

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2020

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-15341

**Donegal Group Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**23-2424711**  
(I.R.S. Employer  
Identification No.)

**1195 River Road, P.O. Box 302, Marietta, PA 17547**  
(Address of principal executive offices) (Zip code)

**(717) 426-1931**  
(Registrant's telephone number, including area code)

**Not applicable**  
(Former name, former address and former fiscal year, if changed since last report)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Trading Symbols	Name of Each Exchange on Which Registered
Class A Common Stock, \$.01 par value	DGICA	The NASDAQ Global Select Market
Class B Common Stock, \$.01 par value	DGICB	The NASDAQ Global Select Market

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

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

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

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input checked="" type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input checked="" type="checkbox"/>
		Emerging growth company	<input type="checkbox"/>

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 24,195,190 shares of Class A Common Stock, par value \$0.01 per share, and 5,576,775 shares of Class B Common Stock, par value \$0.01 per share, outstanding on October 31, 2020.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

Donegal Group Inc. and Subsidiaries  
Consolidated Balance Sheets

	September 30, 2020 (Unaudited)	December 31, 2019
<b>Assets</b>		
Investments		
Fixed maturities		
Held to maturity, at amortized cost	\$ 552,981,914	\$ 476,093,782
Available for sale, at fair value	578,040,314	564,951,803
Equity securities, at fair value	54,944,826	55,477,556
Short-term investments, at cost, which approximates fair value	20,685,938	14,030,222
Total investments	1,206,652,992	1,110,553,363
Cash	87,876,852	49,318,930
Accrued investment income	8,623,259	7,066,029
Premiums receivable	177,674,682	165,732,949
Reinsurance receivable	403,864,468	367,021,468
Deferred policy acquisition costs	61,554,554	59,284,859
Deferred tax asset, net	6,511,012	8,514,311
Prepaid reinsurance premiums	174,391,958	142,475,767
Property and equipment, net	4,436,397	4,558,072
Accounts receivable - securities	299,538	4,961
Federal income taxes recoverable	4,405,349	—
Goodwill	5,625,354	5,625,354
Other intangible assets	958,010	958,010
Other	1,332,570	2,047,058
Total assets	<u>\$2,144,206,995</u>	<u>\$ 1,923,161,131</u>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
Unpaid losses and loss expenses	\$ 941,930,342	\$ 869,673,849
Unearned premiums	558,231,113	510,147,485
Accrued expenses	24,584,358	28,453,744
Reinsurance balances payable	2,376,710	2,116,084
Borrowings under lines of credit	85,000,000	35,000,000
Cash dividends declared to stockholders	—	4,075,234
Subordinated debentures	5,000,000	5,000,000
Accounts payable—securities	9,072,150	1,119
Income taxes payable	—	84,831
Due to affiliate	6,455,268	10,069,171
Other	7,488,378	7,524,095
Total liabilities	<u>1,640,138,319</u>	<u>1,472,145,612</u>
<b>Stockholders' Equity</b>		
Preferred stock, \$.01 par value, authorized 2,000,000 shares; none issued	—	—
Class A common stock, \$.01 par value, authorized 50,000,000 shares, issued 27,141,361 and 26,203,935 shares and outstanding 24,138,773 and 23,201,347 shares	271,414	262,040
Class B common stock, \$.01 par value, authorized 10,000,000 shares, issued 5,649,240 shares and outstanding 5,576,775 shares	56,492	56,492
Additional paid-in capital	281,917,193	268,151,601
Accumulated other comprehensive income	10,370,217	504,170
Retained earnings	252,679,717	223,267,573
Treasury stock, at cost	(41,226,357)	(41,226,357)
Total stockholders' equity	<u>504,068,676</u>	<u>451,015,519</u>
Total liabilities and stockholders' equity	<u>\$2,144,206,995</u>	<u>\$ 1,923,161,131</u>

See accompanying notes to consolidated financial statements.

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

	<b>Three Months Ended September 30,</b>	
	<b>2020</b>	<b>2019</b>
<b>Revenues:</b>		
Net premiums earned	\$ 184,925,733	\$ 189,821,058
Investment income, net of investment expenses	7,403,251	7,389,749
Net investment gains (losses) (includes \$134,795 and \$102,311 accumulated other comprehensive income reclassifications)	3,268,459	(369,041)
Lease income	107,907	110,598
Installment payment fees	806,916	1,057,536
Total revenues	<u>196,512,266</u>	<u>198,009,900</u>
<b>Expenses:</b>		
Net losses and loss expenses	120,881,041	130,743,395
Amortization of deferred policy acquisition costs	29,605,000	31,304,000
Other underwriting expenses	29,480,706	26,516,518
Policyholder dividends	1,811,019	2,446,696
Interest	219,039	443,179
Other expenses, net	183,877	251,228
Total expenses	<u>182,180,682</u>	<u>191,705,016</u>
Income before income tax expense	14,331,584	6,304,884
Income tax expense (includes \$28,307 and \$21,485 income tax expense from reclassification items)	2,494,586	1,118,505
Net income	<u>\$ 11,836,998</u>	<u>\$ 5,186,379</u>
<b>Earnings per common share:</b>		
Class A common stock - basic	\$ 0.41	\$ 0.19
Class A common stock - diluted	\$ 0.41	\$ 0.18
Class B common stock - basic and diluted	\$ 0.37	\$ 0.16

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

	<b>Three Months Ended September 30,</b>	
	<b>2020</b>	<b>2019</b>
Net income	\$ 11,836,998	\$ 5,186,379
Other comprehensive income, net of tax		
Unrealized gain on securities:		
Unrealized holding gain during the period, net of income tax expense of \$29,102 and \$621,120	109,480	2,336,599
Reclassification adjustment for gains included in net income, net of income tax expense of \$28,307 and \$21,485	(106,488)	(80,826)
Other comprehensive income	2,992	2,255,773
Comprehensive income	<u>\$ 11,839,990</u>	<u>\$ 7,442,152</u>

See accompanying notes to consolidated financial statements.

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

	<b>Nine Months Ended September 30,</b>	
	<b>2020</b>	<b>2019</b>
<b>Revenues:</b>		
Net premiums earned	\$ 556,552,279	\$566,657,613
Investment income, net of investment expenses	21,951,679	21,727,904
Net investment (losses) gains (includes \$571,123 and \$154,725 accumulated other comprehensive income reclassifications)	(940,488)	19,294,229
Lease income	326,379	333,852
Installment payment fees	2,433,395	3,204,130
Equity in earnings of Donegal Financial Services Corporation	—	295,000
Total revenues	<u>580,323,244</u>	<u>611,512,728</u>
<b>Expenses:</b>		
Net losses and loss expenses	343,476,586	385,361,331
Amortization of deferred policy acquisition costs	89,176,000	92,821,000
Other underwriting expenses	95,645,601	85,409,737
Policyholder dividends	5,336,677	6,765,834
Interest	871,461	1,311,894
Other expenses, net	994,115	1,155,493
Total expenses	<u>535,500,440</u>	<u>572,825,289</u>
Income before income tax expense	44,822,804	38,687,439
Income tax expense (includes \$119,936 and \$32,492 income tax expense from reclassification items)	6,575,907	5,689,442
Net income	<u>\$ 38,246,897</u>	<u>\$32,997,997</u>
Earnings per common share:		
Class A common stock - basic	<u>\$ 1.34</u>	<u>\$ 1.18</u>
Class A common stock - diluted	<u>\$ 1.33</u>	<u>\$ 1.17</u>
Class B common stock - basic and diluted	<u>\$ 1.21</u>	<u>\$ 1.06</u>

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

	<b>Nine Months Ended September 30,</b>	
	<b>2020</b>	<b>2019</b>
Net income	\$38,246,897	\$32,997,997
Other comprehensive income, net of tax		
Unrealized gain on securities:		
Unrealized holding gain during the period, net of income tax expense of \$2,742,556 and \$3,925,853	10,317,234	14,768,686
Reclassification adjustment for gains included in net income, net of income tax expense of \$119,936 and \$32,492	(451,187)	(122,233)
Other comprehensive income	<u>9,866,047</u>	<u>14,646,453</u>
Comprehensive income	<u>\$48,112,944</u>	<u>\$47,644,450</u>

See accompanying notes to consolidated financial statements.

**Donegal Group Inc. and Subsidiaries**  
**Consolidated Statement of Stockholders' Equity**  
(Unaudited)  
**Nine Months Ended September 30, 2020**

	Class A Shares	Class B Shares	Class A Amount	Class B Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Retained Earnings	Treasury Stock	Total Stockholders' Equity
Balance, December 31, 2019	26,203,935	5,649,240	\$262,040	\$56,492	\$268,151,601	\$ 504,170	\$223,267,573	\$(41,226,357)	\$451,015,519
Issuance of common stock (stock compensation plans)	28,924	—	289	—	376,539	—	—	—	376,828
Share-based compensation	67,087	—	671	—	1,242,315	—	—	—	1,242,986
Net income	—	—	—	—	—	—	3,731,121	—	3,731,121
Cash dividends declared	—	—	—	—	—	—	(5,363)	—	(5,363)
Grant of stock options	—	—	—	—	118,525	—	(118,525)	—	—
Other comprehensive income	—	—	—	—	—	3,199,840	—	—	3,199,840
Balance, March 31, 2020	26,299,946	5,649,240	\$263,000	\$56,492	\$269,888,980	\$ 3,704,010	\$226,874,806	\$(41,226,357)	\$459,560,931
Issuance of common stock (stock compensation plans)	52,964	—	530	—	720,018	—	—	—	720,548
Share-based compensation	160,869	—	1,608	—	2,490,136	—	—	—	2,491,744
Net income	—	—	—	—	—	—	22,678,778	—	22,678,778
Cash dividends declared	—	—	—	—	—	—	(4,255,882)	—	(4,255,882)
Grant of stock options	—	—	—	—	76,354	—	(76,354)	—	—
Other comprehensive income	—	—	—	—	—	6,663,215	—	—	6,663,215
Balance, June 30, 2020	26,513,779	5,649,240	\$265,138	\$56,492	\$273,175,488	\$ 10,367,225	\$245,221,348	\$(41,226,357)	\$487,859,334
Issuance of common stock (stock compensation plans)	22,662	—	226	—	273,689	—	—	—	273,915
Share-based compensation	604,920	—	6,050	—	8,358,388	—	—	—	8,364,438
Net income	—	—	—	—	—	—	11,836,998	—	11,836,998
Cash dividends declared	—	—	—	—	—	—	(4,269,001)	—	(4,269,001)
Grant of stock options	—	—	—	—	109,628	—	(109,628)	—	—
Other comprehensive income	—	—	—	—	—	2,992	—	—	2,992
Balance, September 30, 2020	27,141,361	5,649,240	\$271,414	\$56,492	\$281,917,193	\$ 10,370,217	\$252,679,717	\$(41,226,357)	\$504,068,676

See accompanying notes to consolidated financial statements.

