium and investment income volume, business strategies, reserves, profitability and business relationships and our other business activities during 2003 and beyond. In some cases, you can identify forward-looking statements by terms such as may, will, should, could, would, expect, plan, anticipate, believe, estimate, objective, project, predict, potential, goal and similar expressions. These forward-looking statements r current views about future events, are based on our current assumptions and are subject to known and unknown risks and uncertainties that may cause our results, performance or achievements to differ materially from those anticipated in or implied by those statements. Many of the factors that will determine future events or achievements are beyond our ability to control or predict. Such factors may include those described under Risk Factors beginning on page 8.

The forward-looking statements contained in this prospectus reflect our views and assumptions only as of the date of this prospectus. Except as required by law, we do not intend to, and assume no responsibility for, updating any forward-looking statements. You should read this prospectus, the documents that we incorporate by reference in this prospectus and the exhibits to the registration statement of which this prospectus is a part, completely and with the understanding that our actual future results may be materially different from what we expect.

We qualify all of our forward-looking statements by these cautionary statements.

USE OF PROCEEDS

Our net proceeds from the sale of the shares we are offering is estimated to be $54.4 million ($62.5 million if the underwriters overallotment is exercised in full), after deducting estimated underwriting discounts but not deducting expenses of this offering payable by us. We will use approximately $12.5 million of such proceeds to fund the acquisition of Le Mars and approximately $23.0 million of such proceeds to fund the acquisition of Peninsula. See Business Acquisitions. We will also invest approximately $10.0 million of such proceeds over time in the statutory capital and surplus of Atlantic States and Southern to increase our capacity to write insurance directly and to provide capital for Atlantic States portion of the pooled business. We will use the balance of the proceeds for general corporate purposes, including acquisitions of regional property and casualty insurance companies in the states in which we currently operate and in the Midwest, where we intend to expand. Although our growth strategy contemplates future acquisitions, we currently have no present agreements, understandings or definitive plans regarding any acquisition other than the Le Mars and Peninsula acquisitions. Pending the use by us and by Atlantic States and Southern of such proceeds, we will invest such proceeds in interest-bearing securities consistent with our current investment policies. See Business Investments.

PRICE RANGE OF OUR CLASS A COMMON STOCK AND DIVIDEND HISTORY

The prices of our Class A common stock are quoted on the Nasdaq National Market^{SM} under the symbol DGICA. The following table presents, for the periods indicated, the high and low closing prices of our Class A common stock as reported by the Nasdaq National Market^{SM} and the amount of cash dividends paid per share. We have paid quarterly dividends since 1987.

	Price Range		Cash Dividends
	High	Low	Paid
2003:			
First Quarter	$11.50	$10.75	$0.10
Second Quarter	14.97	11.08	0.11
Third Quarter	19.00	12.43	0.11
Fourth Quarter (through November 21)	19.97	15.70	0.11

	Price Range		Cash Dividends
	High	Low	Paid
2002:			
First Quarter	$10.77	$8.75	$0.10
Second Quarter	12.25	9.05	0.10
Third Quarter	10.99	9.12	0.10
Fourth Quarter	12.12	9.25	0.10

	Price Range		Cash Dividends
	High	Low	Paid
2001:			
First Quarter(1)	$12.75	$ 8.69	$0.10
Second Quarter	14.50	10.00	0.10
Third Quarter	14.59	12.17	0.10
Fourth Quarter	13.88	9.10	0.10

(1) These cash dividends were paid in February 2001 on our common stock prior to our April 2001 recapitalization.

The last reported sale price of our Class A common stock on November 20, 2003 was $18.88 per share. As of September 30, 2003, there were approximately 630 holders of record of our Class A common stock.

CAPITALIZATION

The following table sets forth our consolidated capitalization as of September 30, 2003 and as adjusted to reflect our sale of shares of Class A common stock in this offering at an assumed offering price of $19.23, the closing price of our Class A common stock on November 7, 2003. You should read the following table in conjunction with our annual report on Form 10-K for the year ended December 31, 2002 and our quarterly report on Form 10-Q for the quarter ended September 30, 2003, both of which are incorporated in this prospectus by reference.

	September 30, 2003	
	Actual	As Adjusted
	(In thousands)	
Indebtedness:		
Borrowings under line of credit	$ 12,800	$ 12,800
Subordinated debentures	15,000	15,000
Total indebtedness	27,800	27,800
Stockholders equity:		
Preferred stock, $1.00 par value, authorized:		
2,000,000 shares; none issued		
Class A common stock, $0.01 par value authorized:		
30,000,000 shares, issued 6,403,342 shares and outstanding 6,321,818 shares (9,403,342 shares issued and 9,321,818 shares outstanding as adjusted)(1)	64	94
Class B common stock, $0.01 par value, authorized:		
10,000,000 shares, issued 3,051,811 shares and outstanding 3,011,049 shares(2)	31	31
Additional paid-in capital	63,288	117,630
Accumulated other comprehensive income	5,328	5,328
Retained earnings	78,580	78,580
Treasury stock, at cost	(892)	(892)
Total stockholders equity	146,399	200,771
Total capitalization	$ 174,199	$ 228,571

(1) The information also does not include 1,361,462 shares of Class A common stock reserved for issuance for outstanding stock options under our stock option plans at a weighted average exercise price of $12.01 per share and 575,975 shares, 247,113 shares and 250,563 shares, respectively, of Class A common stock reserved for future issuance, under our stock option plans, our employee stock purchase plan and our agency stock purchase plan.

(2) The information also does not include 128,557 shares of Class B common stock reserved for issuance for outstanding stock options under our stock option plans.

SELECTED HISTORICAL FINANCIAL INFORMATION OF THE COMPANY

The selected historical financial information presented below as of or for the years ended December 31, 1998 through 2002 is derived from our audited consolidated financial statements. Our consolidated financial statements as of December 31, 2001 and 2002 and for each of the years in the three-year period ended December 31, 2002, and our independent auditors report thereon, are included elsewhere in this prospectus. The selected historical financial information presented below as of or for the nine-month periods ended September 30, 2002 and 2003 are derived from our unaudited consolidated financial statements included elsewhere in this prospectus. Our results of operations for the nine months ended September 30, 2003 are not necessarily indicative of our results of operations that may be expected for the year ending December 31, 2003. In the opinion of our management, all adjustments, consisting only of normal recurring accruals, considered necessary for a fair presentation have been included. The financial data set forth below is only a summary and should be read in conjunction with our consolidated financial statements and related notes and Management s Discussion and Analysis of Financial Condition and Results of Operations included elsewhere herein.

	Year Ended December 31,					Nine Months Ended September 30,	
	1998	1999	2000	2001	2002	2002	2003
						(Unaudited)	
	(Amounts in thousands, except per share and other data)						
Statement of Operations Data:							
Net premiums earned	$117,454	$145,517	$151,646	$167,770	$185,841	$138,356	$146,082
Investment income, net	12,344	13,591	16,395	15,886	14,581	11,064	10,007
Realized investment gains (losses)	(14)	(39)	171	(880)	144	(14)	495
Total revenues	132,232	161,739	170,582	185,164	203,804	151,856	159,298
Income before income taxes	11,698	3,845	11,743	7,092	16,495	11,497	18,061
Income taxes (benefit)	2,675	(2,950)	2,906	1,274	4,492	3,122	4,946
Net income	9,023	6,795	8,837	5,818	12,003	8,375	13,115
Balance Sheet Data:							
Total investments	$261,507	$268,011	$289,345	$300,633	$332,299	$319,444	$358,320
Total assets	376,742	389,689	426,009	456,632	501,218	488,770	541,598
Debt obligations	37,500	37,000	40,000	27,600	19,800	19,800	27,800
Stockholders equity	100,915	103,792	114,130	120,928	133,183	131,029	146,399
Per Share Data:							
Basic earnings	$ 1.11	$ 0.82	$ 1.01	$ 0.65	$ 1.32	$ 0.92	$ 1.42
Diluted earnings	1.09	0.82	1.01	0.64	1.31	0.91	1.37
Dividends declared (Class A)				0.40	0.40	0.20	0.22
Dividends declared (Class B)				0.36	0.36	0.18	0.20
Dividends declared (common stock)(1)	0.34	0.36	0.36				
Stockholders equity	12.30	12.28	12.88	13.44	14.52	14.37	15.69
Other Data:							
Return on average equity	9.5%	6.6%	8.1%	5.0%	9.4%	8.9%	12.5%
Donegal GAAP combined ratio	100.1	106.5	101.8	103.8	99.6	100.2	95.4
Industry SAP combined ratio(2)	106.0	108.1	110.4	115.9	107.4	104.9	N/A(3)

(1) Represents dividends declared prior to our April 2001 recapitalization.

(2) As reported by A.M. Best.

(3) Not yet reported by A.M. Best.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION

AND RESULTS OF OPERATIONS

You should read the following discussion and analysis of our financial condition and results of operations in conjunction with the Selected Historical Financial Information of the Company and the consolidated financial statements and the related notes included elsewhere in this prospectus and incorporated by reference herein. In addition to this information, the table entitled Management Evaluation of Operating Results on page 25 directly reflects measurements used by management in evaluating operating results. This table, which management uses internally to monitor and evaluate results, is an alternative presentation of our Consolidated Statements of Income and Comprehensive Income. You should refer to this table in conjunction with reading those portions of the following discussions relating to operating results and measurements.

General

We were organized as a regional insurance holding company by 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 subsidiaries. Our personal lines products consist primarily of homeowners and private passenger automobile policies. Our commercial lines products consist primarily of commercial automobile, commercial multiple-peril and workers compensation policies.

At September 30, 2003, the Mutual Company held approximately 65% of our outstanding Class A common stock and approximately 62% of our outstanding Class B common stock.

Atlantic States, our largest insurance subsidiary, and the Mutual Company have a pooling agreement under which both companies are allocated a given percentage of their combined underwriting results, excluding certain reinsurance assumed by the Mutual Company from our insurance subsidiaries. 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. The pooling agreement is intended to produce more uniform and stable underwriting results from year to year for each pool participant than they would experience individually and to spread the risk of loss among the participants based on each participant s relative amount of surplus and relative access to capital. Each participant in the pool has at its disposal the capacity of the entire pool, rather than being limited to policy exposure of a size commensurate with its own capital and surplus.

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

- catastrophe reinsurance agreements with each of our insurance subsidiaries,
- an excess of loss reinsurance agreement with Southern,
- a workers compensation reallocation agreement with Southern and
- a 100% retrocessional agreement with Southern.

The excess of loss and catastrophe reinsurance agreements are intended to lessen the effects of a single large loss, or an accumulation of losses arising from one event, to levels that are appropriate given each subsidiary s size, underwriting profile and surplus position.

The Mutual Company and Southern have an agreement to reallocate the loss results of workers compensation business written by Southern as part of commercial accounts primarily written by the Mutual Company or Atlantic States. This agreement provides for the workers compensation loss ratio of Southern to be no worse than the average workers compensation loss ratio for the Donegal Insurance Group.

Southern has a 100% retrocessional agreement with the Mutual Company that is intended to provide Southern with the same A.M. Best rating, currently A (Excellent), as the Mutual Company, which Southern might not be able to achieve without this agreement in place. The retrocessional agreement does not otherwise provide for pooling or reinsurance with or by the Mutual Company and does not transfer insurance risk.

