

Brackbill, Robert

From: Peterson, J. Victor (LG) [VPeterson@LATHROPGAGE.COM]
Sent: Monday, April 15, 2013 1:25 PM
To: Brackbill, Robert
Subject: Gregory Shepard
Attachments: Gregory M. Shepard Press Release dated April 11, 2013.PDF; Letter from Gregory M. Shepard to Donald H. Nikolaus, CEO of Donegal Group Inc., dated April 10, 2013.PDF; Report of Duff & Phelps, LLC dated April 10, 2013.PDF

Dear Mr. Brackbill,

Please post the attached documents relating to Gregory Shepard's tender offer for shares of Donegal Group Inc. on the web page for Mr. Shepard's Form A filing.

Thank you.

Regards,

Vic Peterson

**LATHROP
& GAGE** LLP

**Vic Peterson
Of Counsel**

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Gregory M. Shepard
7028 Portmarnock Place
Bradenton, Florida 34202

April 10, 2013

Mr. Donald H. Nikolaus
President & Chief Executive Officer
Donegal Group, Inc.
1195 River Road
Marietta, Pennsylvania 17547

Re: Request for Explanation of Extraordinarily High Level of Option Grants

Dear Mr. Nikolaus:

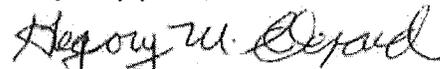
As you know, I have been a longstanding shareholder of Donegal Group, Inc. ("Donegal") and currently hold 3,602,900 shares of Class A and 397,100 shares of Class B stock.

I am very disappointed that you have continued to issue options, especially to yourself and the other executives and directors, including Donegal Mutual Insurance Company directors, in such an outrageously high manner in comparison to even the industry peer companies identified by Donegal. These option grants are potentially highly dilutive to the shareholders.

I would like you to explain to the shareholders at the upcoming Annual Meeting on April 18, 2013, why you believe this was in the shareholders' best interest, given the dismal price performance of Donegal's Class A shares and Class B shares over the last seven years.

I attach an analysis that was compiled based on publicly available data by Duff & Phelps. I ask you to distribute this letter to the shareholders at the annual meeting and to discuss and justify your actions.

Very truly yours,


Gregory M. Shepard

Memo

To: Gregory M. Shepard
From: Duff & Phelps, LLC
Subject: Analysis of Options Grants of Donegal Group, Inc,
Date: April 10, 2013

Dear Mr. Shepard:

We were engaged to perform an analysis of the option grants made by Donegal Group ("Donegal"). Listed below is a summary of our findings. Please refer to the attached appendix which has schedules supporting our analysis.

I. Current Options

- Donegal has 3.1 million Vested options as of 12/31/2012, which is in the upper quartile of the group of selected guideline public companies ("GPCs")
- Donegal has 3.6 million Unvested options as of 12/31/2012, which is the highest number in the group of selected GPCs
- The number of Donegal's in-the-money options is equal to 3.9 million, which equates to a \$3.4 million liability, if exercised
- Relative to GPC, Donegal:
 - o has the highest number of Options Granted with 1.8 million, 2.3 million and 1.3 million, in 2010, 2011 and 2012, respectively
 - o has the highest number of Options Granted in relation to Total Number of Shares Outstanding, with 9.0%, 11.5% and 6.5% in 2010, 2011 and 2012, respectively, all of which are at least 6.0x the average of the GPCs
 - o has the highest number of Options Granted from 2010-2012 in relation to Total Shares Outstanding at 27.0%

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- o has the highest number of Options Granted (Cumulative) in relation to the Total Number of Shares Outstanding, with 20.0%, 26.5% and 33.4% in 2010, 2011 and 2012
- o is the highest in Option Value (calculated as Fair Value as of the date of grant) for all options granted from 2010-2012 as % of Market Capitalization (2.7%)¹
- o is the highest in its group of GPCs in Total Value of Options at Grant Date in 2012, with \$10.3 million in value²
- o is in the top of the upper quartile in its group of GPCs in Options Granted (Cumulative), with 4.0 million, 5.3 million and 6.70 million options outstanding in 2010, 2011 and 2012, respectively.