**Donegal Group Inc. and Subsidiaries**  
**Consolidated Statement of Stockholders' Equity**  
(Unaudited)  
**Nine Months Ended September 30, 2019**

	Class A Shares	Class B Shares	Class A Amount	Class B Amount	Additional Paid-In Capital	Accumulated Other Comprehensive (Loss) Income	Retained Earnings	Treasury Stock	Total Stockholders' Equity
Balance, December 31, 2018	25,819,341	5,649,240	\$ 258,194	\$ 56,492	\$261,258,423	\$ (14,228,059)	\$ 192,751,208	\$(41,226,357)	\$ 398,869,901
Issuance of common stock (stock compensation plans)	33,334	—	333	—	403,722	—	—	—	404,055
Share-based compensation	—	—	—	—	442,920	—	—	—	442,920
Net income	—	—	—	—	—	—	23,023,164	—	23,023,164
Cash dividends declared	—	—	—	—	—	—	(4,752)	—	(4,752)
Grant of stock options	—	—	—	—	144,226	—	(144,226)	—	—
Other comprehensive income	—	—	—	—	—	6,468,473	—	—	6,468,473
Balance, March 31, 2019	<u>25,852,675</u>	<u>5,649,240</u>	<u>\$ 258,527</u>	<u>\$ 56,492</u>	<u>\$262,249,291</u>	<u>\$ (7,759,586)</u>	<u>\$215,625,394</u>	<u>\$(41,226,357)</u>	<u>\$429,203,761</u>
Issuance of common stock (stock compensation plans)	55,933	—	560	—	752,354	—	—	—	752,914
Share-based compensation	60,969	—	609	—	1,218,195	—	—	—	1,218,804
Net income	—	—	—	—	—	—	4,788,454	—	4,788,454
Cash dividends declared	—	—	—	—	—	—	(4,032,416)	—	(4,032,416)
Grant of stock options	—	—	—	—	100,485	—	(100,485)	—	—
Other comprehensive income	—	—	—	—	—	5,922,207	—	—	5,922,207
Balance, June 30, 2019	<u>25,969,577</u>	<u>5,649,240</u>	<u>\$ 259,696</u>	<u>\$ 56,492</u>	<u>\$264,320,325</u>	<u>\$ (1,837,379)</u>	<u>\$216,280,947</u>	<u>\$(41,226,357)</u>	<u>\$437,853,724</u>
Issuance of common stock (stock compensation plans)	22,926	—	229	—	280,385	—	—	—	280,614
Share-based compensation	59,717	—	598	—	1,020,018	—	—	—	1,020,616
Net income	—	—	—	—	—	—	5,186,379	—	5,186,379
Cash dividends declared	—	—	—	—	—	—	(4,045,501)	—	(4,045,501)
Grant of stock options	—	—	—	—	59,452	—	(59,452)	—	—
Other comprehensive income	—	—	—	—	—	2,255,773	—	—	2,255,773
Balance, September 30, 2019	<u>26,052,220</u>	<u>5,649,240</u>	<u>\$ 260,523</u>	<u>\$ 56,492</u>	<u>\$265,680,180</u>	<u>\$ 418,394</u>	<u>\$217,362,373</u>	<u>\$(41,226,357)</u>	<u>\$442,551,605</u>

See accompanying notes to consolidated financial statements.

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

	<u>Nine Months Ended September 30,</u>	
	<u>2020</u>	<u>2019</u>
<b>Cash Flows from Operating Activities:</b>		
Net income	\$ 38,246,897	\$ 32,997,997
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and other non-cash items	5,115,850	4,299,566
Net investment losses (gains)	940,488	(19,294,229)
Equity in earnings of Donegal Financial Services Corporation	—	(295,000)
Changes in assets and liabilities:		
Losses and loss expenses	72,256,493	49,869,114
Unearned premiums	48,083,628	21,508,606
Premiums receivable	(11,941,733)	(17,047,509)
Deferred acquisition costs	(2,269,695)	(3,070,684)
Deferred income taxes	(619,312)	210,518
Reinsurance receivable	(36,843,000)	(18,997,523)
Prepaid reinsurance premiums	(31,916,191)	(6,578,384)
Accrued investment income	(1,557,230)	(724,150)
Due to affiliate	(3,613,903)	(3,858,708)
Reinsurance balances payable	260,626	(1,849,471)
Current income taxes	(4,490,180)	3,266,422
Accrued expenses	(3,869,386)	1,522,732
Other, net	678,760	6,479,153
Net adjustments	<u>30,215,215</u>	<u>15,440,453</u>
Net cash provided by operating activities	<u>68,462,112</u>	<u>48,438,450</u>
<b>Cash Flows from Investing Activities:</b>		
Purchases of fixed maturities, held to maturity	(110,914,229)	(69,297,759)
Purchases of fixed maturities, available for sale	(143,743,351)	(125,791,644)
Purchases of equity securities, available for sale	(6,964,092)	(19,055,851)
Maturity of fixed maturities:		
Held to maturity	39,629,000	13,723,483
Available for sale	120,857,543	88,459,874
Sales of fixed maturities, available for sale	22,172,930	20,548,077
Sales of equity securities, available for sale	5,985,211	37,968,114
Net purchases of property and equipment	(73,706)	(147,005)
Sale of investment in Donegal Financial Services Corporation	—	33,922,773
Net (purchases) sales of short-term investments	(6,655,716)	8,122,436
Net cash used in investing activities	<u>(79,706,410)</u>	<u>(11,547,502)</u>
<b>Cash Flows from Financing Activities:</b>		
Cash dividends paid	(12,605,480)	(12,031,153)
Issuance of common stock	12,407,700	2,814,504
Borrowing under lines of credit	50,000,000	—
Payments on lines of credit	—	(25,000,000)
Net cash provided by (used in) financing activities	<u>49,802,220</u>	<u>(34,216,649)</u>
Net increase in cash	38,557,922	2,674,299
Cash at beginning of period	49,318,930	52,594,461
Cash at end of period	<u>\$ 87,876,852</u>	<u>\$ 55,268,760</u>
Cash paid during period - Interest	\$ 928,474	\$ 321,585
Net cash paid during period - Taxes	\$ 10,800,000	\$ 2,200,000

See accompanying notes to consolidated financial statements.

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

**1 - Organization**

Donegal Mutual Insurance Company (“Donegal Mutual”) organized us as an insurance holding company on August 26, 1986. Our insurance subsidiaries, Atlantic States Insurance Company (“Atlantic States”), Southern Insurance Company of Virginia (“Southern”), the Peninsula Insurance Group (“Peninsula”), which consists of Peninsula Indemnity Company and The Peninsula Insurance Company, and Michigan Insurance Company (“MICO”), write property and casualty insurance exclusively through independent insurance agents in certain Mid-Atlantic, Midwestern, New England and Southern states.

At September 30, 2020, we had three segments: our investment function, our personal lines of insurance and our commercial lines of insurance. The personal lines products of our insurance subsidiaries consist primarily of homeowners and private passenger automobile policies. The commercial lines products of our insurance subsidiaries consist primarily of commercial automobile, commercial multi-peril and workers’ compensation policies.

At September 30, 2020, Donegal Mutual held approximately 42% of our outstanding Class A common stock and approximately 84% of our outstanding Class B common stock. This ownership provides Donegal Mutual with approximately 71% of the total voting power of our common stock. Our insurance subsidiaries and Donegal Mutual have interrelated operations due to a pooling agreement and other intercompany agreements and transactions. While each company maintains its separate corporate existence, Donegal Mutual and our insurance subsidiaries conduct business together as the Donegal Insurance Group. As such, Donegal Mutual and our insurance subsidiaries share the same business philosophy, the same management, the same employees and the same facilities and offer the same types of insurance products.

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

The same executive management and underwriting personnel administer products, classes of business underwritten, pricing practices and underwriting standards of Donegal Mutual and our insurance subsidiaries. In addition, as the Donegal Insurance Group, Donegal Mutual and our insurance subsidiaries share a combined business plan to achieve market penetration and underwriting profitability objectives. The products our insurance subsidiaries and Donegal Mutual market are generally complementary, thereby allowing the Donegal Insurance Group to offer a broader range of products to a given market and to expand the Donegal Insurance Group’s ability to service entire personal lines or commercial lines accounts. Distinctions within the products Donegal Mutual and our insurance subsidiaries offer relate generally to specific risk profiles targeted within similar classes of business, such as preferred tier products versus standard tier products, but we do not allocate all of the standard risk gradients to any specific company within the Donegal Insurance Group. Therefore, the underwriting profitability of the business the individual companies write directly will vary. However, because the risk characteristics of all business Donegal Mutual and Atlantic States write directly are homogenized within the underwriting pool, Donegal Mutual and Atlantic States share the underwriting results in proportion to their respective participation in the underwriting pool.

We and Donegal Mutual sold Donegal Financial Services Corporation (“DFSC”) to Northwest Bancshares, Inc. (“Northwest”) on March 8, 2019, resulting in proceeds valued at approximately \$85.8 million in a combination of cash and Northwest common stock. Immediately prior to the closing of the merger, DFSC paid a dividend of approximately \$29.2 million to us and Donegal Mutual. As the owner of 48.2% of DFSC’s common stock, we received a dividend payment from DFSC of approximately \$14.1 million and consideration from Northwest that included a combination of cash in the amount of \$20.5 million and Northwest common stock with a fair value at the closing date of \$20.9 million. We recorded a gain of \$12.7 million from the sale of DFSC in our results of operations for the first quarter of 2019. We sold the Northwest common stock that we received as part of the consideration during the first quarter of 2019. This transaction represented the culmination of a banking strategy that began with the formation of DFSC in 2000.

On July 18, 2013, our board of directors authorized a share repurchase program pursuant to which we have the authority to purchase up to 500,000 shares of our Class A common stock at prices prevailing from time to time in the open market subject to the provisions of applicable rules of the Securities and Exchange Commission (“SEC”) and in privately negotiated transactions. We did not purchase any shares of our Class A common stock under this program during the nine months ended September 30, 2020 or 2019. We have purchased a total of 57,658 shares of our Class A common stock under this program from its inception through September 30, 2020.

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### 2 - Basis of Presentation

Our financial information for the interim periods included in this Form 10-Q Report is unaudited; however, our financial information we include in this Form 10-Q Report reflects all adjustments, consisting only of normal recurring adjustments that, in the opinion of our management, are necessary for a fair presentation of our financial position, results of operations and cash flows for those interim periods. Our results of operations for the nine months ended September 30, 2020 are not necessarily indicative of the results of operations we expect for the year ending December 31, 2020.

We recommend you read the interim financial statements we include in this Form 10-Q Report in conjunction with the financial statements and the notes to our financial statements contained in our Annual Report on Form 10-K for the year ended December 31, 2019.

### 3 - Earnings Per Share

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

	Three Months Ended September 30,			
	2020		2019	
	Class A	Class B	Class A	Class B
	(in thousands, except per share data)			
Basic earnings per share:				
Numerator:				
Allocation of net income	\$ 9,768	\$2,069	\$ 4,269	\$ 917
Denominator:				
Weighted-average shares outstanding	23,767	5,577	23,015	5,577
Basic earnings per share	<u>\$ 0.41</u>	<u>\$ 0.37</u>	<u>\$ 0.19</u>	<u>\$ 0.16</u>
Diluted earnings per share:				
Numerator:				
Allocation of net income	\$ 9,768	\$2,069	\$ 4,269	\$ 917
Denominator:				
Number of shares used in basic computation	23,767	5,577	23,015	5,577
Weighted-average shares effect of dilutive securities:				
Director and employee stock options	170	—	277	—
Number of shares used in diluted computation	<u>23,937</u>	<u>5,577</u>	<u>23,292</u>	<u>5,577</u>
Diluted earnings per share	<u>\$ 0.41</u>	<u>\$ 0.37</u>	<u>\$ 0.18</u>	<u>\$ 0.16</u>

	<b>Nine Months Ended September 30,</b>			
	<b>2020</b>		<b>2019</b>	
	Class A	Class B	Class A	Class B
(in thousands, except per share data)				
<b>Basic earnings per share:</b>				
Numerator:				
Allocation of net income	<u>\$31,495</u>	<u>\$6,752</u>	<u>\$27,065</u>	<u>\$5,933</u>
Denominator:				
Weighted-average shares outstanding	<u>23,494</u>	<u>5,577</u>	<u>22,933</u>	<u>5,577</u>
Basic earnings per share	<u>\$ 1.34</u>	<u>\$ 1.21</u>	<u>\$ 1.18</u>	<u>\$ 1.06</u>
<b>Diluted earnings per share:</b>				
Numerator:				
Allocation of net income	<u>\$31,495</u>	<u>\$6,752</u>	<u>\$27,065</u>	<u>\$5,933</u>
Denominator:				
Number of shares used in basic computation	23,494	5,577	22,933	5,577
Weighted-average shares effect of dilutive securities:				
Director and employee stock options	<u>185</u>	<u>—</u>	<u>183</u>	<u>—</u>
Number of shares used in diluted computation	<u>23,679</u>	<u>5,577</u>	<u>23,116</u>	<u>5,577</u>
Diluted earnings per share	<u>\$ 1.33</u>	<u>\$ 1.21</u>	<u>\$ 1.17</u>	<u>\$ 1.06</u>

We did not include outstanding options to purchase the following number of shares of Class A common stock in our computation of diluted earnings per share because the exercise price of the options exceeded the average market price of our Class A common stock during the applicable periods.