The Mutual Company provides facilities, personnel and other services to us, and the related expenses are allocated between Atlantic States and the Mutual Company in relation to their relative participation in the pooling agreement. Southern reimburses the Mutual Company for its personnel costs and bears its proportionate share of information services costs based on its percentage of total written premiums of the Donegal Insurance Group.

Subsequent to receipt of applicable board approvals, all agreements and all changes to existing agreements between our subsidiaries and the Mutual Company are subject to approval by a coordinating committee that is comprised of two of our board members who do not serve on the Mutual Company board and two board members of the Mutual Company who do not serve on our board. In order to approve an agreement or a change in an agreement, our members on the coordinating committee must conclude that the agreement or change is fair to us and our stockholders, and the Mutual Company s members on the coordinating committee must conclude that the agreement or change is fair to the Mutual Company and its policyholders.

We have additional related party transactions with certain of our executive officers and directors. See Management and Certain Relationships and Related Transactions.

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 United States generally accepted accounting principles.

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, policy acquisition costs and guaranty fund liability accruals. While we believe our estimates are appropriate, the ultimate amounts may differ from the estimates provided. The methods for making these estimates are continually reviewed, and any adjustment considered necessary is reflected in our current results of operations.

Liability for Losses and Loss Expenses. With respect to reserves for property and casualty insurance unpaid losses and loss expenses, significant components of our estimates include a variety of factors such as medical inflation trends, regulatory and judicial rulings, legal settlements, property replacements and repair cost trends and losses from assumed reinsurance. In recent years, certain of these component costs, such as medical inflation trends and legal settlements, have experienced significant volatility and have resulted in incurred amounts higher than our original estimates, and we have factored these changes in trends into our loss estimates. However, due to the nature of these liabilities, actual results could ultimately vary significantly from the amounts recorded.

Loss reserves are set at full expected cost. Inflation is implicitly provided for in the reserving function through analysis of costs, trends and reviews of historical reserving results.

We occasionally receive new information on files that had previously been closed. For example, one of our policyholders may incur losses that were not known at the time of the original claim settlement. We are also exposed to larger than historical settlements due to changes in law, precedent or underlying inflation on pending and unreported claims. When we experience adverse development of losses from prior accident years, our current year underwriting results are negatively impacted. To the extent our prior year reserve deficiencies are indicative of deteriorating underlying loss trends and are material, we seek to increase the pricing of affected lines of business to the extent permitted by state departments of insurance. We also review trends in loss development in order to determine if adjustments, such as reserve strengthening, are appropriate. Any adjustment considered necessary is reflected in our current results of operations. Because of our participation in the pool, we are exposed to adverse loss development on the business of the Mutual Company included in the pool.

Investments. We make estimates concerning the valuation of our investments and the recognition of other than temporary declines in 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 our 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, the occurrence of industry, company and geographic events that have negatively impacted the value of a security or rating agency downgrades.

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

We held equity securities with unrealized losses representing declines that we considered temporary at September 30, 2003 as follows:

			Length of Unrealized Loss		
	Fair Value	**Unrealized Loss**	**Less Than 6 Months**	**6 to 12 Months**	**Over 12 Months**
			(Amounts in thousands)		
Equity securities	$3,083	$240	$128	$ 2	$110

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.

Guaranty Fund Liability Accruals. We make estimates of our insurance subsidiaries liabilities for guaranty fund and other assessments from states in which the subsidiaries are licensed because of insurance company insolvencies. Generally, an insurer is subject to assessment, depending upon its market share of a given line of business, to assist in the payment of unpaid claims and related costs of insolvent insurance companies. We generally record our liability for such assessments as premiums upon which these assessments will be based are written. As a result of several large insolvencies in recent years, we are currently being assessed at the maximum level permitted by Pennsylvania law for several of our lines of business, and we expect we will continue to be assessed by Pennsylvania at the maximum level for these business lines for a number of years.

Management Evaluation of Operating Results

We evaluate the performance of our commercial lines and personal lines segments primarily based upon our underwriting results as determined under SAP, which our management uses to measure performance for our total business. We use the following financial data to monitor and evaluate our operating results:

	Year Ended December 31,			Nine Months Ended September 30,	
	2000	2001	2002	2002	2003
				(Unaudited)	
			(Amounts in thousands)		
Net Premiums Written:					
Personal lines:					
Automobile	$ 65,528	$ 74,396	$ 84,643	$ 64,183	$ 65,709
Homeowners	29,413	31,431	34,637	26,066	27,650
Other	5,576	5,796	6,497	5,158	5,282
Total personal lines	100,517	111,623	125,777	95,407	98,641
Commercial lines:					
Automobile	15,112	16,527	17,451	13,536	14,294
Workers compensation	21,174	22,979	23,845	18,724	19,299
Commercial multi-peril	21,722	24,174	25,536	19,700	22,828
Other	1,597	1,725	1,895	1,431	1,471
Total commercial lines	59,605	65,405	68,727	53,391	57,892
Total net premiums written	$160,122	$177,028	$194,504	$148,798	$156,533
Statutory Loss Ratios:					
Personal lines:					
Automobile	70.3%	74.6%	79.4%	78.8%	70.7%
Homeowners	72.2	61.8	63.6	65.0	67.2
Other	59.6	42.3	52.2	57.7	59.6
Total personal lines	70.3	69.2	73.6	73.9	69.2
Commercial lines:					
Automobile	78.1	85.0	62.2	59.8	54.0
Workers compensation	64.2	82.5	73.1	69.7	63.2
Commercial multi-peril	67.2	58.4	50.0	52.8	51.9
Other	(0.1)	25.2	43.1	47.6	49.7
Total commercial lines	66.9	72.3	60.9	60.3	56.2
Total business	69.0%	70.5%	69.1%	69.0%	64.5%
Components of GAAP Combined Ratio:					
Loss ratio	68.8%	70.5%	69.6%	69.3%	64.5%
Expense ratio	32.1	32.3	29.5	30.3	30.4
Dividend ratio	0.9	1.0	0.5	0.6	0.5

GAAP combined ratio	101.8%	103.8%	99.6%	100.2%	95.4%

	Year Ended December 31,			Nine Months Ended September 30,	
	2000	2001	2002	2002	2003
				(Unaudited)	
			(Amounts in thousands)		
Revenues:					
Premiums earned:					
Personal lines	$ 97,065	$104,893	$119,838	$ 89,110	$ 93,415
Commercial lines	54,581	62,877	66,003	49,245	52,667
Total premiums earned	151,646	167,770	185,841	138,355	146,082
Net investment income	16,395	15,886	14,581	11,064	10,007
Realized investment gains (losses)	171	(880)	144	(14)	495
Other	2,370	2,388	3,238	2,451	2,714
Total revenues	$170,582	$185,164	$203,804	$151,856	$159,298
Components of Net Income:					
Underwriting income (loss):					
Personal lines	$ (4,649)	$ (5,090)	$ (5,056)	$ (5,289)	$ (794)
Commercial lines	763	(3,037)	6,326	4,548	6,222
SAP underwriting income (loss)	(3,886)	(8,127)	1,270	(741)	5,428
GAAP adjustments	1,144	1,833	(558)	479	1,282
GAAP underwriting income (loss)	(2,742)	(6,294)	712	(262)	6,710
Net investment income	16,395	15,886	14,581	11,064	10,007
Realized investment gains (losses)	171	(880)	144	(14)	495
Other	(2,081)	(1,620)	1,058	709	849
Income before income taxes	11,743	7,092	16,495	11,497	18,061
Income taxes	2,906	1,274	4,492	3,122	4,946
Net income	$ 8,837	$ 5,818	$ 12,003	$ 8,375	$ 13,115

Results of Operations

Nine Months Ended September 30, 2003 Compared to Nine Months Ended September 30, 2002

Net Premiums Written. During the first nine months of 2003, our net premiums written increased by 5.2% to $156.5 million, compared to $148.8 million for the first nine months of 2002. Commercial lines net premiums written increased $4.5 million, or 8.4%, for the first nine months of 2003 compared to the first nine months of 2002. Personal lines net premiums written increased $3.2 million, or 3.4%, for the first nine months of 2003 compared to the same period in 2002. We have benefited during these periods, and expect to continue to benefit, from premium increases by our insurance subsidiaries that have resulted from pricing actions approved by regulators. These increases related primarily to private passenger automobile, commercial multiple peril, workers compensation and homeowners lines of business realized in most of the states in which we operate. In addition to pricing increases, we have also benefited from organic growth in most of the states in which we operate.

Net Premiums Earned. Our net premiums earned increased to $146.1 million for the first nine months of 2003, an increase of $7.7 million, or 5.6%, over the first nine months of 2002. Our net earned premiums during the 2003 period have grown due to the increase in written premiums during the period. 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 will generally reflect increases or decreases in net premiums written in the preceding twelve-month period compared to the same period one year earlier.

Investment Income. For the nine months ended September 30, 2003, our net investment income decreased 9.6% to $10.0 million, compared to $11.1 million for the same period one year ago. An increase in our average invested assets from $310.0 million for the first nine months of 2002 to $345.3 million for the first nine months of 2003 was more than offset by a decrease in our annualized average return on investments from 4.8% for the first nine months of 2002 to 3.9% for the first nine months of 2003, and accounted for the decrease in investment income in the 2003 period compared to the 2002 period. The decrease in our annualized average return during both periods compared to prior periods reflects a declining interest rate environment.

Net Realized Investment Gains/ Losses. Our net realized investment gains for the first nine months of 2003 were $494,763, compared to net realized investment losses of $13,931 for the same period in 2002. Our net realized investment gains for the first nine months of 2003 were net of impairment charges of $255,874, compared to impairment charges of $358,574 recognized in the first nine months of 2002. Our impairment charges for both years were the result of declines in the market value of common stocks that we determined to be other than temporary. The remaining net realized investment gains and losses 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, for the first nine months of 2003 was 64.5%, compared to 69.3% for the first nine months of 2002. Our commercial lines loss ratio decreased to 56.2% for the first nine months of 2003, compared to 60.3% for the first nine months of 2002. Our commercial automobile and workers compensation loss ratios showed improvement for the first nine months of 2003, with the commercial automobile loss ratio decreasing to 54.0% for 2003, compared to 59.8% for the same period in 2002, and the workers compensation loss ratio decreasing to 63.2% for 2003, compared to 69.7% for the same period of 2002. The personal lines loss ratio improved from 73.9% for the first nine months of 2002 to 69.2% for the first nine months of 2003, primarily as a result of improvement in the personal automobile loss ratio for the 2003 period compared to the 2002 period. Improvements in our 2003 loss ratios reflect the benefits of premium pricing increases and more favorable prior accident year loss development compared to the same period in 2002.

Underwriting Expenses. Our expense ratio, which is the ratio of policy acquisition and other underwriting expenses to premiums earned, for the first nine months of 2003 was 30.4%, compared to 30.3% for the first nine months of 2002. Improvements from expense control efforts were offset by higher underwriting-based incentive costs incurred in the first nine months of 2003 compared to the first nine months of 2002.

Combined Ratio. Our combined ratio was 95.4% and 100.2% for the nine months ended September 30, 2003 and 2002, 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 improvement in our combined ratio was primarily attributable to the decrease in the loss ratio between periods.