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2020</b>	<b>2019</b>	<b>2020</b>	<b>2019</b>
Number of options to purchase Class A shares excluded	<u>6,180,592</u>	<u>5,330,525</u>	<u>6,180,592</u>	<u>5,531,561</u>

#### 4 - Reinsurance

Atlantic States and Donegal Mutual have participated in a pooling agreement since 1986 under which they pool their direct premiums written, and Atlantic States and Donegal Mutual then share the underwriting results of the pool in accordance with the terms of the pooling agreement. Atlantic States has an 80% share of the results of the pool, and Donegal Mutual has a 20% share of the results of the pool. Donegal Mutual currently excludes from the pool its underwriting results in four Southwestern states in which Donegal Mutual markets its products together with its insurance subsidiaries as the Mountain States Insurance Group.

Our insurance subsidiaries and Donegal Mutual have a combined third-party reinsurance program. The coverage and parameters of the program are common to all of our insurance subsidiaries and Donegal Mutual. Our insurance subsidiaries and Donegal Mutual use several different reinsurers. They require their reinsurers to maintain an A.M. Best rating of A- (Excellent) or better or, with respect to foreign reinsurers, have a financial condition that, in the opinion of our management, is equivalent to a company with at least an A- rating from A.M. Best. The following information describes the external reinsurance our insurance subsidiaries have in place for 2020:

- excess of loss reinsurance, under which the losses of Donegal Mutual and our insurance subsidiaries are automatically reinsured, through a series of contracts, over a set retention of \$2.0 million; and

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- catastrophe reinsurance, under which Donegal Mutual and our insurance subsidiaries recover, through a series of reinsurance agreements, 100% of an accumulation of many losses resulting from a single event, including natural disasters, over a set retention of \$15.0 million up to aggregate losses of \$185.0 million per occurrence.

In addition to the pooling agreement and third-party reinsurance, our insurance subsidiaries have a catastrophe reinsurance agreement with Donegal Mutual, under which each of our insurance subsidiaries recovers 100% of an accumulation of multiple losses resulting from a single event, including natural disasters, over a set retention of \$2.0 million up to aggregate losses of \$13.0 million per occurrence. The agreement also provides additional coverage for an accumulation of losses from a single event including a combination of our insurance subsidiaries over a combined retention of \$5.0 million.

Our insurance subsidiaries and Donegal Mutual also purchase facultative reinsurance to cover certain exposures, including property exposures that exceeded the limits provided by their respective treaty reinsurance.

## 5 - Investments

The amortized cost and estimated fair values of our fixed maturities at September 30, 2020 were as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Estimated Fair Value</u>
(in thousands)				
<b>Held to Maturity</b>				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 72,912	\$ 4,427	\$ 52	\$ 77,287
Obligations of states and political subdivisions	282,207	20,786	323	302,670
Corporate securities	172,069	15,967	1,064	186,972
Mortgage-backed securities	25,794	1,348	—	27,142
Totals	<u>\$ 552,982</u>	<u>\$ 42,528</u>	<u>\$ 1,439</u>	<u>\$ 594,071</u>
(in thousands)				
<b>Available for Sale</b>				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 47,832	\$ 501	\$ 26	\$ 48,307
Obligations of states and political subdivisions	66,578	2,263	64	68,777
Corporate securities	210,684	9,555	394	219,845
Mortgage-backed securities	233,403	7,719	11	241,111
Totals	<u>\$ 558,497</u>	<u>\$ 20,038</u>	<u>\$ 495</u>	<u>\$ 578,040</u>

At September 30, 2020, our holdings of obligations of states and political subdivisions included general obligation bonds with an aggregate fair value of \$244.6 million and an amortized cost of \$230.6 million. Our holdings at September 30, 2020 also included special revenue bonds with an aggregate fair value of \$126.8 million and an amortized cost of \$118.2 million. With respect to both categories of those bonds at September 30, 2020, we held no securities of any issuer that comprised more than 10% of our holdings of either bond category. Education bonds and water and sewer utility bonds represented 41% and 39%, respectively, of our total investments in special revenue bonds based on the carrying values of these investments at September 30, 2020. Many of the issuers of the special revenue bonds we held at September 30, 2020 have the authority to impose ad valorem taxes. In that respect, many of the special revenue bonds we held at September 30, 2020 are similar to general obligation bonds.

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The amortized cost and estimated fair values of our fixed maturities at December 31, 2019 were as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Estimated Fair Value</u>
	(in thousands)			
<b>Held to Maturity</b>				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 82,916	\$ 1,803	\$ 69	\$ 84,650
Obligations of states and political subdivisions	204,634	14,237	288	218,583
Corporate securities	156,398	8,275	333	164,340
Mortgage-backed securities	32,146	611	16	32,741
Totals	<u>\$ 476,094</u>	<u>\$ 24,926</u>	<u>\$ 706</u>	<u>\$ 500,314</u>
	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Estimated Fair Value</u>
	(in thousands)			
<b>Available for Sale</b>				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 19,302	\$ 82	\$ 19	\$ 19,365
Obligations of states and political subdivisions	55,162	1,641	7	56,796
Corporate securities	154,946	4,477	180	159,243
Mortgage-backed securities	327,429	2,857	738	329,548
Totals	<u>\$ 556,839</u>	<u>\$ 9,057</u>	<u>\$ 944</u>	<u>\$ 564,952</u>

At December 31, 2019, our holdings of obligations of states and political subdivisions included general obligation bonds with an aggregate fair value of \$182.0 million and an amortized cost of \$172.3 million. Our holdings also included special revenue bonds with an aggregate fair value of \$93.4 million and an amortized cost of \$87.5 million. With respect to both categories of bonds, we held no securities of any issuer that comprised more than 10% of that category at December 31, 2019. Education bonds and water and sewer utility bonds represented 44% and 35%, respectively, of our total investments in special revenue bonds based on their carrying values at December 31, 2019. Many of the issuers of the special revenue bonds we held at December 31, 2019 have the authority to impose ad valorem taxes. In that respect, many of the special revenue bonds we held are similar to general obligation bonds.

We made reclassifications from available for sale to held to maturity of certain fixed maturities at fair value on November 30, 2013. We segregated within accumulated other comprehensive income the net unrealized losses of \$15.1 million arising prior to the November 30, 2013 reclassifications. We are amortizing this balance over the remaining life of the related securities as an adjustment to yield in a manner consistent with the accretion of discount on the same fixed maturities. We recorded amortization of \$1.1 million and \$870,186 in other comprehensive income during the nine months ended September 30, 2020 and 2019, respectively. At September 30, 2020 and December 31, 2019, net unrealized losses of \$6.4 million and \$7.5 million, respectively, remained within accumulated other comprehensive income.

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We show below the amortized cost and estimated fair value of our fixed maturities at September 30, 2020 by contractual maturity. Expected maturities may differ from contractual maturities because issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties.

	<u>Amortized Cost</u>	<u>Estimated Fair Value</u>
	(in thousands)	
<b>Held to maturity</b>		
Due in one year or less	\$ 23,089	\$ 23,396
Due after one year through five years	86,376	92,539
Due after five years through ten years	197,347	213,410
Due after ten years	220,376	237,584
Mortgage-backed securities	25,794	27,142
Total held to maturity	<u>\$ 552,982</u>	<u>\$ 594,071</u>
<b>Available for sale</b>		
Due in one year or less	\$ 70,596	\$ 70,923
Due after one year through five years	103,950	109,598
Due after five years through ten years	123,256	128,472
Due after ten years	27,292	27,936
Mortgage-backed securities	233,403	241,111
Total available for sale	<u>\$ 558,497</u>	<u>\$ 578,040</u>

The cost and estimated fair values of our equity securities at September 30, 2020 were as follows:

	<u>Cost</u>	<u>Gross Gains</u>	<u>Gross Losses</u>	<u>Estimated Fair Value</u>
	(in thousands)			
Equity securities	\$42,410	\$ 13,875	\$ 1,340	\$ 54,945

The cost and estimated fair values of our equity securities at December 31, 2019 were as follows:

	<u>Cost</u>	<u>Gross Gains</u>	<u>Gross Losses</u>	<u>Estimated Fair Value</u>
	(in thousands)			
Equity securities	\$43,419	\$ 12,180	\$ 121	\$ 55,478

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Gross investment gains and losses before applicable income taxes for the three and nine months ended September 30, 2020 and 2019 were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	2019	2020	2019
	(in thousands)		(in thousands)	
<b>Gross investment gains:</b>				
Fixed maturities	\$ 159	\$ 107	\$ 811	\$ 479
Equity securities	3,131	721	5,617	8,293
Investment in affiliate	—	—	—	12,662
	<u>3,290</u>	<u>828</u>	<u>6,428</u>	<u>21,434</u>
<b>Gross investment losses:</b>				
Fixed maturities	22	4	240	324
Equity securities	—	1,193	7,128	1,816
	<u>22</u>	<u>1,197</u>	<u>7,368</u>	<u>2,140</u>
Net investment gains (losses)	<u>\$ 3,268</u>	<u>\$ (369)</u>	<u>\$ (940)</u>	<u>\$ 19,294</u>

We recognized \$5.6 million of gains and \$3.6 million of losses on equity securities we held at September 30, 2020 in net investment losses for the nine months ended September 30, 2020. We recognized \$6.7 million of gains and \$1.2 million of losses on equity securities we held at September 30, 2019 in net investment gains for the nine months ended September 30, 2019.

We held fixed maturities with unrealized losses representing declines that we considered temporary at September 30, 2020 as follows:

	Less Than 12 Months		More Than 12 Months	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)			
U.S. Treasury securities and obligations of U.S. government corporations and agencies				
	\$ 19,920	\$ 78	\$ —	\$ —
Obligations of states and political subdivisions	40,735	387	—	—
Corporate securities	51,899	695	5,744	763
Mortgage-backed securities	809	11	274	—
Totals	<u>\$ 113,363</u>	<u>\$ 1,171</u>	<u>\$ 6,018</u>	<u>\$ 763</u>

We held fixed maturities with unrealized losses representing declines that we considered temporary at December 31, 2019 as follows:

	Less Than 12 Months		More Than 12 Months	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)			
U.S. Treasury securities and obligations of U.S. government corporations and agencies				
	\$ 7,461	\$ 46	\$ 5,395	\$ 42
Obligations of states and political subdivisions	23,339	293	2,327	2
Corporate securities	19,363	263	18,803	250
Mortgage-backed securities	28,507	56	74,089	698
Totals	<u>\$ 78,670</u>	<u>\$ 658</u>	<u>\$100,614</u>	<u>\$ 992</u>

We make estimates concerning the valuation of our investments and the recognition of other-than-temporary declines in the value of our investments. For equity securities, we measure investments at fair value, and we recognize changes in fair value in our results of operations. With respect to a debt security that is in an unrealized loss position, we first assess if we intend to sell the debt security. If we determine we intend to sell the debt security, we recognize the impairment loss in our results of operations. If we do not intend to sell the debt security, we determine whether it is more likely than not that we will be required to sell the debt security prior to recovery. If we determine it is more likely than not that we will be required to sell the debt security prior to recovery, we recognize the impairment loss in our results of operations. If we determine it is more likely than

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not that we will not be required to sell the debt security prior to recovery, we then evaluate whether a credit loss has occurred with respect to that security. We determine whether a credit loss has occurred by comparing the amortized cost of the debt security to the present value of the cash flows we expect to collect. If we expect a cash flow shortfall, we consider that a credit loss has occurred. If we determine that a credit loss has occurred, we consider the impairment to be other than temporary. We then recognize the amount of the impairment loss related to the credit loss in our results of operations, and we recognize the remaining portion of the impairment loss in our other comprehensive income, net of applicable taxes. In addition, we may write down securities in an unrealized loss position based on a number of other factors, including when the fair value of an investment is significantly below its cost, when the financial condition of the issuer of a security has deteriorated, the occurrence of industry, issuer or geographic events that have negatively impacted the value of a security and rating agency downgrades. We held 77 debt securities that were in an unrealized loss position at September 30, 2020. Based upon our analysis of general market conditions and underlying factors impacting these debt securities, we considered these declines in value to be temporary.

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

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

### **6 - Segment Information**

We evaluate the performance of our personal lines and commercial lines segments based upon the underwriting results of our insurance subsidiaries using statutory accounting principles (“SAP”) that various state insurance departments prescribe or permit. Our management uses SAP to measure the performance of our insurance subsidiaries instead of United States generally accepted accounting principles (“GAAP”). SAP financial measures are considered non-GAAP financial measures under applicable SEC rules because they include or exclude certain items that the most comparable GAAP financial measures do not ordinarily include or exclude.

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Financial data by segment for the three and nine months ended September 30, 2020 and 2019 is as follows:

	<b>Three Months Ended September 30,</b>	
	<b>2020</b>	<b>2019</b>
	(in thousands)	
<b>Revenues:</b>		
Premiums earned:		
Commercial lines	\$ 103,436	\$ 98,324
Personal lines	81,490	91,497
Premiums earned	184,926	189,821
Net investment income	7,403	7,390
Investment gains (losses)	3,268	(369)
Other	915	1,168
<b>Total revenues</b>	<b>\$ 196,512</b>	<b>\$ 198,010</b>
<b>Income before income tax expense:</b>		
Underwriting income (loss):		
Commercial lines	\$ (1,703)	\$ 2,521
Personal lines	6,427	(3,312)
SAP underwriting income (loss)	4,724	(791)
GAAP adjustments	(1,576)	(399)
GAAP underwriting income (loss)	3,148	(1,190)
Net investment income	7,403	7,390
Investment gains (losses)	3,268	(369)
Other	513	474
<b>Income before income tax expense</b>	<b>\$ 14,332</b>	<b>\$ 6,305</b>

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	<b>Nine Months Ended September 30,</b>	
	<b>2020</b>	<b>2019</b>
(in thousands)		
<b>Revenues:</b>		
Premiums earned:		
Commercial lines	\$ 307,080	\$ 284,593
Personal lines	249,472	282,065
Premiums earned	556,552	566,658
Net investment income	21,952	21,728
Investment (losses) gains	(940)	19,294
Equity in earnings of DFSC	—	295
Other	2,759	3,538
<b>Total revenues</b>	<b>\$ 580,323</b>	<b>\$ 611,513</b>
<b>Income before income tax expense:</b>		
Underwriting income (loss):		
Commercial lines	\$ 2,203	\$ 4,946
Personal lines	19,528	(10,077)
SAP underwriting income (loss)	21,731	(5,131)
GAAP adjustments	1,186	1,431
GAAP underwriting income (loss)	22,917	(3,700)
Net investment income	21,952	21,728
Investment (losses) gains	(940)	19,294
Equity in earnings of DFSC	—	295
Other	894	1,070
<b>Income before income tax expense</b>	<b>\$ 44,823</b>	<b>\$ 38,687</b>

## 7 - Borrowings

### Lines of Credit

In August 2020, we entered into a new credit agreement with Manufacturers and Traders Trust Company (“M&T”) that related to a \$20.0 million unsecured demand line of credit. The line of credit has no expiration date, no annual fees and no covenants. At September 30, 2020, we had no outstanding borrowings from M&T and had the ability to borrow up to \$20.0 million at interest rates equal to the then-current LIBOR rate plus 2.00%.

Atlantic States is a member of the FHLB of Pittsburgh. Through its membership, Atlantic States has the ability to issue debt to the FHLB of Pittsburgh in exchange for cash advances. In August 2019, Atlantic States exchanged a variable-rate cash advance of \$35.0 million that was due in March 2020 for a fixed-rate cash advance of \$35.0 million that was outstanding at September 30, 2020. Atlantic States incurred a penalty of \$176,000 related to the early termination of its previous cash advance. The new cash advance carries a fixed interest rate of 1.74% and is due in August 2024. In March 2020, Atlantic States issued \$50.0 million of debt to the FHLB of Pittsburgh in exchange for a cash advance in the same amount that was outstanding at September 30, 2020. The debt carries a fixed interest rate of 0.83% and is due in March 2021. Atlantic States obtained this contingent liquidity funding in light of uncertainty surrounding the economic impact of the COVID-19 pandemic. The table below presents the amount of FHLB of Pittsburgh stock Atlantic States purchased, collateral pledged and assets related to Atlantic States’ membership in the FHLB of Pittsburgh at September 30, 2020.

FHLB of Pittsburgh stock purchased and owned	\$ 3,690,100
Collateral pledged, at par (carrying value \$97,159,981)	95,332,095
Borrowing capacity currently available	10,960,030

## **Subordinated Debentures**

Donegal Mutual holds a \$5.0 million surplus note that MICO issued to increase MICO's statutory surplus. The surplus note carries an interest rate of 5.00%, and any repayment of principal or payment of interest on the surplus note requires prior approval of the Michigan Department of Insurance and Financial Services.

## **8 - Share-Based Compensation**

We measure all share-based payments to employees, including grants of stock options, and use a fair-value-based method for the recording of related compensation expense in our results of operations. In determining the expense we record for stock options granted to directors and employees of our subsidiaries and affiliates, we estimate the fair value of each option award on the date of grant using the Black-Scholes option pricing model. The significant assumptions we utilize in applying the Black-Scholes option pricing model are the risk-free interest rate, the expected term, the dividend yield and the expected volatility.

We charged compensation expense related to our stock compensation plans against income before income taxes of \$219,051 and \$247,301 for the three months ended September 30, 2020 and 2019, respectively, with a corresponding income tax benefit of \$46,001 and \$51,933, respectively. We charged compensation expense related to our stock compensation plans against income before income taxes of \$863,592 and \$1.1 million for the nine months ended September 30, 2020 and 2019, respectively, with a corresponding income tax benefit of \$181,354 and \$233,851, respectively. At September 30, 2020, we had \$1.0 million of unrecognized compensation expense related to nonvested share-based compensation granted under our stock compensation plans that we expect to recognize over a weighted average period of approximately 1.4 years.

We received cash from option exercises under all stock compensation plans during the three months ended September 30, 2020 and 2019 of \$8.1 million and \$772,969, respectively. We received cash from option exercises under all stock compensation plans during the nine months ended September 30, 2020 and 2019 of \$11.2 million and \$1.6 million, respectively. We realized actual tax benefits for the tax deductions related to those option exercises of \$163,245 and \$22,414 for the three months ended September 30, 2020 and 2019, respectively. We realized actual tax benefits for the tax deductions related to those option exercises of \$232,123 and \$38,376 for the nine months ended September 30, 2020 and 2019, respectively.

## **9 - Fair Value Measurements**

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

Level 1 – quoted prices in active markets for identical assets and liabilities;

Level 2 – directly or indirectly observable inputs other than Level 1 quoted prices; and

Level 3 – unobservable inputs not corroborated by market data.

For investments that have quoted market prices in active markets, we use the quoted market price as fair value and include these investments in Level 1 of the fair value hierarchy. We classify publicly-traded equity securities as Level 1. When quoted market prices in active markets are not available, we base fair values on quoted market prices of comparable instruments or price estimates we obtain from independent pricing services and include these investments in Level 2 of the fair value hierarchy. We classify our fixed maturity investments as Level 2. Our fixed maturity investments consist of U.S. Treasury securities and obligations of U.S. government corporations and agencies, obligations of states and political subdivisions, corporate securities and mortgage-backed securities.

We present our investments in available-for-sale fixed maturity and equity securities at estimated fair value. The estimated fair value of a security may differ from the amount that could be realized if we sold the security in a forced transaction. In addition, the valuation of fixed maturity investments is more subjective when markets are less liquid, increasing the potential that the estimated fair value does not reflect the price at which an actual transaction would occur. We utilize nationally recognized independent pricing services to estimate fair values or obtain market quotations for substantially all of our fixed maturity and equity investments. These pricing services utilize market quotations for fixed maturity and equity securities that have quoted prices in active markets. For fixed maturity securities that generally do not trade on a daily basis, the pricing services prepare estimates of fair value measurements based predominantly on observable market inputs. The pricing services do not use broker quotes in determining the fair values of our investments. Our investment personnel review the estimates of

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fair value the pricing services provide to verify that the estimates we obtain from the pricing services are representative of fair values based upon our investment personnel's general knowledge of the market, their research findings related to unusual fluctuations in value and their comparison of such values to execution prices for similar securities. Our investment personnel regularly monitor the market, current trading ranges for similar securities and the pricing of specific investments. Our investment personnel review all pricing estimates that we receive from the pricing services against their expectations with respect to pricing based on fair market curves, security ratings, interest rates, security types and recent trading activity. Our investment personnel periodically review documentation with respect to the pricing services' pricing methodology that they obtain to determine if the primary pricing sources, market inputs and pricing frequency for various security types are reasonable. At September 30, 2020, we received two estimates per security from the pricing services, and we priced substantially all of our Level 1 and Level 2 investments using those prices. In our review of the estimates the pricing services provided at September 30, 2020, we did not identify any material discrepancies, and we did not make any adjustments to the estimates the pricing services provided.

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

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

We evaluate our assets and liabilities to determine the appropriate level at which to classify them for each reporting period.

The following table presents our fair value measurements for our investments in available-for-sale fixed maturity and equity securities at September 30, 2020:

	Fair Value Measurements Using			
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2) (in thousands)	Significant Unobservable Inputs (Level 3)
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 48,307	\$ —	\$ 48,307	\$ —
Obligations of states and political subdivisions	68,777	—	68,777	—
Corporate securities	219,845	—	219,845	—
Mortgage-backed securities	241,111	—	241,111	—
Equity securities	54,945	50,541	4,404	—
Total investments in the fair value hierarchy	<u>\$632,985</u>	<u>\$ 50,541</u>	<u>\$ 582,444</u>	<u>\$ —</u>

The following table presents our fair value measurements for our investments in available-for-sale fixed maturity and equity securities at December 31, 2019:

	Fair Value Measurements Using			
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2) (in thousands)	Significant Unobservable Inputs (Level 3)
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 19,364	\$ —	\$ 19,364	\$ —
Obligations of states and political subdivisions	56,796	—	56,796	—
Corporate securities	159,243	—	159,243	—
Mortgage-backed securities	329,548	—	329,548	—
Equity securities	55,478	53,124	2,354	—
Totals	<u>\$620,429</u>	<u>\$ 53,124</u>	<u>\$ 567,305</u>	<u>\$ —</u>

**10 - Income Taxes**

On March 27, 2020, the Coronavirus Aid, Relief and Security Act (the “CARES Act”) was signed into law. The CARES Act amended net operating loss provisions in effect prior to its enactment. The CARES Act allows for the carryback of losses arising in taxable years beginning after December 31, 2017 and before January 1, 2021 to each of the five taxable years preceding the taxable year of such loss. As a result, we filed amended tax returns to carry back net operating losses from taxable year 2018 to past tax years. We recorded a tax benefit of \$1.6 million in the first quarter of 2020 in anticipation of a refund of taxes we paid in prior years as a result of the carryback.

At September 30, 2020 and December 31, 2019, respectively, we had no material unrecognized tax benefits or accrued interest and penalties. Tax years 2016 through 2019 remained open for examination at September 30, 2020. We provide a valuation allowance when we believe it is more likely than not that we will not realize some portion of our tax assets. We established a valuation allowance of \$7.5 million for our net state operating loss carryforward. We have determined that we are not required to establish a valuation allowance for our other deferred tax assets of \$25.6 million and \$26.1 million at September 30, 2020 and December 31, 2019, respectively, because it is more likely than not that we will realize these deferred tax assets through reversals of existing temporary differences, future taxable income and the implementation of tax planning strategies.

**11 - Liability for Losses and Loss Expenses**

The establishment of an appropriate liability for losses and loss expenses is an inherently uncertain process, and we can provide no assurance that our insurance subsidiaries’ ultimate liability for losses and loss expenses will not exceed their loss and loss expense reserves and have an adverse effect on our results of operations and financial condition. Furthermore, we cannot predict the timing, frequency and extent of adjustments to our insurance subsidiaries’ estimated future liabilities, because the historical conditions and events that serve as a basis for our insurance subsidiaries’ estimates of ultimate claim costs may change. As is the case for substantially all property and casualty insurance companies, our insurance subsidiaries have found it necessary in the past to increase their estimated future liabilities for losses and loss expenses in certain periods, and, in other periods, their estimated future liabilities for losses and loss expenses have exceeded their actual liabilities for losses and loss expenses. Changes in our insurance subsidiaries’ estimate of their liability for losses and loss expenses generally reflect actual payments and their evaluation of information received subsequent to the prior reporting period.