Interest Expense. Our interest expense for the first nine months of 2003 was $879,496, compared to $870,079 for the first nine months of 2002, reflecting an increase in interest expense related to the issuance of $15.0 million of subordinated debentures in May 2003, offset by decreases in the average interest rates and average borrowings under our line of credit for the 2003 period compared to the 2002 period.

Income Taxes. Income tax expense was $4.9 million for the first nine months of 2003, compared to $3.1 million for the first nine months of 2002, representing effective tax rates of 27.4% and 27.2%, respectively.

Net Income and Earnings Per Share. Our net income for the first nine months of 2003 was $13.1 million, an increase of 56.6% over the $8.4 million reported for the first nine months of 2002. Our diluted earnings per share were $1.37 for the first nine months of 2003 compared to $0.91 for the same period last year.

Year Ended December 31, 2002 Compared to Year Ended December 31, 2001

Net Premiums Written. Our net premiums written for 2002 increased by 9.9% to $194.5 million compared to $177.0 million for 2001. Personal lines net premiums written increased $14.2 million, or 12.7%, for 2002 compared to 2001. Commercial lines net premiums written increased $3.3 million, or 5.1%, for 2002 compared to 2001. We implemented rate increases in various lines of business throughout 2002 to improve profitability.

Net Premiums Earned. Our net premiums earned for 2002 increased to $185.8 million, an increase of $18.1 million, or 10.8%, over 2001. Earned premiums grew due to the increase in written premiums during 2002.

Investment Income. Our investment income for 2002 decreased 8.2% to $14.6 million, compared to $15.9 million for 2001. An increase in average invested assets from $295.0 million in 2001 to $316.5 million in 2002 was more than offset by a decrease in the annualized average return on investments from 5.3% in 2001 to 4.6% in 2002, and accounted for the decrease in investment income in 2002 compared to 2001. The decrease in our annualized average return reflects a declining interest rate environment during both periods.

Net Realized Investment Gains/ Losses. Our net realized investment gains in 2002 were $144,190, compared to net realized investment losses of $880,254 in 2001. Our net realized investment gains in 2002 were net of impairment charges of $378,672, compared to impairment charges of $1.5 million in 2001. The impairment charges in both years were the result of declines in the market value of common stocks that were determined to be other than temporary.

Losses and Loss Expenses. Our loss ratio in 2002 was 69.6%, compared to 70.5% in 2001. Our commercial lines loss ratio decreased significantly to 61.5% in 2002, compared to 72.7% in 2001, with the commercial automobile loss ratio showing the greatest improvement as it decreased from 85.0% in 2001 to 61.6% in 2002. Our personal lines loss ratio increased from 69.2% in 2001 to 73.3% in 2002. Net losses and loss expenses for 2002 and 2001 included adverse development of prior accident year losses amounting to $6.8 million and $8.0 million, respectively. In 2002, the adverse loss development was primarily in private passenger automobile liability and physical damage and, to a lesser extent, in commercial lines of business, such as workers compensation, commercial automobile liability and commercial multi-peril. The 2002 loss development resulted principally from accident year 2001 claims and the normal claims review process and not from any changes in key assumptions or changes in reserving philosophy. The 2001 adverse loss development was primarily in commercial lines of business. The 2001 loss development included $4.2 million of reserve strengthening primarily in the workers compensation and commercial auto lines of business.

Underwriting Expenses. Our expense ratio in 2002 was 29.5%, compared to 32.3% in 2001. Improvement in our loss expense ratio was primarily a result of the cost-reduction program implemented in late 2001. The expense ratio in 2001 included a guaranty fund assessment of approximately $543,000 resulting from the insolvency of Reliance Insurance Company. This assessment also contributed to the change in the expense ratio between years.

Combined Ratio. Our combined ratio was 99.6% in 2002, compared to 103.8% in 2001. The improvement in our combined ratio was primarily attributable to the decrease in the expense ratio between periods.

Interest Expense. Interest expense in 2002 was $1.1 million, compared to $2.2 million in 2001, reflecting decreases in average borrowings under our line of credit and decreases in the average interest rates for the respective periods.

Income Taxes. Income tax expense was $4.5 million in 2002, an effective tax rate of 27.2%, compared to $1.3 million, or an effective tax rate of 18.0%, in 2001. Tax-exempt interest represented a smaller proportion of net income before taxes in 2002 compared to 2001 and accounted for most of the difference between the effective rates.

Net Income and Earnings Per Share. Our net income in 2002 was $12.0 million, an increase of 106.3% over the $5.8 million reported in 2001. Diluted earnings per share were $1.31 for 2002 compared to $0.64 for the previous year.

Year Ended December 31, 2001 Compared to Year Ended December 31, 2000

Net Premiums Written. Our net premiums written for 2001 increased by 10.6% to $177.0 million, compared to $160.1 million for 2000. Personal lines net premiums written increased $11.1 million, or 11.0%, for 2001 compared to 2000. Commercial lines net premiums increased $5.8 million, or 9.7% for 2001 compared to 2000.

Net Premiums Earned. Our net premiums earned for 2001 increased to $167.8 million, an increase of $16.1 million, or 10.6%, over 2000. An increase in Atlantic States share of the pooling agreement with the Mutual Company from 65% to 70% effective July 1, 2000 accounted for $4.3 million of the increase in net premiums earned in 2001 compared to 2000.

Investment Income. Our investment income for 2001 decreased 3.1% to $15.9 million, compared to $16.4 million for 2000. An increase in average invested assets from $278.7 million in 2000 to $295.0 million in 2001 was more than offset by a decrease in the annualized average return on investments from 5.9% in 2000 to 5.3% in 2001. This decrease accounted for the decrease in investment income. The decline in our annualized average return for 2001 reflects a declining interest rate environment in 2001.

Net Realized Investment Gains/ Losses. Our net realized investment losses in 2001 were $880,254, compared to net realized investment gains of $170,852 in 2000. The net realized investment losses in 2001 included impairment charges of $1.5 million, compared to impairment charges of $436,943 that were netted from net realized investment gains in 2000. The impairment charges in both years were the result of declines in the market value of common stocks that we determined to be other than temporary.

Losses and Loss Expenses. Our loss ratio for 2001 was 70.5%, compared to 68.8% for 2000. The commercial lines loss ratio for 2001 increased significantly to 72.7%, compared to 67.0% for 2000. Our personal lines loss ratio for 2001 decreased to 69.2% compared to 70.3% for 2000. Net losses and loss expenses for 2001 and 2000 included adverse development of prior accident year losses amounting to $8.0 million and $0.7 million, respectively. In 2001, our adverse loss development was primarily in commercial lines of business, such as workers compensation, commercial automobile liability and commercial multi-peril. The 2001 loss development included $4.2 million of reserve strengthening primarily in the workers compensation and commercial automobile lines of business.

Underwriting Expenses. Our expense ratio for 2001 was 32.3%, compared to 32.1% for 2000. Our expense ratio for 2001 included a guaranty fund assessment of approximately $543,000 resulting from the insolvency of Reliance Insurance Company. This assessment accounted for most of the increase in the expense ratio in 2001 compared to 2000.

Combined Ratio. Our combined ratio was 103.8% for 2001, compared to 101.8% for 2000. The increased loss ratio for 2001 compared to 2000 accounted for the majority of the increase in the combined ratio between years.

Interest Expense. Our interest expense for 2001 was $2.2 million, compared to $3.3 million for 2000, reflecting decreases in 2001 in our average borrowings under our line of credit and decreases in the average interest rates for 2001 compared to 2000.

Income Taxes. Our income tax expense was $1.3 million for 2001, an effective rate of 18.0%, compared to $2.9 million, or an effective rate of 24.7% for 2000. Tax-exempt interest in 2001 represented a larger proportion of our net income before taxes compared to 2000 and accounted for most of the difference between the effective rates.

Net Income and Earnings Per Share. Our net income for 2001 was $5.8 million, a decrease of 34.2% from the $8.8 million reported for 2000. Our diluted earnings per share were $0.64 for 2001 compared to $1.01 for the previous year.

Financial Condition

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 generate sufficient net positive cash flow from our operations to fund our commitments and build our investment portfolio, thereby increasing future investment returns. We maintain a high degree of liquidity in our investment portfolio through investments in readily-marketable fixed maturities, equity securities and short-term investments. Net cash flows provided by operating activities in the first nine months of 2002 and 2003 were $25.5 million and $23.8 million, respectively. Net cash flows provided by operating activities in 2000, 2001 and 2002 were $18.5 million, $22.0 million and $34.1 million, respectively.

On May 15, 2003, we received $15.0 million in 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 September 30, 2003, the interest rate on the debentures was 5.23% and the rate will next be subject to adjustment on November 15, 2003.

We also had unsecured borrowings of $12.8 million as of September 30, 2003 under a credit agreement with Fleet National Bank of Connecticut, which we refer to as the Bank. Per the terms of the credit agreement, we may currently borrow up to $16.0 million at interest rates equal to the Bank s then current prime rate or the then current London interbank eurodollar bank rate plus 1.70%. At September 30, 2003, the interest rate on the outstanding balances was 2.825% on an outstanding eurodollar balance of $4.8 million and 2.84% on an outstanding eurodollar balance of $8.0 million. In addition, we pay the Bank a non-use fee at a rate of 3/10 of 1% per annum on the average daily unused portion of the Bank s commitment. Each July 27th, the credit line is reduced by $8.0 million and was $16.0 million as of September 30, 2003. Any outstanding loan in excess of the remaining credit line, after such reduction, will then be payable.

On October 10, 2003, we signed a commitment letter with Manufacturers and Traders Trust Company relating to a $35.0 million line of credit. We anticipate this line of credit will close by November 30, 2003, at which time we intend to draw against the line of credit to repay our existing indebtedness of $12.8 million to Fleet National Bank. We currently have no other plans to draw against this line of credit.

On October 29, 2003, DGI Statutory Trust II, which we call the Trust, and is a wholly owned Connecticut statutory trust, issued $10.0 million aggregate principal amount of trust preferred securities. We own all of the common securities of the Trust. The proceeds from the issuance of the common securities and the trust preferred securities were used by the Trust to purchase $10.31 million of our floating rate junior subordinated deferrable interest debentures, which pay interest at a floating rate adjustable quarterly equal to the three-month LIBOR plus 385 basis points. The interest rate for the initial period ending January 29, 2004 is 5.010%.

The following table shows our significant contractual obligations as of September 30, 2003.

	Total	2003	2004	2005	2006	2007	After 2007
	(Amounts in thousands)						
Borrowings under line of credit	$12,800	$	$4,800	$8,000	$	$	$
Subordinated debentures	15,000						15,000
Total contractual obligations	$27,800	$	$4,800	$8,000	$	$	$15,000

Dividends declared to stockholders totaled $3.2 million, $3.5 million and $3.5 million in 2000, 2001 and 2002, respectively. 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. Atlantic States and Southern are required by law to maintain certain minimum surplus on a statutory basis, and are subject to regulations under which payment of dividends from statutory surplus is restricted and may require prior approval of their domiciliary insurance regulatory authorities. Atlantic States and Southern are subject to risk-based capital or RBC requirements. At December 31, 2002, Atlantic States and Southern s capital were each substantially above RBC requirements. During 2003, amounts available for distribution as dividends to us without prior approval of their domiciliary insurance regulatory authorities were $10.6 million from Atlantic States and $2.5 from Southern.

On September 4, 2003, we announced our intention to acquire Le Mars from the Mutual Company. We expect the Le Mars acquisition to be completed on or about January 1, 2004. We will invest approximately $12.5 million in cash to fund this acquisition.