We summarize activity in our insurance subsidiaries’ liability for losses and loss expenses as follows:

	<b>Nine Months Ended September 30,</b>	
	<b>2020</b>	<b>2019</b>
	(in thousands)	
Balance at January 1	\$ 869,674	\$ 814,665
Less reinsurance recoverable	(362,768)	(339,267)
Net balance at January 1	<u>506,906</u>	<u>475,398</u>
Incurred related to:		
Current year	353,798	393,301
Prior years	(10,321)	(7,940)
Total incurred	<u>343,477</u>	<u>385,361</u>
Paid related to:		
Current year	169,610	197,234
Prior years	139,024	157,691
Total paid	<u>308,634</u>	<u>354,925</u>
Net balance at end of period	541,749	505,834
Plus reinsurance recoverable	400,181	358,700
Balance at end of period	<u>\$ 941,930</u>	<u>\$ 864,534</u>

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Our insurance subsidiaries recognized a decrease in their liability for losses and loss expenses of prior years of \$10.3 million and \$7.9 million for the nine months ended September 30, 2020 and 2019, respectively. Our insurance subsidiaries made no significant changes in their reserving philosophy or claims management personnel, and they have made no significant offsetting changes in estimates that increased or decreased their loss and loss expense reserves in those years. The 2020 development represented 2.0% of the December 31, 2019 net carried reserves and resulted primarily from lower-than-expected severity in nearly all lines of business, with the exception of modest higher-than-expected severity in commercial automobile. The majority of the 2020 development related to decreases in the liability for losses and loss expenses of prior years for MICO and Atlantic States. The 2019 development represented 1.7% of the December 31, 2018 net carried reserves and resulted primarily from lower-than-expected severity in the workers' compensation line of business. The majority of the 2019 development related to decreases in the liability for losses and loss expenses of prior years for MICO.

Short-duration contracts are contracts for which our insurance subsidiaries receive premiums that they recognize as revenue over the period of the contract in proportion to the amount of insurance protection our insurance subsidiaries provide. Our insurance subsidiaries consider the policies they issue to be short-duration contracts. We consider the material lines of business of our insurance subsidiaries to be personal automobile, homeowners, commercial automobile, commercial multi-peril and workers' compensation.

Our insurance subsidiaries determine incurred but not reported ("IBNR") reserves by subtracting the cumulative loss and loss expense amounts our insurance subsidiaries have paid and the case reserves our insurance subsidiaries have established at the balance sheet date from their actuaries' estimate of the ultimate cost of losses and loss expenses. Accordingly, the IBNR reserves of our insurance subsidiaries include their actuaries' projections of the cost of unreported claims as well as their actuaries' projected development of case reserves on known claims and reopened claims. Our insurance subsidiaries' methodology for estimating IBNR reserves has been in place for many years, and their actuaries made no significant changes to that methodology during the nine months ended September 30, 2020.

The actuaries for our insurance subsidiaries generally prepare an initial estimate for ultimate losses and loss expenses for the current accident year by multiplying earned premium by an expected loss ratio for each line of business our insurance subsidiaries write. Expected loss ratios represent the actuaries' expectation of losses at the time our insurance subsidiaries price and write their policies and before the emergence of any actual claims experience. The actuaries determine an expected loss ratio by analyzing historical experience and adjusting for loss cost trends, loss frequency and severity trends, premium rate level changes, reported and paid loss emergence patterns and other known or observed factors.

The actuaries use a variety of actuarial methods to estimate the ultimate cost of losses and loss expenses. These methods include paid loss development, incurred loss development and the Bornhuetter-Ferguson method. The actuaries base their selection of a point estimate on a judgmental weighting of the estimates each of these methods produce.

The actuaries consider loss frequency and severity trends when they develop expected loss ratios and point estimates. Loss frequency is a measure of the number of claims per unit of insured exposure, and loss severity is a measure of the average size of claims. Factors that affect loss frequency include changes in weather patterns and economic activity. Factors that affect loss severity include changes in policy limits, reinsurance retentions, inflation rates and judicial interpretations.

Our insurance subsidiaries create a claim file when they receive notice of an actual demand for payment, an event that may lead to a demand for payment or when they otherwise determine that a demand for payment could potentially lead to a future demand for payment on another coverage under the same policy or another policy they have issued. In recent years, our insurance subsidiaries have noted an increase in the period of time between the occurrence of a casualty loss event and the date at which they receive notice of a liability claim. Changes in the length of time between the loss occurrence date and the claim reporting date affect the actuaries' ability to predict loss frequency accurately and the amount of IBNR reserves our insurance subsidiaries require.

Our insurance subsidiaries generally create a claim file for a policy at the claimant level by type of coverage and generally recognize one count for each claim event. In certain lines of business where it is common for multiple parties to claim damages arising from a single claim event, our insurance subsidiaries recognize one count for each claimant involved in the event. Atlantic States recognizes one count for each claim event, or claimant involved in a multiple-party claim event, related to losses Atlantic States assumes through its participation in its pooling agreement with Donegal Mutual. Our insurance subsidiaries accumulate the claim counts and report them by line of business.

## 12 - Impact of New Accounting Standards

In February 2016, the FASB issued guidance that requires lessees to recognize leases, including operating leases, on the lessee's balance sheet, unless a lease is considered a short-term lease. This guidance also requires entities to make new judgments to identify leases. The guidance is effective for annual and interim reporting periods beginning after December 15, 2018 and permits early adoption. Our adoption of this guidance on January 1, 2019 did not have a significant impact on our financial position, results of operations or cash flows.

In January 2017, the FASB issued guidance that simplifies the measurement of goodwill by modifying the goodwill impairment test previous guidance required. The guidance requires an entity to perform its annual or interim goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount and recognize impairment for the amount by which the reporting unit's carrying amount exceeds its fair value. The guidance is effective for annual and interim reporting periods beginning after December 15, 2019 and permits early adoption. We early adopted this guidance in 2019. The adoption of this guidance did not have a significant impact on our financial position, results of operations or cash flows.

In August 2018, the FASB issued guidance that modifies disclosure requirements related to fair value measurements. The guidance removes the requirements to disclose the amounts of, and reasons for, transfers between Level 1 and Level 2 of the fair value hierarchy. The guidance is effective for annual and interim reporting periods beginning after December 15, 2019 and permits early adoption. We early adopted this guidance in 2019. The adoption of this guidance on January 1, 2019 did not have a significant impact on our financial position, results of operations or cash flows.

In September 2016, the FASB issued guidance that amends previous guidance on the impairment of financial instruments by adding an impairment model that requires an entity to recognize expected credit losses as an allowance rather than impairments as credit losses are incurred. The intent of this guidance is to reduce complexity and result in a more timely recognition of expected credit losses. In November 2019, the FASB issued guidance that delays the effective date for "smaller reporting companies," as defined in Item 10(f)(1) of Regulation S-K, to annual and interim reporting periods beginning after December 15, 2022 from December 15, 2019. We are a smaller reporting company and are in the process of evaluating the impact of the adoption of this guidance on our financial position, results of operations and cash flows.

In December 2019, the FASB issued guidance that simplifies accounting for income taxes. The guidance eliminates certain exceptions related to the approach for intra-period tax allocation, the methodology for calculating income taxes in an interim period and the recognition of deferred tax liabilities for outside basis differences. The guidance is effective January 1, 2021, using the retrospective method or modified retrospective method for certain changes and the prospective method for all other changes, and permits early adoption. We do not expect our adoption of this guidance in 2021 to have a significant impact on our financial position, results of operations or cash flows.

### 13 - Risks and Uncertainties

In the first nine months of 2020, the COVID-19 pandemic resulted in significant disruptions in economic activity throughout our operating regions. COVID-19 concerns have also contributed to financial market volatility. We cannot predict at this time the ultimate impact that the economic and financial disruption related to the ongoing COVID-19 pandemic or any other future pandemic will have on our financial position, results of operations and cash flows. The impact of the following risks and uncertainties could be material:

- the revenues of our insurance subsidiaries may decrease as a result of reduced demand for their insurance products as the ongoing economic disruption adversely impacts current and potential insurance customers;
- our insurance subsidiaries may incur an increase in their losses and loss expenses in certain lines of business as a result of COVID-19 and related economic disruption, and such losses and loss expenses may exceed the reserves our insurance subsidiaries have established or may establish in the future;
- our insurance subsidiaries may incur increased costs related to legal disputes over policy coverages or exclusions and their defense against litigation related to COVID-19;
- legislative, judicial and regulatory actions may expand coverage definitions, retroactively mandate coverage or otherwise require our insurance subsidiaries to pay losses for damages that their policies explicitly excluded or did not intend to cover;
- legislative, judicial and regulatory actions may require our insurance subsidiaries to reduce or refund premiums, suspend cancellation of policies for non-payment of premiums or otherwise grant extended grace periods and time allowances for the payment of premium balances due to them;
- our insurance subsidiaries may not be able to collect premium balances due to them, resulting in reduced operating cash flows and an increase in premium write-offs that would increase their operating expenses;
- our insurance subsidiaries may suffer declines in the market values of their investments as a result of financial market volatility related to COVID-19 concerns and related economic disruption;
- our insurance subsidiaries may experience declines in investment income as a result of lower interest rates that may be available upon reinvestment of the proceeds of maturing investments; and
- Economic disruption related to COVID-19 could result in significant declines in the credit quality of issuers, ratings downgrades or changes in financial market conditions and regulatory changes that might adversely impact the value of the fixed-maturity investments that our insurance subsidiaries own.

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

We recommend that you read the following information in conjunction with the historical financial information and the footnotes to that financial information we include in this Quarterly Report on Form 10-Q. We also recommend you read Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2019.

## Critical Accounting Policies and Estimates

We combine our financial statements with those of our insurance subsidiaries and present our financial statements on a consolidated basis in accordance with GAAP.

Our insurance subsidiaries make estimates and assumptions that can have a significant effect on amounts and disclosures we report in our financial statements. The most significant estimates relate to the reserves of our insurance subsidiaries for property and casualty insurance unpaid losses and loss expenses. While we believe our estimates and the estimates of our insurance subsidiaries are appropriate, the ultimate amounts of these liabilities may differ from the estimates we provided. We regularly review our methods for making these estimates and we reflect any adjustment we consider necessary in our current consolidated results of operations.

### Liability for Unpaid Losses and Loss Expenses

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

Our insurance subsidiaries maintain liabilities for the payment of losses and loss expenses with respect to both reported and unreported claims. Our insurance subsidiaries establish these liabilities for the purpose of covering the ultimate costs of settling all losses, including investigation and litigation costs. Our insurance subsidiaries base the amount of their liability for reported losses primarily upon a case-by-case evaluation of the type of risk involved, knowledge of the circumstances surrounding each claim and the insurance policy provisions relating to the type of loss the policyholder incurred. Our insurance subsidiaries determine the amount of their liability for unreported claims and loss expenses on the basis of historical information by line of insurance. Our insurance subsidiaries account for inflation in the reserving function through analysis of costs and trends and reviews of historical reserving results. Our insurance subsidiaries monitor their liabilities closely and recompute them periodically using new information on reported claims and a variety of statistical techniques. Our insurance subsidiaries do not discount their liabilities for losses and loss expenses.

Reserve estimates can change over time because of unexpected changes in assumptions related to our insurance subsidiaries' external environment and, to a lesser extent, assumptions related to our insurance subsidiaries' internal operations. For example, our insurance subsidiaries have experienced an increase in claims severity and a lengthening of the claim settlement periods on bodily injury claims during the past several years. These trend changes give rise to greater uncertainty as to the pattern of future loss settlements on bodily injury claims. Related uncertainties regarding future trends include the cost of medical technologies and procedures and changes in the utilization of medical procedures. Assumptions related to our insurance subsidiaries' external environment include the absence of significant changes in tort law and the legal environment that increase liability exposure, consistency in judicial interpretations of insurance coverage and policy provisions and the rate of loss cost inflation. Internal assumptions include consistency in the recording of premium and loss statistics, consistency in the recording of claims, payment and case reserving methodology, accurate measurement of the impact of rate changes and changes in policy provisions, consistency in the quality and characteristics of business written within a given line of business and consistency in reinsurance coverage and collectability of reinsured losses, among other items. To the extent our insurance subsidiaries determine that underlying factors impacting their assumptions have changed, our insurance subsidiaries make adjustments in their reserves that they consider appropriate for such changes. Accordingly, our insurance subsidiaries' ultimate liability for unpaid losses and loss expenses will likely differ from the amount recorded at September 30, 2020. For every 1% change in our insurance subsidiaries' loss and loss expense reserves, net of reinsurance recoverable, the effect on our pre-tax results of operations would be approximately \$5.4 million.