On October 30, 2003, we announced that we entered into an agreement to purchase Peninsula from Folksamerica Holding Company, Inc. for approximately $23.0 million in cash. We expect this acquisition to be consummated on or about January 1, 2004.

As of September 30, 2003, we had no material commitments for capital expenditures.

Investments

We had total cash, cash equivalents and invested assets with a carrying value of $363.3 million and $333.4 million as of September 30, 2003 and December 31, 2002, respectively. The following table summarizes our cash, cash equivalents and invested assets as of the dates indicated:

	September 30, 2003		
	Amortized Cost	Fair Value	% of Total at Fair Value
	(Amounts in thousands)		
Fixed maturities, held to maturity	$113,746	$117,192	32.0%
Fixed maturities, available for sale	171,681	178,898	48.8
Equity securities, available for sale	23,976	24,956	6.8
Cash and cash equivalents	4,953	4,953	1.4
Short-term investments	40,720	40,720	11.0
Total	$355,076	$366,719	100.0%

	December 31, 2002		
	Amortized Cost	Fair Value	% of Total at Fair Value
	(Amounts in thousands)		
Fixed maturities, held to maturity	$ 86,702	$ 89,785	26.7%
Fixed maturities, available for sale	187,496	194,732	57.9
Equity securities, available for sale	21,587	21,836	6.5
Cash and cash equivalents	1,125	1,125	0.3
Short-term investments	29,029	29,029	8.6
Total	$325,939	$336,507	100.0%

The amortized cost and estimated fair values of fixed maturities and equity securities at September 30, 2003, were as follows:

	Held to Maturity			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(Amounts in thousands)			
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 28,630	$ 160	$209	$ 28,581
Canadian government obligation	500	30		530
Obligations of states and political subdivisions	42,708	1,001	83	43,626
Corporate securities	28,608	2,331		30,939
Mortgage-backed securities	13,300	304	88	13,516
Total	$113,746	$3,826	$380	$117,192

	Available for Sale			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(Amounts in thousands)			
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 48,607	$1,439	$ 15	$ 50,031
Obligations of states and political subdivisions	79,804	3,408	3	83,209
Corporate securities	32,438	2,288		34,726
Mortgage-backed securities	10,832	113	13	10,932
Equity securities	23,976	1,220	240	24,956
Total	$195,657	$8,468	$271	$203,854

Quantitative and Qualitative Disclosures About Market Risk

We are exposed to the impact of interest rate changes, changes in market values of investments and to credit risk.

In the normal course of business, we employ established policies and procedures to manage our exposure to changes in interest rates, fluctuations in the fair market value of our debt and equity securities and credit risk. We seek to mitigate these risks by various actions described below.

Interest Rate Risk

Our exposure to market risk for a change in interest rates is concentrated in our investment portfolio. We monitor this exposure through periodic reviews of asset and liability positions. Estimates of cash flows and the impact of interest rate fluctuations relating to our investment portfolio are monitored regularly. Generally, we do not hedge our exposure to interest rate risk because we have the capacity to, and do, hold fixed maturity investments to maturity.

Principal cash flows and related weighted-average interest rates by expected maturity dates for financial instruments sensitive to interest rates are as follows:

	As of December 31, 2002	
	Principal Cash Flows	Weighted-Average Interest Rate
	(Amounts in thousands)	
Fixed maturities and short-term investments:		
2003	$ 46,729	2.85%
2004	15,700	5.81
2005	30,250	5.27
2006	37,873	5.63
2007	36,687	5.49
Thereafter	132,548	5.37
Total	$299,787	
Market Value	$313,546	
Debt:		
2003	$ 3,800	3.46%
2004	8,000	3.46
2005	8,000	3.46
Total	$ 19,800	
Fair value	$ 19,800	

Actual cash flows from investments may differ from those stated as a result of calls and prepayments.

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.

The combined total of our realized and unrealized equity investment losses were $650,229, $131,146 and $515,320 in 2000, 2001 and 2002, respectively. During these three years, the largest total equity investment gain and (loss) in a quarter were $829,914 and $(440,947), respectively.

Credit Risk

Our portfolio of fixed-maturity securities and, to a lesser extent, our short-term investments are 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 our 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 areas. The majority of this business is billed directly to the insured, although a portion of our commercial business is billed through our agents who are extended credit in the normal course of business.

Because the pooling agreement between the Mutual Company and Atlantic States does not relieve Atlantic States of primary liability as the originating insurer, we are subject to a concentration of credit risk arising from the business Atlantic States cedes to the Mutual Company through the pool. Our insurance subsidiaries maintain other reinsurance agreements 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.

BUSINESS

Who We Are

We are a property and casualty insurance holding company whose insurance subsidiaries offer personal and commercial lines of insurance to small businesses and individuals in 14 Mid-Atlantic and Southeastern states. We provide our policyholders with a selection of insurance products at competitive rates, while pursuing profitability through adherence to a strict underwriting discipline. At September 30, 2003, we had total assets of $541.6 million and stockholders equity of $146.4 million. Our net income was $13.1 million for the nine months ended September 30, 2003 compared to $12.0 million for the year ended December 31, 2002.

We derive a substantial portion of our insurance business from smaller to mid-sized regional communities. We believe this focus provides us with competitive advantages in terms of local market knowledge, marketing, underwriting, claims servicing and policyholder service. At the same time, we believe we have cost advantages over many regional insurers because of our centralized accounting, administrative, investment, data processing and other services.

Strategy

Our premiums earned have increased from $117.5 million in 1998 to $185.8 million in 2002, a compound annual growth rate of 12.2%. Over the same time period, our combined ratio has consistently been more favorable than that of the industry. We seek to grow our business and enhance our profitability by:

Achieving underwriting profitability.

We focus on achieving a combined ratio of less than 100%, and believe that underwriting profitability is a fundamental component of our long-term financial strength because it allows us to generate profits without relying on our investment income. We seek to enhance our underwriting results by carefully selecting the product lines we underwrite, minimizing our exposure to catastrophe-prone areas and continually evaluating our claims history to ensure the adequacy of our underwriting guidelines and product pricing. For our personal lines products, we insure standard and preferred risks primarily in private passenger automobile and homeowners lines. For our commercial lines products, we limit our exposure to industrial companies, and we have no exposure to asbestos and limited exposure to other environmental liabilities. We seek to provide more than one policy to a given personal or commercial customer because this account selling strategy diversifies our risk and has historically improved our underwriting results. Finally, we use reinsurance to manage our exposure and limit our maximum net loss from large single risks or risks in concentrated areas. We believe these practices are key factors in our ability to maintain a combined ratio that has been traditionally more favorable than the combined ratio of our industry.

Our combined ratio and that of our industry for the years 1998 through 2002 are shown in the following table:

	1998	1999	2000	2001	2002
Donegal GAAP combined ratio	100.1%	106.5%	101.8%	103.8%	99.6%
Industry SAP combined ratio(1)	106.0	108.1	110.4	115.9	107.4

(1) As reported by A.M. Best.

Pursuing profitable growth by organic expansion within our traditional operating territories through developing and maintaining quality agency representation.

We believe that continued expansion within our existing markets will be a key source of our continued premium growth, and maintaining an effective and growing network of independent agents is integral to our expansion. We seek to be among the top three insurers within each of our agencies for the lines of business we write by providing a consistent, competitive and stable market for our products. We believe that the consistency of our product offerings enables us to compete effectively for agents with other insurers whose product offerings fluctuate based on industry conditions. We offer our agents a competitive compensation program that rewards them for pursuing profitable growth on our behalf, and we provide them with ongoing support that enables them to better attract and service customers, including Internet-based information systems, training programs, marketing support and field visitations by our marketing personnel and senior management. Finally, we only appoint agencies with a strong underwriting and growth track record. We believe that by carefully selecting, motivating and supporting our agency force, we will be able to drive continued long-term growth.

Acquiring property and casualty insurance companies to augment our organic growth in existing markets and to expand into new geographic regions.

We have completed four acquisitions of property and casualty insurance companies since 1995, and we have two pending acquisitions, Peninsula and Le Mars. We believe we have an opportunity to continue our growth by selectively pursuing affiliations and acquisitions that meet our criteria. Our criteria include:

Location in regions where we are currently conducting business or would like to conduct business;

A mix of business similar to our business;

Targeted premium volume between $20.0 million and $80.0 million; and

Transaction terms that are fair and reasonable to us.

We believe that our affiliation with the Mutual Company assists us in pursuing affiliations with and subsequent acquisitions of other mutual companies because we have a strong understanding of the concerns and issues mutual companies face. In particular, we have had success affiliating with and acquiring undercapitalized mutual companies by utilizing our strengths and financial position to significantly improve their operations post-affiliation. We generally evaluate a number of areas for operational improvement when considering acquisitions, including product underwriting, expenses, the cost of reinsurance and technology.

Focusing on expense controls and utilization of technology to increase our operating efficiency.

We maintain stringent expense controls with direct involvement by our senior management. We consolidate all processing and administrative activities at our home office to realize operating synergies and better control expenses. We utilize technology to automate much of our underwriting to facilitate agency and policyholder communications on an efficient and cost-effective basis. In 2002, we completed a reorganization begun in 2001 that streamlined our operations and allowed us to operate more efficiently. As a result of our focus on expense control, we have reduced our expense ratio from 35.9% for 1998 to 30.4% for the nine months ended September 30, 2003. We have also increased our annual premium per employee, a measure of efficiency that we use to evaluate our operations, from approximately $470,000 in 1998 to approximately $700,000 on an annualized basis as of September 30, 2003.

Providing responsive and friendly customer and agent service to enable us to attract new policyholders and retain existing policyholders.

We believe that excellent policyholder service is important to attracting new policyholders and retaining existing policyholders. We work closely with our agency force to provide a consistently responsive level of claims service, underwriting and customer support. We seek to respond expeditiously and effectively to address customer and agent inquiries, including working to:

Quickly reply to information requests and policy submissions; and

Promptly respond to and process claims.

As a part of our focus on customer service, we conduct policyholder service surveys to evaluate the effectiveness of our support programs, and our management meets frequently with agency personnel to seek service improvement recommendations, react to service issues and better understand local market conditions.

Maintaining premium rate adequacy to enhance our underwriting results, while maintaining our existing book of business and preserving our ability to write new business.

We are committed to maintaining discipline in our pricing by pursuing rate increases to maintain or improve our underwriting profitability without unduly affecting our ability to attract and retain customers. In addition to pursuing appropriate pricing, we take numerous actions to ensure that our premium rates are adequate relative to our level of underwriting risk. We review loss trends on a periodic basis to identify changes in the frequency and severity of our claims and to assess the adequacy of our rates and underwriting standards. We also carefully monitor and audit the key information that we use to price our policies, enabling us to receive an adequate level of premiums for our risk. For example, we inspect and perform loss control surveys on most of the risks we insure to determine adequacy of insurance to value, assess property conditions and identify any liability exposures. We audit the payroll data of our workers compensation customers to verify that the assumptions we used to price a particular policy were accurate. By aggressively pursuing appropriate rate increases and thoroughly understanding the risks we insure, we are able to support our strategy of achieving consistent underwriting profitability.

Our Organizational Structure

Approximately 65% of our Class A common stock and approximately 62% of our Class B common stock is owned by the Mutual Company, which was founded in 1889. Our insurance operations are interrelated with those of the Mutual Company, and, we conduct our insurance business together with the other entities comprising the Donegal Insurance Group. As such, while maintaining the separate corporate existence of each company, we share the same business philosophy, management, employees and facilities as the Mutual Company and offer the same types of insurance products. We conduct most of our operations through our two insurance subsidiaries, Atlantic States and Southern. We also own 47.5% of Donegal Financial Services Corporation, a registered savings and loan holding company that owns Province Bank, a federal savings bank that began operations in 2000. The Mutual Company owns the remaining 52.5% of Donegal Financial Services Corporation. While not yet profitable nor material to our operations, we believe Province Bank, with total assets of $46.6 million at September 30, 2003, will complement our product offerings. The following chart depicts our organizational structure, including our principal subsidiaries.

Atlantic States, our largest insurance subsidiary, and the Mutual Company have a pooling agreement under which both companies are allocated a given percentage of their combined underwriting results, excluding certain intercompany reinsurance assumed by the Mutual Company from our insurance subsidiaries. Under the terms of the pooling agreement, Atlantic States cedes its underwriting results to the Mutual Company. The Mutual Company in turn pools its underwriting results with the underwriting results of Atlantic States. The pooled underwriting results are then allocated 70% to Atlantic States and 30% to the Mutual Company. Pursuant to amendments to the pooling agreement since its commencement on October 1, 1986, the participation of Atlantic States in the underwriting results of the pool has gradually increased.

The following chart depicts our underwriting pool:

The pooling agreement may be amended or terminated at the end of any calendar year by agreement of the parties, subject to approval by the coordinating committee discussed below. The allocations of pool participation percentages between the Mutual Company and Atlantic States have been based on their approximate relative amounts of capital and surplus, expectations of future relative amounts of capital and surplus and our ability to raise capital for Atlantic States. We do not currently anticipate a further increase in Atlantic States percentage of participation in the pool, nor do we intend to terminate the participation of Atlantic States in the pooling agreement.

The Mutual Company provides facilities, personnel and other services to us, and the related expenses are allocated between Atlantic States and the Mutual Company in relation to their relative participation in the pooling agreement. Southern reimburses the Mutual Company for its personnel costs and bears its proportionate share of information services costs based on its percentage of total written premiums of the Donegal Insurance Group. Expenses allocated to us under such agreements were $28.6 million in 2002.

Subsequent to receipt of applicable board approvals, all agreements and all changes to existing agreements between the Mutual Company and us are subject to approval by a coordinating committee that is comprised of two of our board members and two board members of the Mutual Company who do not serve on the other board. In order to approve an agreement or a change in an agreement, our members on the coordinating committee must conclude that the agreement or change is fair to us and our stockholders, and the Mutual Company s members on the coordinating committee must conclude that the agreement or change is fair to the Mutual Company and its policyholders.

We believe our relationship with the Mutual Company offers us a number of competitive advantages, including:

Facilitating our stable management, consistent underwriting discipline, external growth and long-term profitability.

- Creating operational and expense synergies given the combined resources and operating efficiencies of the Mutual Company and us.
- Enhancing our ability to affiliate with and eventually acquire other mutual insurance companies.
- Producing a more uniform and stable underwriting result from year to year than we could achieve on our own.
- Giving Atlantic States the benefit of the underwriting capacity of the entire pool, rather than being limited by the amount of its own capital and surplus.

Acquisitions

General

Our growth strategy includes the acquisition of other insurance companies to expand our business in a given region or to commence operations in a new region. Our prior acquisitions have either taken the form of:

- a purchase of the stock of an existing stock insurance company; or
- a two-step acquisition of an existing mutual insurance company as follows:
  - First, the Mutual Company purchases a surplus note in the target mutual insurance company, enters into a management agreement with the target mutual insurance company and appoints its designees as a majority of the target mutual insurance company s board of directors.
  - Second, the mutual insurance company is demutualized. We acquire the stock of the resulting stock insurance company only after the company is restructured and its book of business is reunderwritten to our satisfaction.

We believe that our ability to make direct acquisitions or to structure acquisitions through Mutual Company surplus note transactions provides us with flexibility that is a competitive advantage in seeking acquisitions. We also believe we have demonstrated our ability to acquire control of a troubled insurance company, reunderwrite its book of business, reduce its cost structure and return it to profitability. When the Mutual Company makes a surplus note investment in another company, the financial results of that company are not consolidated with our financial results or those of the Mutual Company, and neither we nor the Mutual Company are responsible for the insurance obligations of that company.

The following table highlights our acquisition history since 1988:

Insurance Company Acquired	State	Year Acquired by Us	Method of Acquisition
Southern Mutual Insurance Company	Virginia	1988	Surplus note investment by the Mutual Company in 1984; demutualization in 1988; acquisition of stock by us in 1988.
Delaware Mutual Insurance Company(1)	Delaware	1995	Surplus note investment by the Mutual Company in 1993; demutualization in 1994; acquisition of stock by us in 1995.
Pioneer Mutual Insurance Company(1)	Ohio	1997	Surplus note investment by the Mutual Company in 1992; demutualization in 1993; acquisition of stock by us in 1997.
Southern Heritage Insurance Company(1)	Georgia	1998	Stock purchase in 1998.
Pioneer Mutual Insurance Company(1)	New York	2001	Surplus note investment by the Mutual Company in 1995; demutualization in 1998; acquisition of stock by us in 2001.
Le Mars Mutual Insurance Company of Iowa	Iowa	Pending	Surplus note investment by the Mutual Company in 2002; demutualization approved; expected acquisition of stock by us on or about January 1, 2004.
Peninsula Insurance Group	Maryland	Pending	Awaiting regulatory approval; expected stock purchase on or about January 1, 2004.

(1) To reduce administrative and compliance costs and expenses, the designated entities were merged into one of our existing insurance subsidiaries.

We generally maintain the home office of an acquired company as part of our strategy to provide local marketing, underwriting and claims servicing even if the acquired company is merged into another subsidiary.

Le Mars

In June 2002, the Mutual Company consummated an affiliation with Le Mars. As part of the affiliation, the Mutual Company entered into a management agreement with Le Mars and acquired control of Le Mars through the appointment of five Mutual Company designees to Le Mars nine-member board of directors. At the time of the affiliation, the Mutual Company made a $4.0 million investment in Le Mars surplus and was issued a surplus note, which we refer to as the Le Mars Surplus Note.

On August 11, 2003, Le Mars board of directors adopted a plan of conversion to convert to a stock insurance company. The plan of conversion was approved by the policyholders of Le Mars on October 6, 2003, and, on October 7, 2003, the Insurance Commissioner of Iowa held a public hearing regarding approval of the plan of conversion. On November 6, 2003, the Insurance Commissioner of Iowa approved the plan of conversion, and we will acquire Le Mars on or about January 1, 2004 for approximately $12.5 million in cash as follows:

We will purchase the Le Mars surplus note from the Mutual Company for approximately $4.3 million in cash, which amount represents outstanding principal and interest under the Le Mars surplus note.

We will contribute the Le Mars surplus note to Le Mars in exchange for 100% of Le Mars capital stock.

In connection with its demutualization, Le Mars will pay its policyholders approximately $8.2 million out of its surplus. We have agreed to make a capital contribution of $8.2 million in cash to Le Mars to replace this surplus.

Le Mars, which was organized under the laws of Iowa in 1901, operates as a property and casualty insurer in Iowa, Nebraska, Oklahoma and South Dakota. Personal lines coverages represent a majority of Le Mars premiums written, with the balance coming from farmowners and mercantile and service businesses. Le Mars largest lines of business are private passenger automobile liability and physical damage; its other principal lines are homeowners and commercial multi-peril. Le Mars had net premiums earned of $20.5 million in 2002 and $13.3 million for the nine months ended September 30, 2003. The statutory surplus and total admitted assets of Le Mars as of September 30, 2003 were $11.6 million and $37.7 million, respectively.

Peninsula

On October 30, 2003, we announced an agreement to purchase Peninsula from Folksamerica Holding Company, Inc., a part of the White Mountains Insurance Group, Ltd., for a price in cash equal to 107.5% of Peninsula s GAAP stockholders equity as of the closing of the acquisition. We believe the purchase price will be approximately $23.0 million, which was 107.5% of Peninsula s GAAP stockholders equity at September 30, 2003. Consummation of the acquisition is subject to a number of conditions, including the approval of the Maryland Commissioner of Insurance. We expect that the acquisition will be completed on or about January 1, 2004.

Peninsula consists of Peninsula Indemnity Company and The Peninsula Insurance Company, both of which are organized under Maryland law, with headquarters in Salisbury, Maryland. Peninsula specializes in private passenger automobile coverages. Peninsula also writes homeowners, commercial multi-peril, workers compensation and commercial automobile coverages. Peninsula operates primarily in Maryland, Delaware and Virginia. For the year ended December 31, 2002 and the nine months ended September 30, 2003, Peninsula had net premiums earned of $29.7 million and $24.4 million, respectively. Peninsula s stockholders equity and its total assets as of September 30, 2003 were $21.8 million and $61.4 million, respectively. Both of Peninsula s insurance subsidiaries have an A.M. Best rating of A (Excellent).

Distribution

Our insurance products are marketed primarily in the Mid-Atlantic and Southeast regions through approximately 1,200 insurance agencies that are comprised of approximately 6,800 agents. The Donegal Insurance Group is licensed to do business in 15 states and, at September 30, 2003, operated in 14 states (Alabama, Arkansas, Connecticut, Delaware, Georgia, Louisiana, Maryland, New York, North Carolina, Ohio, Pennsylvania, South Carolina, Tennessee and Virginia). We believe our relationships with our independent agents are valuable in identifying, obtaining and retaining profitable business. We maintain a stringent agency selection procedure that emphasizes appointing agencies with proven marketing strategies for the development of profitable business, and we only appoint agencies with a strong underwriting and growth track record. We also regularly evaluate our agencies based on their profitability and performance in relation to our objectives. We seek to be among the top three insurers within each of our agencies for the lines of business we write.

The following table sets forth the percentage of our share of 2002 direct premiums written in each of the states where we conduct business:

Pennsylvania	58.8%
Virginia	16.4
Maryland	5.2
Georgia	5.1
Delaware	4.7
Ohio	3.7
North Carolina	1.6
New York	1.4
Other	3.1
Total	100.0%

We believe we have developed a number of policies and procedures that enable us to attract, retain and motivate our agents. The consistency, competitiveness and stability of our product offerings assists us in competing effectively for agents with other insurers whose product offerings may fluctuate based upon industry conditions. We have developed a competitive contingent commission plan for agents, under which additional commissions are payable based upon the volume of premiums produced and the profitability of the business of the agency. We provide our agents ongoing support that enables them to better attract and retain customers, including Internet-based information systems, training programs, marketing support and field visitations by our marketing personnel and senior management. Finally, we encourage our independent agencies to focus on account selling , or serving all of a particular insured s property and casualty insurance needs, which we believe generally results in more favorable loss experience than covering a single risk for an individual insured.

Products

Our personal lines of business consist primarily of automobile and homeowners insurance. Our commercial lines of business consist primarily of commercial automobile, commercial multi-peril and workers compensation insurance. These types of insurance are described in greater detail below:

Personal

Private passenger automobile policies that provide protection against liability for bodily injury and property damage arising from automobile accidents, and protection against loss from damage to automobiles owned by the insured.