The establishment of appropriate liabilities is an inherently uncertain process and we can provide no assurance that our insurance subsidiaries' ultimate liability will not exceed our insurance subsidiaries' loss and loss expense reserves and have an adverse effect on our results of operations and financial condition. Furthermore, we cannot predict the timing, frequency and extent of adjustments to our insurance subsidiaries' estimated future liabilities, because the historical conditions and events that serve as a basis for our insurance subsidiaries' estimates of ultimate claim costs may change. As is the case for substantially all property and casualty insurance companies, our insurance subsidiaries have found it necessary in the past to

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increase their estimated future liabilities for losses and loss expenses in certain periods and, in other periods, their estimated future liabilities for losses and loss expenses have exceeded their actual liabilities for losses and loss expenses. Changes in our insurance subsidiaries' estimates of their liability for losses and loss expenses generally reflect actual payments and their evaluation of information received subsequent to the prior reporting period.

Excluding the impact of severe weather events and reduced claim frequency in the second and third quarters of 2020 due to restrictions related to COVID-19, our insurance subsidiaries have noted stable amounts in the number of claims incurred and the number of claims outstanding at period ends relative to their premium base in recent years across most of their lines of business. However, the amount of the average claim outstanding has increased gradually over the past several years due to various factors such as rising medical loss costs and increased litigation trends. We have also experienced a general slowing of settlement rates in litigated claims. Our insurance subsidiaries could have to make further adjustments to their estimates in the future. However, on the basis of our insurance subsidiaries' internal procedures, which analyze, among other things, their prior assumptions, their experience with similar cases and historical trends such as reserving patterns, loss payments, pending levels of unpaid claims and product mix, as well as court decisions, economic conditions and public attitudes, we believe that our insurance subsidiaries have made adequate provision for their liability for losses and loss expenses.

Atlantic States' participation in the pool with Donegal Mutual exposes Atlantic States to adverse loss development on the business of Donegal Mutual that the pool includes. However, pooled business represents the predominant percentage of the net underwriting activity of both companies, and Donegal Mutual and Atlantic States share proportionately any adverse risk development relating to the pooled business. The business in the pool is homogeneous and each company has a pro-rata share of the entire pool. Since the predominant percentage of the business of Atlantic States and Donegal Mutual is pooled and the results shared by each company according to its participation level under the terms of the pooling agreement, the intent of the underwriting pool is to produce a more uniform and stable underwriting result from year to year for each company than either would experience individually and to spread the risk of loss between the companies.

Donegal Mutual and our insurance subsidiaries operate together as the Donegal Insurance Group and share a combined business plan designed to achieve market penetration and underwriting profitability objectives. The products our insurance subsidiaries and Donegal Mutual offer are generally complementary, thereby allowing Donegal Insurance Group to offer a broader range of products to a given market and to expand Donegal Insurance Group's ability to service an entire personal lines or commercial lines account. Distinctions within the products of Donegal Mutual and our insurance subsidiaries generally relate to specific risk profiles targeted within similar classes of business, such as preferred tier products compared to standard tier products, but we do not allocate all of the standard risk gradients to one company. Therefore, the underwriting profitability of the business the individual companies write directly will vary. However, because the pool homogenizes the risk characteristics of the predominant percentage of the business Donegal Mutual and Atlantic States write directly and each company shares the underwriting results according to each company's participation percentage, each company realizes its percentage share of the underwriting results of the pool.

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Our insurance subsidiaries' unpaid liability for losses and loss expenses by major line of business at September 30, 2020 and December 31, 2019 consisted of the following:

	September 30, 2020	December 31, 2019
	(in thousands)	
<b>Commercial lines:</b>		
Automobile	\$ 143,055	\$ 126,224
Workers' compensation	117,583	109,060
Commercial multi-peril	116,498	102,424
Other	13,279	9,115
Total commercial lines	<u>390,415</u>	<u>346,823</u>
<b>Personal lines:</b>		
Automobile	124,976	132,191
Homeowners	20,074	23,494
Other	6,284	4,398
Total personal lines	<u>151,334</u>	<u>160,083</u>
Total commercial and personal lines	541,749	506,906
Plus reinsurance recoverable	400,181	362,768
Total liability for unpaid losses and loss expenses	<u>\$ 941,930</u>	<u>\$ 869,674</u>

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

Percentage Change in Loss and Loss Expense Reserves Net of Reinsurance	Adjusted Loss and Loss Expense Reserves Net of Reinsurance at September 30, 2020	Percentage Change in Stockholders' Equity at September 30, 2020(1)	Adjusted Loss and Loss Expense Reserves Net of Reinsurance at December 31, 2019	Percentage Change in Stockholders' Equity at December 31, 2019(1)
		(dollars in thousands)		
(10.0)%	\$487,574	8.5%	\$456,215	8.9%
(7.5)	501,118	6.4	468,888	6.7
(5.0)	514,662	4.2	481,561	4.4
(2.5)	528,205	2.1	494,233	2.2
Base	541,749	—	506,906	—
2.5	555,293	(2.1)	519,579	(2.2)
5.0	568,836	(4.2)	532,251	(4.4)
7.5	582,380	(6.4)	544,924	(6.7)
10.0	595,924	(8.5)	557,597	(8.9)

(1) Net of income tax effect.

### Non-GAAP Information

We prepare our consolidated financial statements on the basis of GAAP. Our insurance subsidiaries also prepare financial statements based on statutory accounting principles state insurance regulators prescribe or permit ("SAP"). SAP financial measures are considered non-GAAP financial measures under applicable SEC rules because the SAP financial measures include or exclude certain items that the most comparable GAAP financial measures do not ordinarily include or exclude. Our calculation of non-GAAP financial measures may differ from similar measures other companies use, so investors should exercise caution when comparing our non-GAAP financial measures to the non-GAAP financial measures other companies use.

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Because our insurance subsidiaries do not prepare GAAP financial statements, we evaluate the performance of our personal lines and commercial lines segments utilizing SAP financial measures that reflect the growth trends and underwriting results of our insurance subsidiaries. The SAP financial measures we utilize are net premiums written and statutory combined ratio.

### *Net Premiums Written*

We define net premiums written as the amount of full-term premiums our insurance subsidiaries record for policies effective within a given period less premiums our insurance subsidiaries cede to reinsurers. Net premiums earned is the most comparable GAAP financial measure to net premiums written. Net premiums earned represent the sum of the amount of net premiums written and the change in net unearned premiums during a given period. Our insurance subsidiaries earn premiums and recognize them as revenue over the terms of their policies, which are one year or less in duration. Therefore, increases or decreases in net premiums earned generally reflect increases or decreases in net premiums written in the preceding 12-month period compared to the comparable period one year earlier.

The following table provides a reconciliation of our net premiums earned to our net premiums written for the three and nine months ended September 30, 2020 and 2019:

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2020</u>	<u>2019</u>	<u>2020</u>	<u>2019</u>
	(in thousands)			
Net premiums earned	\$ 184,926	\$ 189,821	\$ 556,552	\$ 566,658
Change in net unearned premiums	(4,146)	(5,951)	16,168	14,930
Net premiums written	<u>\$ 180,780</u>	<u>\$ 183,870</u>	<u>\$ 572,720</u>	<u>\$ 581,588</u>

### *Statutory Combined Ratio*

The combined ratio is a standard measurement of underwriting profitability for an insurance company. The combined ratio does not reflect investment income, net investment gains or losses, federal income taxes or other non-operating income or expense. A combined ratio of less than 100% generally indicates underwriting profitability.

The statutory combined ratio is a non-GAAP financial measure that is based upon amounts determined under SAP. We calculate our statutory combined ratio as the sum of:

- the statutory loss ratio, which is the ratio of calendar-year net incurred losses and loss expenses to net premiums earned;
- the statutory expense ratio, which is the ratio of expenses incurred for net commissions, premium taxes and underwriting expenses to net premiums written; and
- the statutory dividend ratio, which is the ratio of dividends to holders of workers' compensation policies to net premiums earned.

The calculation of our statutory combined ratio differs from the calculation of our GAAP combined ratio. In calculating our GAAP combined ratio, we do not deduct installment payment fees from incurred expenses, and we base the expense ratio on net premiums earned instead of net premiums written. Differences between our GAAP loss ratio and our statutory loss ratio result from anticipating salvage and subrogation recoveries for our GAAP loss ratio but not for our statutory loss ratio.

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### Combined Ratios

The following table presents comparative details with respect to our GAAP and statutory combined ratios for the three and nine months ended September 30, 2020 and 2019:

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2020</u>	<u>2019</u>	<u>2020</u>	<u>2019</u>
<b>GAAP Combined Ratios (Total Lines)</b>				
Loss ratio (non-weather)	56.3%	61.6%	54.1%	60.8%
Loss ratio (weather-related)	9.1	7.3	7.6	7.2
Expense ratio	31.9	30.5	33.2	31.5
Dividend ratio	1.0	1.2	1.0	1.2
Combined ratio	<u>98.3%</u>	<u>100.6%</u>	<u>95.9%</u>	<u>100.7%</u>
<b>Statutory Combined Ratios</b>				
Commercial lines:				
Automobile	109.9%	113.9%	110.5%	114.3%
Workers' compensation	86.8	85.4	85.9	82.0
Commercial multi-peril	109.2	98.7	98.1	94.4
Other	93.5	76.6	79.5	79.3
Total commercial lines	102.4	97.9	97.3	95.8
Personal lines:				
Automobile	89.0	103.3	88.6	103.9
Homeowners	97.7	109.4	99.3	106.0
Other	84.0	73.6	76.5	77.7
Total personal lines	91.9	103.9	91.6	103.3
Total commercial and personal lines	97.7	100.8	94.7	99.5

## Results of Operations - Three Months Ended September 30, 2020 Compared to Three Months Ended September 30, 2019

*Net Premiums Earned.* Our insurance subsidiaries' net premiums earned for the third quarter of 2020 were \$184.9 million, a decrease of \$4.9 million, or 2.6%, compared to \$189.8 million for the third quarter of 2019, primarily reflecting decreases in net premiums written during 2020 and 2019.

*Net Premiums Written.* Our insurance subsidiaries' net premiums written for the three months ended September 30, 2020 were \$180.8 million, a decrease of \$3.1 million, or 1.7%, from the \$183.9 million of net premiums written for the third quarter of 2019. Commercial lines net premiums written increased \$4.1 million, or 4.3%, for the third quarter of 2020 compared to the third quarter of 2019. We attribute the increase in commercial lines net premiums written primarily to increased writings of new commercial accounts and net premium rate increases. Personal lines net premiums written decreased \$7.2 million, or 8.0%, for the third quarter of 2020 compared to the third quarter of 2019. We attribute the decrease in personal lines net premiums written primarily to net attrition as a result of measures our insurance subsidiaries have implemented to improve underwriting profitability, partially offset by the impact of premium rate increases our insurance subsidiaries have implemented.

*Investment Income.* Our net investment income was \$7.4 million for the third quarter of 2020 and 2019.

*Net Investment Gains (Losses).* Net investment gains for the third quarter of 2020 were \$3.3 million, compared to net investment losses of \$369,041 for the third quarter of 2019. The net investment gains for the third quarter of 2020 resulted primarily from unrealized gains within our equity securities portfolio at September 30, 2020. We did not recognize any impairment losses in our investment portfolio during the third quarter of 2020 or 2019.

*Losses and Loss Expenses.* Our insurance subsidiaries' loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, was 65.4% for the third quarter of 2020, a decrease from our insurance subsidiaries' loss ratio of 68.9% for the third quarter of 2019. We attribute this decrease primarily to various actions we implemented to improve profitability and reduced frequency of personal automobile claims as a result of lower traffic density during the third quarter of 2020. Weather-related losses of \$16.9 million for the third quarter of 2020, or 9.1 percentage points of the loss ratio, increased from \$13.9 million, or 7.3 percentage points of the loss ratio, for the third quarter of 2019. Weather-related loss activity for the third quarter of 2020 was comparable to our previous five-year average of \$15.9 million for third quarter weather-related losses. On a statutory basis, our insurance subsidiaries' commercial lines loss ratio was 68.2% for the third quarter of 2020, compared to 65.2% for the third quarter of 2019, primarily due to a weather-related increase in the commercial multiple-peril loss ratio. The personal lines statutory loss ratio of our insurance subsidiaries decreased to 61.1% for the third quarter of 2020, compared to 73.4% for the third quarter of 2019. We attribute this decrease primarily to decreases in the homeowners and personal automobile loss ratios. Our insurance subsidiaries experienced unfavorable loss reserve development of approximately \$542,000 during the third quarter of 2020, compared to favorable loss reserve development of \$1.0 million during the third quarter of 2019.