Homeowners policies that provide coverage for damage to residences and their contents from a broad range of perils, including, fire, lightning, windstorm and theft. These policies also cover liability of the insured arising from injury to other persons or their property while on the insured s property and under other specified conditions.

Commercial

Commercial multi-peril policies that provide protection to businesses against many perils, usually combining liability and physical damage coverages.

Workers compensation policies purchased by employers to provide benefits to employees for injuries sustained during employment. The extent of coverage is established by the workers compensation laws of each state.

Commercial automobile policies that provide protection against liability for bodily injury and property damage arising from automobile accidents, and protection against loss from damage to automobiles owned by the insured.

The following table sets forth the net premiums written by line of insurance for our business for the periods indicated:

	Year Ended December 31,						Nine Months Ended September 30,			
	2000		2001		2002		2002		2003	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
	(Dollars in thousands)									
Net Premiums Written:										
Personal lines:										
Automobile	$ 65,528	40.9%	$ 74,396	42.0%	$ 84,643	43.5%	$ 64,183	43.1%	$ 65,709	42.0%
Homeowners	29,413	18.4	31,431	17.8	34,637	17.8	26,066	17.5	27,650	17.6
Other	5,576	3.5	5,796	3.3	6,497	3.4	5,158	3.5	5,282	3.4
Total personal lines	100,517	62.8	111,623	63.1	125,777	64.7	95,407	64.1	98,641	63.0
Commercial lines:										
Automobile	15,112	9.4	16,527	9.3	17,451	9.0	13,536	9.1	14,294	9.1
Workers compensation	21,174	13.2	22,979	13.0	23,845	12.2	18,724	12.6	19,299	12.3
Commercial multi-peril	21,722	13.6	24,174	13.6	25,536	13.1	19,700	13.2	22,828	14.6
Other	1,597	1.0	1,725	1.0	1,895	1.0	1,431	1.0	1,471	1.0
Total commercial lines	59,605	37.2	65,405	36.9	68,727	35.3	53,391	35.9	57,892	37.0
Total business	$160,122	100.0%	$177,028	100.0%	$194,504	100.0%	$148,798	100.0%	$156,533	100.0%

Underwriting

Our underwriting department, which is divided into personal lines underwriting and commercial lines underwriting, evaluates and selects those risks we believe will enable us to achieve an underwriting profit. Our underwriting department has significant interaction with our independent agents regarding our underwriting philosophy and underwriting guidelines and assists our research and development department in the development of quality products at competitive prices to promote growth and profitability.

In order to achieve underwriting profitability on a consistent basis, we:

- assess and select quality standard and preferred risks;
- adhere to disciplined underwriting and reunderwriting guidelines;
- inspect all commercial lines risks and a substantial number of personal lines risks; and

utilize various types of risk management and loss control services.

We also review our existing policies and accounts to determine whether those risks continue to meet our underwriting guidelines. If a given policy or account no longer meets our underwriting guidelines, we will take appropriate action regarding those policies or accounts, including raising premium rates or non-renewing the policy to the extent permitted by applicable law.

As part of our effort to maintain acceptable underwriting results, we conduct annual reviews of agencies that have failed to meet our underwriting profitability criteria. Our review process includes an analysis of the underwriting and reunderwriting practices of the agency, the completeness and accuracy of the applications submitted by the agency, the adequacy of the training of the agency s staff and the agency s record of adherence to our underwriting guidelines and service standards. Based on the results of this review process, our marketing and underwriting personnel develop, together with the agency, a plan to improve its underwriting profitability. We monitor the agency s compliance with the plan, and take other measures as required in our judgment, including the termination of agencies that are unable to achieve acceptable underwriting profitability to the extent permitted by applicable law.

Claims

The management of claims is a critical component of our philosophy of underwriting profitability and is fundamental to our successful operations and our dedication to excellent service.

Our claims department rigorously manages claims to assure that legitimate claims are settled quickly and fairly and that questionable claims are identified for defense. In the majority of cases, claims are adjusted by our own personnel, who we believe are experienced in our industry and who know our service philosophy. We provide various means of claims reporting on a 24-hour, seven day a week basis, including toll-free numbers and Internet reporting through our website. We strive to respond to notifications of claims promptly, generally within the day reported. We believe that by responding promptly to claims, we provide quality customer service and minimize the ultimate cost of the claims. We engage independent adjusters as needed to handle claims in areas in which the volume of claims is not sufficient to justify our hiring of internal claims adjusters. We also employ private investigators, structural experts and various outside legal counsel to supplement our in-house staff and assist us in the investigation of claims. We have a special investigative unit, commonly known as SIU, staffed by former law enforcement officers that attempts to identify and prevent fraud and abuse and to control questionable claims.

Our claims department management develops and implements policies and procedures for the establishment of adequate claim reserves. The management and staff of our claims department resolve policy coverage issues, manage and process reinsurance recoveries and handle salvage and subrogation matters. Our litigation and personal injury sections manage all claims litigation, and all branch office claims above $35,000 require home office review and settlement authorization. Claims adjusters are given reserving and settlement authority based upon their experience and demonstrated abilities. Larger or more complicated claims require consultation and approval of top department management.

Our field office staff is supported by home office technical, litigation, material damage, subrogation and medical audit personnel who provide specialized claims support.

Liabilities for Losses and Loss Expenses

Liabilities for losses and loss expenses are estimates at a given point in time of what an insurer expects to pay to claimants, based on facts and circumstances then known, and it can be expected that the insurer s 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 estimates of future trends and 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 eventual 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.

The establishment of appropriate liabilities is an inherently uncertain process, and there can be no assurance that the ultimate liability will not exceed our loss and loss expense reserves and have an adverse effect on our results of operations and financial condition. As is the case for substantially all property and casualty insurance companies, we have found it necessary in the past to revise our estimated future liabilities for losses and loss expenses, and further adjustments could be required in the future. On the basis of our internal procedures, which analyze, among other things, 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 adequate provision has been made for our liability for losses and loss expenses.

Differences between liabilities reported in our financial statements prepared on the basis of GAAP and our insurance subsidiaries financial statements prepared on a SAP basis result from reducing statutory liabilities for anticipated salvage and subrogation recoveries. These differences amounted to $8.0 million, $8.2 million and $7.3 million at December 31, 2000, 2001 and 2002, respectively.

The following table sets forth a reconciliation of our beginning and ending net liability for unpaid losses and loss expenses for the periods indicated:

	Year Ended December 31,		
	2000	2001	2002
		(In thousands)	
Gross liability for unpaid losses and loss expenses at beginning of year	$144,180	$156,476	$179,840
Less reinsurance recoverable	44,946	53,767	65,296
Net liability for unpaid losses and loss expenses at beginning of year	99,234	102,709	114,544
Provision for net losses and loss expenses for claims incurred in the current year	103,671	110,143	122,434
Change in provision for estimated net losses and loss expenses for claims incurred in prior years	712	8,035	6,834
Total incurred	104,383	118,178	129,268
Net losses and loss payments for claims incurred during:			
The current year	61,848	63,290	67,656
Prior years	39,060	43,053	46,869
Total paid	100,908	106,343	114,525
Net liability for unpaid losses and loss expenses at end of year	102,709	114,544	129,287
Plus reinsurance recoverable	53,767	65,296	81,405
Gross liability for unpaid losses and loss expenses at end of year	$156,476	$179,840	$210,692

We recognized an increase in the liability of losses and loss expenses for prior years of $712,000, $8.0 million and $6.8 million in 2000, 2001 and 2002, respectively. These developments are primarily attributable to variations from expected claim severity in the private passenger and commercial automobile liability, workers compensation and commercial multiple peril lines of business.

The following table sets forth the development of our liability for net unpaid losses and loss expenses from 1992 to 2002, with supplemental loss data for 2001 and 2002. Loss data in the table includes business we are allocated from the Mutual Company as part of the pooling agreement.

Net liability at end of year for unpaid losses and loss expenses sets forth the estimated liability for net unpaid losses and loss expenses recorded at the balance sheet date for each of the indicated years. This liability represents the estimated amount of net losses and loss expenses for claims arising in the current and all prior years that are unpaid at the balance sheet date, including losses incurred but not reported.

The Net liability reestimated as of portion of the table shows the reestimated amount of the previously recorded liability based on experience for each succeeding year. The estimate is increased or decreased as payments are made and more information becomes known about the severity of the remaining unpaid claims. For example, the 1993 liability has developed a redundancy after nine years, in that reestimated net losses and loss expenses are expected to be $12.7 million less than the estimated liability initially established in 1993 of $52.8 million.

The Cumulative excess shows the cumulative excess at December 31, 2002 of the liability estimate shown on the top line of the corresponding column. An excess in liability means that the liability established in prior years exceeded actual net losses and loss expenses or were reevaluated at less than the original amount. A deficiency in liability would mean that the liability established in prior years was less than actual net losses and loss expenses or were reevaluated at more than the original amount.

The Cumulative amount of liability paid through portion of the table shows the cumulative net losses and loss expense payments made in succeeding years for net losses incurred prior to the balance sheet date. For example, the 1993 column indicates that as of December 31, 2002 payments equal to $39.9 million of the currently reestimated ultimate liability for net losses and loss expenses of $40.1 million had been made.

During the past several years, we have experienced a period during which redundancies in our loss and loss expense reserves have declined. During 2001 and 2002, we have experienced deficiencies in reserves for certain prior years. These deficiencies were primarily related to the workers compensation and commercial automobile lines of business.

	Year Ended December 31,										
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
	(In thousands)										
Net liability at end of year for unpaid losses and loss expenses	$44,339	$ 52,790	$ 63,317	$ 75,372	$78,889	$80,256	$96,015	$ 99,234	$102,709	$114,544	$129,287
Net liability reestimated as of:											
One year later	45,408	50,583	60,227	72,380	77,400	77,459	95,556	100,076	110,744	121,378	
Two years later	42,752	48,132	56,656	70,451	73,438	76,613	95,315	103,943	112,140		
Three years later	40,693	44,956	54,571	66,936	71,816	74,851	94,830	104,073			
Four years later	38,375	42,157	51,825	64,356	69,378	73,456	94,354				
Five years later	37,096	41,050	50,493	63,095	69,485	73,103					
Six years later	36,682	40,572	49,593	62,323	69,949						
Seven years later	36,730	39,991	49,504	62,534							
Eight years later	36,437	40,113	49,758								
Nine years later	36,515	40,131									
Ten years later	36,586										
Cumulative (excess) deficiency	$ (7,753)	$(12,659)	$(13,559)	$(12,838)	$ (8,940)	$ (7,153)	$ (1,661)	$ 4,839	$ 9,431	$ 6,834	
Cumulative amount of liability paid through:											
One year later	$16,579	$ 16,126	$ 19,401	$ 24,485	$27,229	$27,803	$37,427	$ 39,060	$ 43,053	$ 46,869	
Two years later	24,546	25,393	30,354	37,981	41,532	46,954	57,347	60,622	67,689		
Three years later	29,385	32,079	38,684	47,027	53,555	58,883	69,973	76,811			
Four years later	32,925	36,726	43,655	53,276	59,995	65,898	78,757				
Five years later	34,757	39,122	46,331	56,869	63,048	70,642					
Six years later	35,739	40,440	47,802	58,286	65,595						
Seven years later	36,518	40,903	48,520	59,160							
Eight years later	36,809	41,152	48,925								
Nine years later	37,000	39,877									
Ten years later	37,174										

	Year Ended December 31,								
	1994	1995	1996	1997	1998	1999	2000	2001	2002
	(In thousands)								
Gross liability at end of year	$ 88,484	$108,118	$113,346	$115,801	$136,727	$144,180	$156,476	$179,840	$210,692
Reinsurance recoverable	25,167	32,746	34,457	35,545	40,712	44,946	53,767	65,296	81,405
Net liability at end of year	63,317	75,372	78,889	80,256	96,015	99,234	102,709	114,544	129,287
Gross reestimated liability latest	66,058	84,341	102,370	105,667	129,795	158,315	173,051	194,303	
Reestimated recoverable latest	16,300	21,807	32,421	32,564	35,441	54,242	60,911	72,925	
Net reestimated liability latest	49,758	62,534	69,949	73,103	94,354	104,073	112,140	121,378	
Gross cumulative deficiency (excess)	(22,426)	(23,777)	(10,976)	(10,134)	(6,932)	14,135	16,575	14,463	

Technology

The Mutual Company owns our technology systems, and we use them pursuant to an intercompany agreement. Our technology systems consist of an integrated central processing computer, a series of server-based computer networks and various communications systems that allow our home office and branch offices to utilize the same systems for the processing of business. The Mutual Company maintains backup facilities and systems through a contract with a leading provider of computer disaster recovery sites, and these backup facilities and systems are tested on a regular basis. Atlantic States and Southern bear their proportionate share of information services expenses based on their percentages of the total net written premiums of the Donegal Insurance Group.

Our business strategy depends on the use, development and implementation of integrated technology systems. These systems enable us to provide a high level of service to our agents and policyholders by processing our business in a timely and efficient manner, communicating and sharing data with our agents, providing a variety of methods for the payment of premiums and allowing for the accumulation and analysis of information for our management.

We believe the implementation of our various technology systems has resulted in improved service to our agents and customers and increased efficiencies in the processing of our business, resulting in lower operating costs. Two of the key components of our integrated system are our agency interface system and our imaging system. Our agency interface system provides us with a high level of data sharing both to, and from, our agents systems and also provides them with an integrated means of processing new business. Our imaging system reduces our need to handle paper files, while providing greater access to the same information by a variety of personnel.

Third Party Reinsurance

We and the Mutual Company 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 external reinsurance we and the Mutual Company purchase includes:

- excess of loss reinsurance, under which our losses are automatically reinsured, through a series of contracts, over a set retention ($300,000 for 2003), 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 2003).

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.

Our principal third party reinsurance agreement in 2003 is a multi-line per risk excess of loss treaty with GMAC Re Corporation, Dorinco Reinsurance Company and Erie Insurance Group that provides coverage up to $1.0 million for both property and liability losses.

For property insurance, we also have excess of loss treaties that provide for additional coverage over the multi-line treaty up to $2.5 million per occurrence. For liability insurance, we have excess of loss treaties that provide for additional coverage over the multi-line treaty up to $40.0 million per occurrence. For workers compensation insurance, we have excess of loss treaties that provide for additional coverage over the multi-line treaty up to $5.0 million on any one life.

We have property catastrophe coverage through a series of layered treaties up to aggregate losses of $80.0 million for the Donegal Insurance Group for any single event. This coverage is provided through as many as twenty reinsurers on any one treaty with no reinsurer taking more than 20.0% of any one contract.

On both property and casualty insurance, we and the Mutual Company purchase facultative reinsurance to cover exposures from losses that exceed the limits provided by our respective treaty reinsurance.

Competition

The property and casualty insurance industry is highly competitive on the basis of both price and service. There are numerous companies competing for business in the geographic areas where we operate, many of which are substantially larger and have greater financial resources than we do, and no single company dominates. In addition, because our insurance products and those of the Mutual Company are marketed exclusively through independent insurance agencies, most of which represent more than one company, we face competition within agencies as well as competition to retain qualified independent agencies.

Investments

Our return on invested assets is an important element of our financial results, and our investment strategy is to generate sufficient after-tax income on invested assets while minimizing credit risk through investments in high-quality securities. As a result, we seek to invest a high percentage of our funds in a diversified, highly rated and readily marketable group of fixed-maturity instruments. Our fixed-maturity portfolio consists of both taxable and tax-exempt securities. We maintain a sufficient portion of our portfolio in short-term securities, such as investments in commercial paper, to provide liquidity for the payment of claims and operation of our business and maintain a small percentage of our portfolio in equity securities that are primarily dividend-paying preferred stocks.

At December 31, 2002, all of our debt securities were rated investment grade with the exception of one unrated obligation of $252,500, and the investment portfolio did not contain any mortgage loans or any non-performing assets.

The following table shows the composition of our debt securities investment portfolio (at carrying value), excluding short-term investments, by rating as of December 31, 2002:

	December 31, 2002	
Rating(1)	Amount	Percent
	(Dollars in thousands)	
U.S. Treasury and U.S. agency securities(2)	$ 99,183	35.24%
Aaa or AAA	90,469	32.15
Aa or AA	51,870	18.43
A	19,979	7.10
BBB	19,679	6.99
Not rated(3)	253	.09
Total	$281,433	100.00%

(1) Ratings assigned by Moody s Investors Services, Inc. or Standard & Poor s Corporation.

(2) Includes mortgage-backed securities of $28,254,582.

(3) Represents one unrated obligation of The Lancaster County Hospital Authority Mennonite Home Project that our management believes to be equivalent to investment grade securities with respect to repayment risk.

We invest in both taxable and tax-exempt securities as part of our strategy to maximize after-tax income. Our strategy considers, among other factors, the alternative minimum tax. Tax-exempt securities made up approximately 33.0%, 30.9% and 41.0% of our debt securities investment portfolio at December 31, 2000, 2001 and 2002, respectively.

The following table shows the classification of our investments (at carrying value) at December 31, 2000, 2001 and 2002:

	December 31,					
	2000		2001		2002	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
	(Dollars in thousands)					
Fixed maturities(1):						
Held to maturity:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 38,779	13.4%	$ 23,809	7.9%	$ 12,641	3.8%
Canadian government obligation	499	0.2	499	0.2	499	0.2
Obligations of states and political subdivisions	66,831	23.1	24,982	8.3	33,892	10.2
Corporate securities	21,621	7.5	27,423	9.1	29,552	8.9
Mortgage-backed securities	15,452	5.3	8,610	2.9	10,118	3.0
Total held to maturity	143,182	49.5	85,323	28.4	86,702	26.1
Available for sale:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	67,901	23.5	68,975	23.0	58,287	17.5
Obligations of states and political subdivisions	18,256	6.3	55,147	18.3	81,446	24.5
Corporate securities	22,908	7.9	34,807	11.6	36,863	11.1
Mortgage-backed securities	5,546	1.9	14,790	4.9	18,136	5.5
Total available for sale	114,611	39.6	173,719	57.8	194,732	58.6
Total fixed maturities	257,793	89.1	259,042	86.2	281,434	84.7
Equity securities(2)	12,112	4.2	17,517	5.8	21,836	6.6
Short-term investments(3)	19,440	6.7	24,074	8.0	29,029	8.7
Total investments	$289,345	100.0%	$300,633	100.0%	$332,299	100.0%

(1) We account for our investments in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, Accounting For Certain Investments in Debt and Equity Securities. See Notes 1 and 3 to the Consolidated Financial Statements incorporated by reference herein. Fixed maturities classified as held to maturity are valued at amortized cost; those fixed maturities classified as available for sale are valued at fair value. Total fair value of fixed maturities classified as held to maturity was $144.7 million at December 31, 2000, $86.9 million at December 31, 2001 and $89.8 million at December 31, 2002. The amortized cost of fixed maturities classified as available for sale was $114.5 million at December 31, 2000, $170.3 million at December 31, 2001 and $187.5 million at December 31, 2002.

(2) Equity securities are valued at fair value. Total cost of equity securities was $12.5 million at December 31, 2000, $16.6 million at December 31, 2001 and $21.6 million at December 31, 2002.

(3) Short-term investments are valued at cost, which approximates market.

The following table sets forth the maturities (at carrying value) in our fixed maturity and short-term investment portfolio at December 31, 2000, December 31, 2001 and December 31, 2002:

	December 31,					
	2000		2001		2002	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
	(Dollars in thousands)					
Due in(1):						
One year or less	$ 37,731	13.6%	$ 37,120	13.1%	$ 47,034	15.1%
Over one year through three years	35,426	12.8	44,845	15.8	47,367	15.3
Over three years through five years	41,995	15.1	69,585	24.6	66,655	21.5
Over five years through ten years	112,396	40.6	96,642	34.1	64,271	20.7
Over ten years through fifteen years	22,243	8.0	7,573	2.7	52,517	16.9
Over fifteen years	6,444	2.3	3,951	1.4	4,365	1.4
Mortgage-backed securities	20,998	7.6	23,400	8.3	28,254	9.1
	$277,233	100.0%	$283,116	100.0%	$310,463	100.0%

(1) Based on stated maturity dates with no prepayment assumptions. Actual maturities will differ because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

As shown above, we held investments in mortgage-backed securities having a carrying value of $28.3 million at December 31, 2002. Included in these investments are collateralized mortgage obligations, or CMOs, with a carrying value of $4.7 million at December 31, 2002. We have attempted to reduce the prepayment risks associated with mortgage-backed securities by investing approximately 100%, as of December 31, 2002, of our holdings of CMOs in planned amortization and very accurately defined tranches. Such investments are designed to alleviate the risk of prepayment by providing predictable principal prepayment schedules within a designated range of prepayments. If principal is repaid earlier than originally anticipated, investment yields may decrease due to reinvestment of the proceeds at current interest rates (which may be lower) and capital gains or losses may be realized since the book value of securities purchased at premiums or discounts may be different from the prepayment amount.

Our investment results for the years ended December 31, 2000, 2001 and 2002 are shown in the following table:

	Year Ended December 31,		
	2000	2001	2002
	(Dollars in thousands)		
Invested assets(1)	$278,678	$294,989	$316,466
Investment income(2)	16,395	15,886	14,581
Average yield	5.9%	5.3%	4.6%

(1) Average of the aggregate invested amounts at the beginning and end of the period.

(2) Investment income is net of investment expenses and does not include realized investment gains or losses or provision for income taxes.

A.M. Best Rating

Currently, the A.M. Best rating of Atlantic States, Southern and the Mutual Company, is A (Excellent), based upon their respective current financial condition and historical statutory results of operations and retrocessional agreements. We believe that our A.M. Best rating is an important factor in marketing our products to our agents and customers. A.M. Best s ratings are industry ratings based on a comparative analysis of the financial condition and operating performance of insurance companies as determined by their publicly available reports. A.M. Best s classifications are A++ and A+ (Superior), A and A- (Excellent), B++ and B+ (Very Good), B and B- (Good), C++ and C+ (Fair), C and C- (Marginal), D (Below Minimum Standards) and E and F (Liquidation). A.M. Best s ratings are based upon factors relevant to policyholders and are not directed toward the protection of investors. According to A.M. Best, an Excellent rating is assigned to those companies that, in A.M. Best s opinion, have achieved excellent overall performance when compared to the norms of the property and casualty insurance industry and have generally demonstrated a strong ability to meet policyholder and other contractual obligations.