*Underwriting Expenses.* The expense ratio for an insurance company is the ratio of policy acquisition costs and other underwriting expenses to premiums earned. The expense ratio of our insurance subsidiaries was 31.9% for the third quarter of 2020, compared to 30.5% for the third quarter of 2019. The increase in the expense ratio primarily reflected an increase in technology systems-related expenses, higher commercial growth incentive costs for our agents and increased underwriting-based incentive costs for our agents and employees during the third quarter of 2020 compared to the third quarter of 2019. The increase in technology systems-related expenses was primarily due to an increased allocation of costs from Donegal Mutual to our insurance subsidiaries following the successful implementation of the first phase of our ongoing systems modernization project in February 2020.

*Combined Ratio.* The combined ratio represents the sum of the loss ratio, the expense ratio and the dividend ratio, which is the ratio of policyholder dividends incurred to premiums earned. Our insurance subsidiaries' combined ratios were 98.3% and 100.6% for the third quarter ended September 30, 2020 and 2019, respectively. We attribute the decrease in the combined ratio primarily to a decrease in the loss ratio for the third quarter of 2020 compared to the third quarter of 2019.

*Interest Expense.* Our interest expense for the third quarter of 2020 was \$219,039, compared to \$443,179 for the third quarter of 2019. We attribute the decrease primarily to a pre-payment penalty of \$176,000 incurred during the third quarter of 2019 related to Atlantic States' early repayment of a cash advance with the FHLB of Pittsburgh.

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*Income Taxes.* We recorded income tax expense of \$2.5 million for the third quarter of 2020, representing an effective tax rate of 17.4%. We recorded income tax expense of \$1.1 million for the third quarter of 2019, representing an effective tax rate of 17.7%. The income tax expense and effective tax rate for the third quarter of 2020 and 2019 represented an estimate based on our projected annual taxable income.

*Net Income and Income Per Share.* Our net income for the third quarter of 2020 was \$11.8 million, or \$.41 per diluted share of Class A common stock and \$.37 per share of Class B common stock, compared to \$5.2 million, or \$.18 per diluted share of Class A common stock and \$.16 per share of Class B common stock, for the third quarter of 2019. We had 24.1 million and 23.0 million Class A shares outstanding at September 30, 2020 and 2019, respectively. We had 5.6 million Class B shares outstanding at the end of both periods.

### **Results of Operations - Nine Months Ended September 30, 2020 Compared to Nine Months Ended September 30, 2019**

*Net Premiums Earned.* Our insurance subsidiaries' net premiums earned for the first nine months of 2020 were \$556.6 million, a decrease of \$10.1 million, or 1.8%, compared to \$566.7 million for the first nine months of 2019, primarily reflecting decreases in net premiums written during 2020 and 2019.

*Net Premiums Written.* Our insurance subsidiaries' net premiums written for the nine months ended September 30, 2020 were \$572.7 million, a decrease of \$8.9 million, or 1.5%, from the \$581.6 million of net premiums written for the first nine months of 2019. Commercial lines net premiums written increased \$16.2 million, or 5.2%, for the first nine months of 2020 compared to the first nine months of 2019. We attribute the increase in commercial lines net premiums written primarily to increased writings of new commercial accounts and net premium rate increases. Personal lines net premiums written decreased \$25.1 million, or 9.3%, for the first nine months of 2020 compared to the first nine months of 2019. We attribute the decrease in personal lines net premiums written primarily to net attrition as a result of measures our insurance subsidiaries have implemented to improve underwriting profitability, partially offset by the impact of premium rate increases our insurance subsidiaries have implemented.

*Investment Income.* Our net investment income increased slightly to \$22.0 million for the first nine months of 2020, compared to \$21.7 million for the first nine months of 2019. We attribute the increase primarily to an increase in average invested assets, offset partially by a decrease in the average investment yield.

*Net Investment (Losses) Gains.* Net investment losses for the first nine months of 2020 were \$940,488, compared to net investment gains of \$19.3 million for the first nine months of 2019. The net investment losses for the first nine months of 2020 resulted primarily from realized losses on sales of equity securities, offset partially by unrealized gains in the fair value of equity securities held at September 30, 2020. The net investment gains for the first nine months of 2019 included \$12.7 million from the sale of DFSC and \$5.5 million related to unrealized gains within our equity securities portfolio and a limited partnership that invests in equity securities. We did not recognize any impairment losses in our investment portfolio during the first nine months of 2020 or 2019.

*Losses and Loss Expenses.* Our insurance subsidiaries' loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, was 61.7% for the first nine months of 2020, a decrease from our insurance subsidiaries' loss ratio of 68.0% for the first nine months of 2019. We attribute this decrease primarily to various actions we implemented to improve profitability and reduced frequency of personal automobile claims as a result of lower driving activity during the second quarter of 2020 and lower traffic density during the third quarter of 2020. Weather-related losses of \$42.5 million for the first nine months of 2020, or 7.6 percentage points of the loss ratio, increased from \$40.6 million, or 7.2 percentage points of the loss ratio, for the first nine months of 2019. Weather-related loss activity for the first nine months of 2020 was comparable to our previous five-year average of \$41.6 million for first nine months weather-related losses. On a statutory basis, our insurance subsidiaries' commercial lines loss ratio was 63.1% for the first nine months of 2020, compared to 63.2% for the first nine months of 2019, primarily due to a decrease in the commercial automobile loss ratio. The personal lines statutory loss ratio of our insurance subsidiaries decreased to 59.8% for the first nine months of 2020, compared to 72.7% for the first nine months of 2019. We attribute this decrease primarily to decreases in the homeowners and personal automobile loss ratios. Our insurance subsidiaries experienced favorable loss reserve development of approximately \$10.3 million and \$7.9 million during the first nine months of 2020 and 2019, respectively.

*Underwriting Expenses.* The expense ratio for an insurance company is the ratio of policy acquisition costs and other underwriting expenses to premiums earned. The expense ratio of our insurance subsidiaries was 33.2% for the first nine months of 2020, compared to 31.5% for the first nine months of 2019. The increase in the expense ratio primarily reflected \$2.0 million in reserves we established during the first nine months of 2020 for potential credit losses related to uncollectible premiums due to the effect of COVID-19 economic disruption, an increase in technology systems-related expenses, higher commercial growth

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incentive costs for our agents and increased underwriting-based incentive costs for our agents and employees. The increase in technology systems-related expenses was primarily due to an increased allocation of costs from Donegal Mutual to our insurance subsidiaries following the successful implementation of the first phase of our ongoing systems modernization project in February 2020.

*Combined Ratio.* The combined ratio represents the sum of the loss ratio, the expense ratio and the dividend ratio, which is the ratio of policyholder dividends incurred to premiums earned. Our insurance subsidiaries' combined ratios were 95.9% and 100.7% for the nine months ended September 30, 2020 and 2019, respectively. We attribute the decrease in the combined ratio to a decrease in the loss ratio for the first nine months of 2020 compared to the first nine months of 2019.

*Interest Expense.* Our interest expense for the first nine months of 2020 was \$871,461, compared to \$1.3 million for the first nine months of 2019. We attribute the decrease primarily to lower average interest rates for borrowings under our lines of credit, offset partially by higher average borrowings during the first nine months of 2020 compared to the first nine months of 2019.

*Income Taxes.* We recorded income tax expense of \$6.6 million for the first nine months of 2020, representing an effective tax rate of 14.7%. Income tax expense for the first nine months of 2020 included a \$1.6 million income tax benefit related to the carryback of 2018 net operating losses to past tax years with higher statutory income tax rates than are currently in effect, as allowed under the Coronavirus Aid, Relief and Economic Security Act that was enacted in March 2020. We recorded income tax expense of \$5.7 million for the first nine months of 2019, representing an effective tax rate of 14.7%. The income tax expense and effective tax rate for the first nine months of 2020 and 2019 primarily represented an estimate based on our projected annual taxable income.

*Net Income and Income Per Share.* Our net income for the first nine months of 2020 was \$38.2 million, or \$1.33 per diluted share of Class A common stock and \$1.21 per share of Class B common stock, compared to \$33.0 million, or \$1.17 per diluted share of Class A common stock and \$1.06 per share of Class B common stock, for the first nine months of 2019. We had 24.1 million and 23.0 million Class A shares outstanding at September 30, 2020 and 2019, respectively. We had 5.6 million Class B shares outstanding at the end of both periods.

### **Liquidity and Capital Resources**

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

Our operations have historically generated sufficient net positive cash flow to fund our commitments and add to our investment portfolio, thereby increasing future investment returns and enhancing our liquidity. The impact of the pooling agreement between Donegal Mutual and Atlantic States has historically been cash-flow positive because of the consistent underwriting profitability of the pool. Donegal Mutual and Atlantic States settle their respective obligations to each other under the pool monthly, thereby resulting in cash flows substantially similar to the cash flows that would result from each company writing the business directly. We have not experienced any unusual variations in the timing of claim payments associated with the loss reserves of our insurance subsidiaries. We maintain significant liquidity in our investment portfolio in the form of readily marketable fixed maturities, equity securities and short-term investments. We structure our fixed-maturity investment portfolio following a "laddering" approach, so that projected cash flows from investment income and principal maturities are evenly distributed from a timing perspective, thereby providing an additional measure of liquidity to meet our obligations should an unexpected variation occur in the future. Our operating activities provided net cash flows in the first nine months of 2020 and 2019 of \$68.5 million and \$48.4 million, respectively.

At September 30, 2020, we had no outstanding borrowings under our line of credit with M&T and had the ability to borrow up to \$20.0 million at interest rates equal to the then-current LIBOR rate plus 2.00%. At September 30, 2020, Atlantic States had \$85.0 million in outstanding advances with the FHLB of Pittsburgh, consisting of a \$35.0 million advance that carries a fixed interest rate of 1.74% and a \$50.0 million advance that carries a fixed interest rate of 0.83%. In March 2020, Atlantic States issued \$50.0 million of debt to the FHLB of Pittsburgh in exchange for a cash advance in the same amount. Atlantic States obtained this contingent liquidity funding in light of uncertainty surrounding the economic impact of the COVID-19 pandemic.

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The following table shows our expected payments for significant contractual obligations at September 30, 2020:

	<u>Total</u>	<u>Less than 1 year</u>	<u>1-3 years</u>	<u>4-5 years</u>	<u>After 5 years</u>
			(in thousands)		
Net liability for unpaid losses and loss expenses of our insurance subsidiaries	\$541,749	\$ 244,246	\$255,615	\$20,374	\$ 21,514
Subordinated debentures	5,000	—	—	—	5,000
Borrowings under lines of credit	85,000	50,000	—	35,000	—
Total contractual obligations	<u>\$631,749</u>	<u>\$ 294,246</u>	<u>\$255,615</u>	<u>\$55,374</u>	<u>\$ 26,514</u>

We estimate the date of payment for the net liability for unpaid losses and loss expenses of our insurance subsidiaries based on historical experience and expectations of future payment patterns. We show the liability net of reinsurance recoverable on unpaid losses and loss expenses to reflect expected future cash flows related to such liability. Amounts Atlantic States assumes pursuant to the pooling agreement with Donegal Mutual represent a substantial portion of our insurance subsidiaries' gross liability for unpaid losses and loss expenses, and amounts Atlantic States cedes pursuant to the pooling agreement represent a substantial portion of our insurance subsidiaries' reinsurance recoverable on unpaid losses and loss expenses. We include cash settlement of Atlantic States' assumed liability from the pool in monthly settlements of pooled activity, as we net amounts ceded to and assumed from the pool. Although Donegal Mutual and we do not anticipate any changes in the pool participation levels in the foreseeable future, any such change would be prospective in nature and therefore would not impact the timing of expected payments by Atlantic States for its percentage share of pooled losses occurring in periods prior to the effective date of such change.

We discuss in Note 7 – Borrowings our estimate of the timing of the amounts payable for the borrowings under our lines of credit based on their contractual maturities. The borrowings under our lines of credit carry interest rates that we discuss in Note 7 – Borrowings.

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

On July 18, 2013, our board of directors authorized a share repurchase program pursuant to which we have the authority to purchase up to 500,000 shares of our Class A common stock at prices prevailing from time to time in the open market subject to the provisions of applicable rules of the SEC and in privately negotiated transactions. We did not purchase any shares of our Class A common stock under this program during the nine months ended September 30, 2020 or 2019. We have purchased a total of 57,658 shares of our Class A common stock under this program from its inception through September 30, 2020.

On October 15, 2020, our board of directors declared quarterly cash dividends of 15.0 cents per share of our Class A common stock and 13.25 cents per share of our Class B common stock, payable on November 16, 2020 to our stockholders of record as of the close of business on November 2, 2020. We are not subject to any restrictions on our payment of dividends to our stockholders, although there are state law restrictions on the payment of dividends by our insurance subsidiaries to us. Dividends from our insurance subsidiaries are our principal source of cash for payment of dividends to our stockholders. Our insurance subsidiaries are subject to regulations that restrict the payment of dividends from statutory surplus and may require prior approval of their domiciliary insurance regulatory authorities. Our insurance subsidiaries are also subject to risk based capital ("RBC") requirements that limit their ability to pay dividends to us. Our insurance subsidiaries' statutory capital and surplus at December 31, 2019 exceeded the amount of statutory capital and surplus necessary to satisfy regulatory requirements, including the RBC requirements, by a significant margin. Our insurance subsidiaries paid \$14.0 million in dividends to us during the first nine months of 2020. Amounts remaining available for distribution to us as dividends from our insurance subsidiaries without prior approval of their domiciliary insurance regulatory authorities in 2020 are \$20.9 million from Atlantic States, \$0 from Southern, \$1.0 million from Peninsula and \$576,859 from MICO, or a total of approximately \$22.5 million.

At September 30, 2020, we had no material commitments for capital expenditures.

### **Equity Price Risk**

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

### **Credit Risk**

Our portfolio of fixed-maturity securities and, to a lesser extent, our portfolio of short-term investments is subject to credit risk, which we define as the potential loss in market value resulting from adverse changes in the borrower's ability to repay its debt. We manage this risk by having our investment personnel perform an analysis of prospective investments and regular reviews of our portfolio of fixed-maturity securities. We also limit the percentage and amount of our total investment portfolio that we invest in the securities of any one issuer.

Our insurance subsidiaries provide property and casualty insurance coverages through independent insurance agencies. We bill the majority of this business directly to the insured, although we bill a portion of our commercial business through licensed insurance agents to whom our insurance subsidiaries extend credit in the normal course of business.

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

### **Impact of Inflation**

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

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

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

Other than interest rate and pricing fluctuations related to the COVID-19 pandemic, there have been no material changes to our quantitative or qualitative market risk exposure from December 31, 2019 through September 30, 2020.

### **Item 4. Controls and Procedures.**

#### **Evaluation of Disclosure Controls and Procedures**

Our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act). Based on such evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that, at September 30, 2020, our disclosure controls and procedures were effective in recording, processing, summarizing and reporting, on a timely basis, information we are required to disclose in the reports that we file or submit under the Exchange Act, and our disclosure controls and procedures were also effective to ensure that information we disclose in the reports we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, to allow timely decisions regarding required disclosure.

## **Changes in Internal Control Over Financial Reporting**

During 2020, Donegal Mutual implemented new infrastructure and applications systems that Donegal Mutual and our insurance subsidiaries began to utilize for the issuance of new and renewal workers' compensation policies effective beginning in the second quarter of 2020. Such changes resulted in changes to procedures related to our financial reporting. Prior to the implementation of the new systems, we identified and designed new internal controls that we incorporated into our internal controls over financial reporting. Following the implementation, we validated these new controls according to our established processes. The implementation of the new systems represented the first phase of a multi-year systems modernization initiative Donegal Mutual is implementing to achieve various benefits for Donegal Mutual and our insurance subsidiaries, including streamlined workflows and innovative business solutions. We are not implementing these changes in internal controls to respond to any actual or perceived significant deficiencies in our internal control over financial reporting.

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

We base all statements contained in this Quarterly Report on Form 10-Q that are not historic facts on our current expectations. Such statements are forward-looking in nature (as defined in the Private Securities Litigation Reform Act of 1995) and necessarily involve risks and uncertainties. Forward-looking statements we make may be identified by our use of words such as "will," "expects," "intends," "plans," "anticipates," "believes," "seeks," "estimates" and similar expressions. Our actual results could vary materially from our forward-looking statements. The factors that could cause our actual results to vary materially from the forward-looking statements we have previously made include, but are not limited to, prolonged economic challenges resulting from the COVID-19 pandemic and related business shutdown, adverse and catastrophic weather events, our ability to maintain profitable operations, the adequacy of the loss and loss expense reserves of our insurance subsidiaries, the availability and successful operation of the information technology systems our insurance subsidiaries utilize, the successful development of new information technology systems to allow our insurance subsidiaries to compete effectively, business and economic conditions in the areas in which we and our insurance subsidiaries operate, interest rates, competition from various insurance and other financial businesses, terrorism, the availability and cost of reinsurance, legal and judicial developments including those related to COVID-19 business interruption coverage exclusions, adverse litigation and other industry trends that could increase our loss costs, changes in regulatory requirements, changes in our A.M. Best rating, our ability to integrate and manage successfully the companies we may acquire from time to time and the other risks that we describe from time to time in our filings with the SEC. We disclaim any obligation to update such statements or to announce publicly the results of any revisions that we may make to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

## **Part II. Other Information**

### **Item 1. Legal Proceedings.**

None.

### **Item 1A. Risk Factors.**

Our business, results of operations and financial condition, and, therefore, the value of our Class A common stock and our Class B common stock, are subject to a number of risks. For a description of certain risks, we refer to "Risk Factors" in our 2019 Annual Report on Form 10-K that we filed with the SEC on March 6, 2020. Other than the information we discuss below, there have been no material changes in the risk factors we disclosed in that Form 10-K Report during the nine months ended September 30, 2020.

***The emergence of COVID-19 has impacted the business operations of our insurance subsidiaries, and economic disruption related to the ongoing COVID-19 pandemic may adversely affect our revenues, profitability, results of operations, cash flows, liquidity and financial condition.***

In the first nine months of 2020, the COVID-19 pandemic resulted in significant disruptions in economic activity throughout our operating regions. COVID-19 concerns have also contributed to financial market volatility. We cannot predict at this time the ultimate impact that the economic and financial disruption related to the ongoing COVID-19 pandemic or any other future pandemic will have on us. Risks related to COVID-19 include, but are not limited to, the following:

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- The business operations of our insurance subsidiaries could be disrupted by the illness of significant numbers of their employees and remedial efforts that would be required upon discovery of exposure to COVID-19 within their facilities.
- The business operations of our insurance subsidiaries are dependent upon technology systems for which regular physical access is required to maintain critical operational capabilities. The business operations of our insurance subsidiaries would be adversely impacted by government mandates requiring closure of facilities where those technology systems are located or restricting physical access to such facilities.
- The revenues of our insurance subsidiaries may decrease as a result of reduced demand for their insurance products as the ongoing economic disruption adversely impacts current and potential insurance customers.
- Our insurance subsidiaries may incur an increase in their losses and loss expenses in certain lines of business as a result of COVID-19 and related economic disruption, and such losses and loss expenses may exceed the reserves our insurance subsidiaries have established or may establish in the future.
- Our insurance subsidiaries may incur increased costs related to legal disputes over policy coverages or exclusions and their defense against litigation related to COVID-19.
- Legislative, judicial and regulatory actions may expand coverage definitions, retroactively mandate coverage or otherwise require our insurance subsidiaries to pay losses for damages that their policies explicitly excluded or did not intend to cover.
- Legislative, judicial and regulatory actions may require our insurance subsidiaries to reduce or refund premiums, suspend cancellation of policies for non-payment of premiums or otherwise grant extended grace periods and time allowances for the payment of premium balances due to them.
- Our insurance subsidiaries may not be able to collect premium balances due to them, resulting in reduced operating cash flows and an increase in premium write-offs that would increase their operating expenses.
- Our insurance subsidiaries may suffer declines in the market values of their investments as a result of financial market volatility related to COVID-19 concerns and related economic disruption.
- Our insurance subsidiaries may experience declines in investment income as a result of lower interest rates that may be available upon reinvestment of the proceeds of maturing investments.
- Economic disruption related to COVID-19 could result in significant declines in the credit quality of issuers, ratings downgrades or changes in financial market conditions and regulatory changes that might adversely impact the value of the fixed-maturity investments that our insurance subsidiaries own.

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

<b>Period</b>	<b>(a) Total Number of Shares (or Units) Purchased</b>	<b>(b) Average Price Paid per Share (or Unit)</b>	<b>(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs</b>	<b>(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs</b>
Month #1 July 1-31, 2020	Class A – None Class B – None	Class A – None Class B – None	Class A – None Class B – None	
Month #2 August 1-31, 2020	Class A – 101,667 Class B – None	Class A – \$14.87 Class B – None	Class A – 101,667 Class B – None	(1)
Month #3 September 1-30, 2020	Class A – 180,000 Class B – None	Class A – \$14.79 Class B – None	Class A – 180,000 Class B – None	(1)
Total	Class A – 281,667 Class B – None	Class A – \$14.82 Class B – None	Class A – 281,667 Class B – None	

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

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

None.

### **Item 4. Removed and Reserved.**

### **Item 5. Other Information.**

None.

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### **Item 6. Exhibits.**

<u>Exhibit No.</u>	<u>Description</u>
Exhibit 31.1	<a href="#">Certification of Chief Executive Officer</a>
Exhibit 31.2	<a href="#">Certification of Chief Financial Officer</a>
Exhibit 32.1	<a href="#">Statement of Chief Executive Officer pursuant to 18 U.S.C. Section 1350 of Title 18 of the United States Code</a>
Exhibit 32.2	<a href="#">Statement of Chief Financial Officer pursuant to 18 U.S.C. Section 1350 of Title 18 of the United States Code</a>
Exhibit 101.INS	XBRL Instance Document
Exhibit 101.SCH	XBRL Taxonomy Extension Schema Document
Exhibit 101.PRE	XBRL Taxonomy Presentation Linkbase Document
Exhibit 101.CAL	XBRL Taxonomy Calculation Linkbase Document
Exhibit 101.LAB	XBRL Taxonomy Label Linkbase Document
Exhibit 101.DEF	XBRL Taxonomy Extension Definition Linkbase Document

**Signatures**

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

**DONEGAL GROUP INC.**

November 5, 2020

**By:** /s/ Kevin G. Burke  
Kevin G. Burke, President and Chief Executive Officer

November 5, 2020

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

## CERTIFICATION

I, Kevin G. Burke, certify that:

1. I have reviewed this quarterly report on Form 10-Q for the quarter ended September 30, 2020 of Donegal Group Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 5, 2020

/s/ Kevin G. Burke

Kevin G. Burke,  
President and Chief Executive Officer

## CERTIFICATION

I, Jeffrey D. Miller, certify that:

1. I have reviewed this quarterly report on Form 10-Q for the quarter ended September 30, 2020 of Donegal Group Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 5, 2020

/s/ Jeffrey D. Miller

Jeffrey D. Miller, Executive Vice President  
and Chief Financial Officer

Statement of President  
Pursuant to Section 1350 of Title 18 of the United States Code

Pursuant to Section 1350 of Title 18 of the United States Code, I, Kevin G. Burke, the President and Chief Executive Officer of Donegal Group Inc. (the "Company"), hereby certify that, to the best of my knowledge:

1. The Company's Form 10-Q Quarterly Report for the period ended September 30, 2020 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 5, 2020

/s/ Kevin G. Burke

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Kevin G. Burke,  
President and Chief Executive Officer

Statement of Chief Financial Officer  
Pursuant to Section 1350 of Title 18 of the United States Code

Pursuant to Section 1350 of Title 18 of the United States Code, I, Jeffrey D. Miller, the Executive Vice President and Chief Financial Officer of Donegal Group Inc. (the "Company"), hereby certify that, to the best of my knowledge:

1. The Company's Form 10-Q Quarterly Report for the period ended September 30, 2020 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 5, 2020

/s/ Jeffrey D. Miller

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Jeffrey D. Miller, Executive Vice President  
and Chief Financial Officer