Regulation

Insurance companies are subject to supervision and regulation in the states in which they transact business. Such supervision and regulation relate to numerous aspects of an insurance company s business and financial condition. The primary purpose of such supervision and regulation is the protection of policyholders. The extent of such regulation varies, but generally derives from state statutes that delegate regulatory, supervisory and administrative authority to state insurance departments. Accordingly, the authority of the state insurance departments includes the establishment of standards of solvency that must be met and maintained by insurers, the licensing to do business of insurers and agents, the nature of and limitations on investments, premium rates for property and casualty insurance, the provisions that insurers must make for current losses and future liabilities, the deposit of securities for the benefit of policyholders, the approval of policy forms, notice requirements for the cancellation of policies and the approval of certain changes in control. State insurance departments also conduct periodic examinations of the affairs of insurance companies and require the filing of annual and other reports relating to the financial condition of insurance companies.

In addition to state-imposed insurance laws and regulations, the NAIC has established a risk-based capital system for assessing the adequacy of statutory capital and surplus, which augments the states current fixed dollar minimum capital requirements for insurance companies. At December 31, 2002, our insurance subsidiaries and the Mutual Company each exceeded the minimum levels of statutory capital required by risk-based capital rules. There can be no assurance that the statutory capital requirements applicable to our insurance subsidiaries will not increase in the future.

Generally, every state has guaranty fund laws under which insurers licensed to do business in such states can be assessed on the basis of premiums written by the insurer in that state in order to fund policyholder liabilities of insolvent insurance companies. Under these laws in general, an insurer is subject to assessment, depending upon its market share of a given line of business, to assist in the payment of policyholder claims against insolvent insurers. Atlantic States, Southern and the Mutual Company have made accruals for their portion of assessments related to such insolvencies based upon the most current information furnished by the guaranty associations. During 2000, 2001 and 2002, we incurred assessments totaling $813,000, $1.3 million and $486,000, respectively, from the Pennsylvania Insurance Guaranty Association primarily relating to the insolvencies of three medical malpractice insurers and Reliance Insurance Company.

Most states have enacted legislation that regulates insurance holding company systems. Each insurance company in the holding company system is required to register with the insurance supervisory agency of its state of domicile and furnish information concerning the operations of companies within the holding company system that may materially affect the operations, management or financial condition of the insurers within the system. Pursuant to these laws, the respective insurance departments may examine our insurance subsidiaries or the Mutual Company at any time, require disclosure of material transactions by the holding company and require prior notice or prior approval of certain transactions, such as extraordinary dividends from the insurance subsidiaries to the holding company.

The Pennsylvania Insurance Holding Companies Act requires that all transactions within a holding company system to which an insurer is a party must be fair and reasonable and any charges or fees for services performed must be reasonable. Any management agreement, service agreement, cost sharing arrangement and reinsurance agreements must be filed with the Pennsylvania Insurance Department and are subject to Department review. The pooling agreement and other intercompany reinsurance agreements were accordingly filed with the Pennsylvania Insurance Department. The Pennsylvania Insurance Department has never provided any notification of disapproval to any member of the Mutual Company or us.

Approval of the applicable insurance commissioner is also required prior to consummation of transactions affecting the control of an insurer. In some states, including Pennsylvania, the acquisition of 10% or more of the outstanding capital stock of an insurer or its holding company is presumed to be a change in control. Pursuant to an order issued in April 2003, the Pennsylvania Insurance Department has approved the Mutual Company s ownership of up to 75% of our outstanding Class A common stock and up to 100% of our outstanding Class B common stock. These laws also require notice to the applicable insurance commissioner of certain material transactions between an insurer and any person in its holding company system and, in some states, certain of such transactions cannot be consummated without the prior approval of the applicable insurance commissioner.

We are required to participate in involuntary insurance programs for automobile insurance, as well as other property and casualty insurance lines, in states in which we operate. These programs include joint underwriting associations, assigned risk plans, fair access to insurance requirements (FAIR) plans, reinsurance facilities and windstorm plans. Legislation establishing these programs requires all companies that write lines covered by these programs to provide coverage, either directly or through reinsurance, for insureds who cannot obtain insurance in the voluntary market. The legislation creating these programs usually allocates a pro rata portion of risks attributable to such insureds to each company on the basis of direct premiums written or the number of automobiles insured. Generally, state law requires participation in such programs as a condition to doing business. The loss ratio on insurance written under involuntary programs has traditionally been greater than the loss ratio on insurance in the voluntary market.

Our insurance subsidiaries are restricted by the insurance laws of their respective states of domicile as to the amount of dividends or other distributions they may pay to us without the prior approval of the respective state regulatory authorities. Generally, the maximum amount that may be paid by an insurance subsidiary during any year after notice to, but without prior approval of, the insurance commissioners of these states is limited to a stated percentage of that subsidiary s statutory capital and surplus as of the end of the preceding year, or the net income excluding realized capital gains of the subsidiary for the preceding year. As of September 30, 2003, the amount of dividends our insurance subsidiaries could pay us during the remainder of 2003 without the prior approval of the various insurance commissioners was $3.2 million, in the case of Atlantic States, and $1.5 million, in the case of Southern.

The Mutual Company

The Mutual Company was organized in 1889. At December 31, 2002, the Mutual Company had admitted assets of $192.1 million and policyholders surplus of $75.6 million. At December 31, 2002, the Mutual Company had no debt and, of its total liabilities of $116.5 million, reserves for net losses and loss expenses accounted for $59.1 million and unearned premiums accounted for $29.7 million. Of the Mutual Company s investment portfolio of $115.5 million at December 31, 2002, investment-grade bonds accounted for $20.9 million and mortgages accounted for $6.3 million. At December 31, 2002, the Mutual Company owned 4,031,912 shares, or approximately 65.0%, of our Class A common stock, which were carried on the Mutual Company s books at $46.4 million, and 1,852,088 shares, or approximately 62.0%, of our Class B common stock, which were carried on the Mutual Company s books at $21.3 million. The foregoing financial information is presented on the statutory basis of accounting required by the NAIC Accounting Practices and Procedures Manual. The Mutual Company does not, nor is it required to, prepare financial statements in accordance with GAAP.

We and Atlantic States share headquarters with the Mutual Company in a building owned by the Mutual Company. The Mutual Company charges us for an appropriate portion of the building expenses under an inter-company allocation agreement that is consistent with the terms of the pooling agreement. The headquarters of the Mutual Company has approximately 172,600 square feet of office space. Southern owns a facility of approximately 10,000 square feet in Glen Allen, Virginia.

Donegal Financial Services Corporation

We own 47.5% of Donegal Financial Services Corporation, which we also call DFSC and is a registered savings and loan holding company that operates solely through its wholly owned subsidiary, Province Bank. The Mutual Company owns the remaining 52.5% of DFSC. As savings and loan holding companies, both we and the Mutual Company are subject to regulation by the Office of Thrift Supervision, or OTS, under the holding company provisions of the federal Home Owners Loan Act, or HOLA. As a federally chartered and insured stock savings association, Province Bank is subject to regulation and supervision by the OTS, which is the primary federal regulator of savings associations, and the Federal Deposit Insurance Corporation, in its role as federal deposit insurer. The primary purpose of the statutory and regulatory scheme is to protect depositors, the financial institutions and the financial system as a whole rather than the stockholders of financial institutions or their holding companies.

Transactions between a savings association and its affiliates are subject to quantitative and qualitative restrictions under Sections 23A and 23B of the Federal Reserve Act. Affiliates of a savings association include, among other entities, the savings association s holding company and non-banking companies that are under common control with the savings association. These affiliate restrictions apply to transactions between DFSC and Province Bank, on the one hand, and us and our insurance subsidiaries, on the other hand. These restrictions also apply to transactions among DFSC, Province Bank and the Mutual Company.

The ability of DFSC to make dividend payments to us will depend in part upon the receipt of funds from Province Bank. The OTS capital regulations contain prompt corrective action provisions that require certain mandatory remedial actions and authorize certain other discretionary actions to be taken by the OTS against a savings association that falls within specified categories of capital deficiency. In general, the prompt corrective action regulations prohibit an OTS-regulated institution from declaring any dividends, making any other capital distribution or paying a management fee to a controlling person, such as its parent holding company, if, following the distribution or payment, the institution would be within any of the three undercapitalized categories. Outside of the prompt corrective action provisions, the OTS may block a dividend by Province Bank if the OTS believes it would be harmful to Province Bank.

MANAGEMENT

Directors

Our board of directors currently consists of six members, and we are seeking additional directors. Each director is elected for a three-year term and until his successor has been elected. Certain information as to our directors is as follows:

Name	Age	Director Since	Year Term Will Expire
Robert S. Bolinger	67	1986	2005
Patricia A. Gilmartin	63	1986	2005
Philip A. Glatfelter, II	73	1986	2005
John J. Lyons	63	2001	2004
Donald H. Nikolaus	61	1986	2006
R. Richard Sherbahn	74	1986	2004

Mr. Bolinger retired in 2001 as Chairman and Chief Executive Officer of Susquehanna Bancshares, Inc., a position held since 1982.

Mrs. Gilmartin has been an employee since 1969 of Donegal Insurance Agency, which has no affiliation with us, except that Donegal Insurance Agency receives insurance commissions in the ordinary course of business from our insurance subsidiaries in accordance with such subsidiaries standard commission schedules and agency contracts. Mrs. Gilmartin has been a director of the Mutual Company since 1979.

Mr. Glatfelter retired in 1989 as a Vice President of Meridian Bank, a position he held for more than five years prior to his retirement. Mr. Glatfelter has been a director of the Mutual Company since 1981, was Vice Chairman of the Mutual Company from 1991 to 2001 and has been Chairman of the Board of the Company and the Mutual Company since 2001.

Mr. Lyons has been President and Chief Operating Officer of Keefe Managers, Inc., a manager of private investment funds, since February 1999. In his capacity as a professional bank consultant, Mr. Lyons served (a) from September 1997 to February 1999 as President and Chief Executive Officer of Gateway American Bank of Florida, Fort Lauderdale, Florida, (b) from August 1996 to April 1997, as President and Chief Executive Officer of Regent National Bank, Philadelphia, Pennsylvania, (c) from April 1995 to August 1996, as President and Chief Executive Officer and a director of Monarch Savings Bank, FSB, Clark, New Jersey and (d) from December 1993 until April 1995, as President and Chief Executive Officer of Jupiter Tequesta National Bank, Tequesta, Florida. Mr. Lyons was Vice Chairman of Advest, Inc. during 1993 and from 1989 through 1993 was a member of its Board of Directors. He is a director of The BISYS Group, Inc. with a term that will expire in November 2003.

Mr. Nikolaus has been President and Chief Executive Officer of the Mutual Company since 1981 and a director of the Mutual Company since 1972. He has been President and Chief Executive Officer of the Company since 1986. Mr. Nikolaus has been a partner in the law firm of Nikolaus & Hohenadel since 1972.

Mr. Sherbahn has owned and operated Sherbahn Associates, Inc., a life insurance and financial planning firm, since 1974. Mr. Sherbahn has been a director of the Mutual Company since 1967.

While we have business relationships with firms affiliated with certain members of our board of directors, our board of directors has determined that the membership of our audit committee satisfies applicable independence requirements. We are seeking additional independent directors, and have identified one who will join our board of directors in January 200