II. Earnings Dilution

- The analysis in Section II assumes that the additional 10 million shares are authorized and issued in 2013.
- We assume two different Net Income Forecasts for 2013.
 - o If we assume that 2013 Net Income remains unchanged from 2012 at \$18.5:
 - The increase in Class A Shares Outstanding would dilute EPS from \$0.91 in 2012 to \$0.61 in 2013
 - This increase in Class A Shares Outstanding would also result in decreased earnings attributable to Mr. Shepherd from \$3.27 million in 2012 to \$2.19 million in 2013
 - o If we assume that 2013 Net Income increased to \$24.1 million (based on a forecast from Thomson Reuters):
 - The increase in Total Number of Class A Shares Outstanding would dilute EPS from \$0.91 in 2012 to \$0.79 in 2013

¹ This analysis excludes certain competitors whose Market Capitalization was less than \$250 million or greater than \$750 million as of 12/31/2012.

² Id.

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- This increase in Class A Shares Outstanding would also result in decreased earnings attributable to Mr. Shepherd from \$3.27 million in 2012 to \$2.86 million in 2013

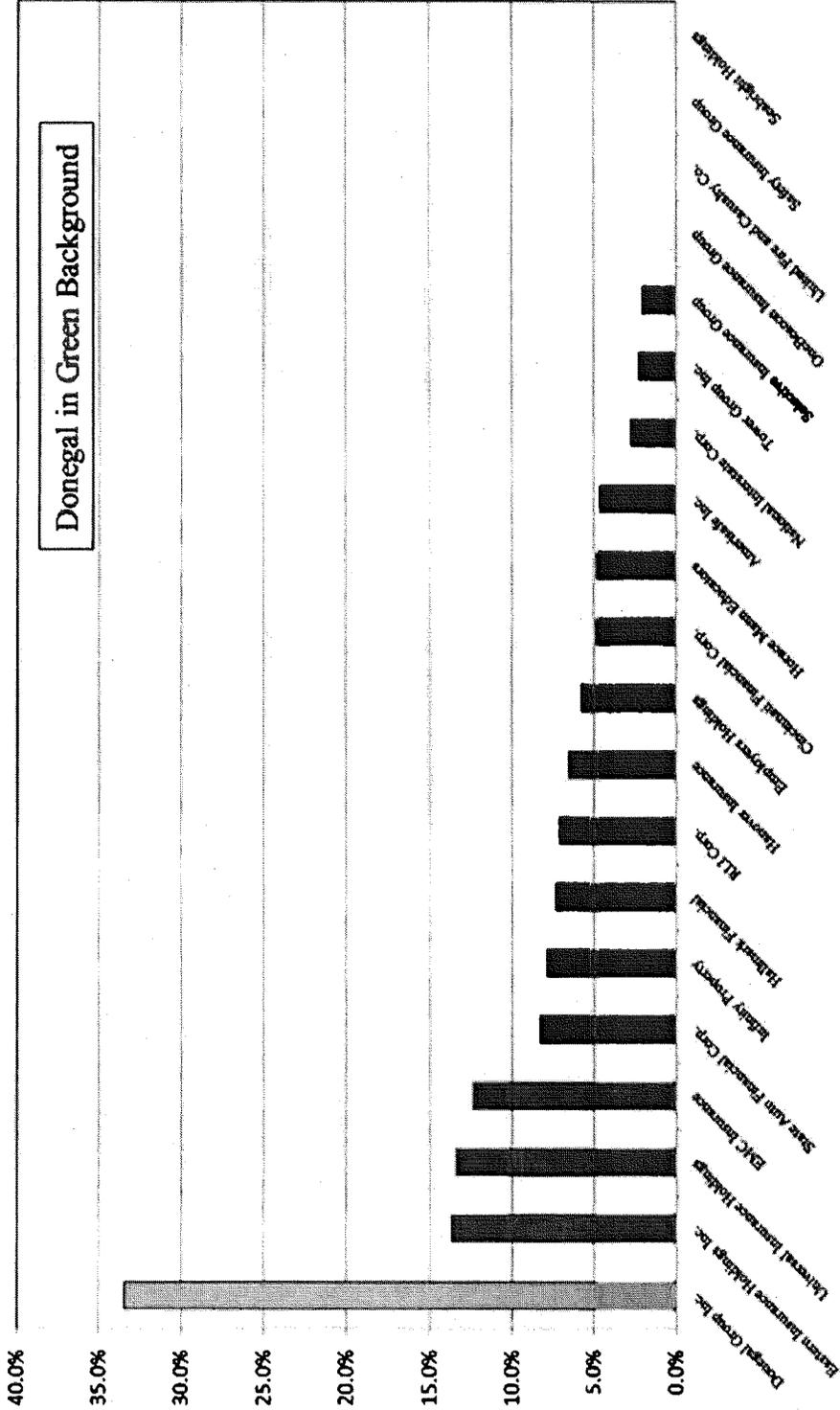
III. Voting Dilution

If the 10 million additional authorized shares are issued in 2013:

- o The number of Total Number of Class A Shares Outstanding increases to 30.05 million (approximately 50% increase)
- o The increase in Class A Shares Outstanding dilutes Mr. Shepherd's voting rights from 9.99% in 2012 to 8.8% in 2013
- o This increase in Class A Shares Outstanding would also dilute the voting rights of the average shareholder by roughly 11.6% (1 less 2012 Voting Shares of 7.58 million divided by 2013 Voting Shares of 8.58 million)

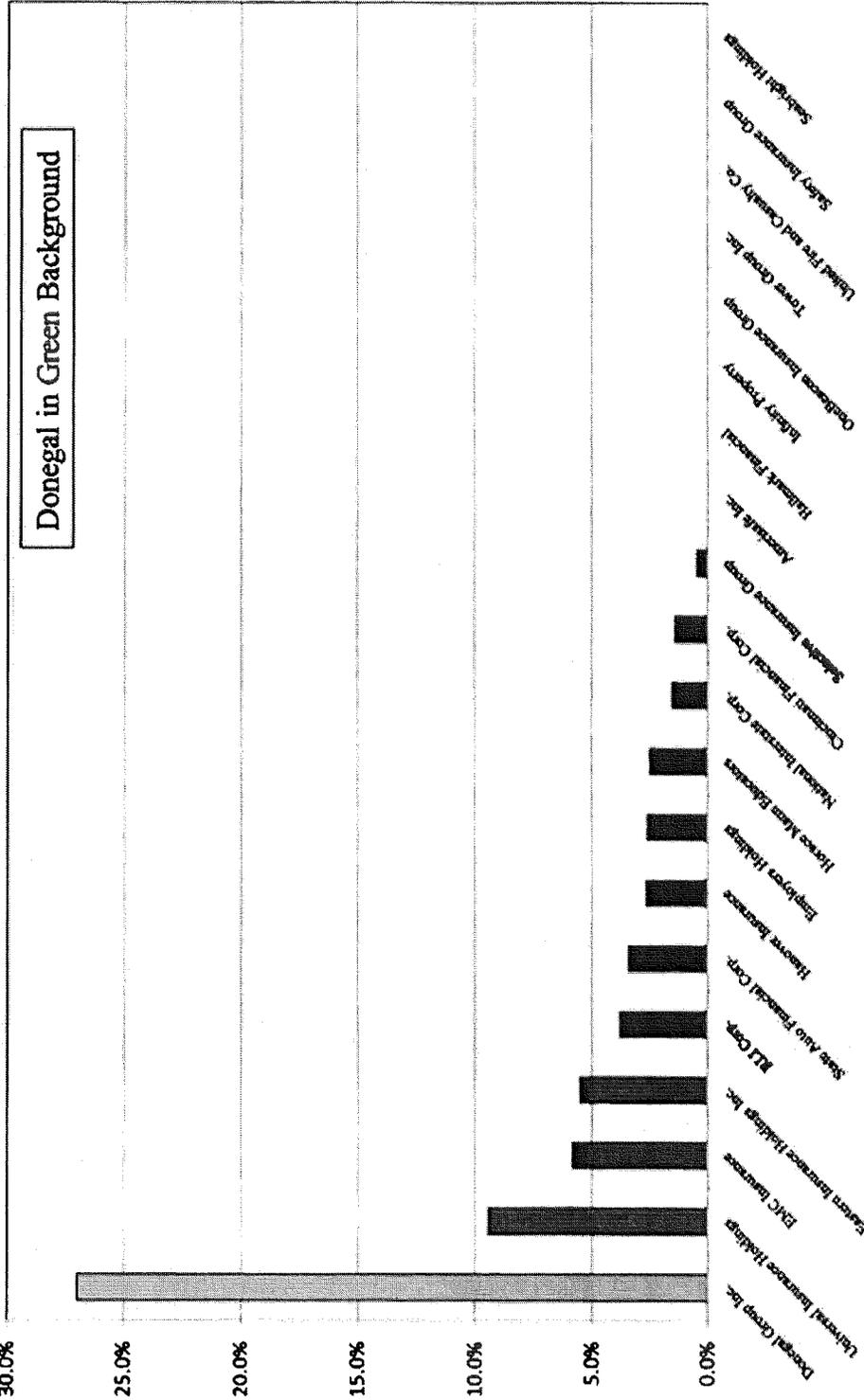
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Cumulative Granted Options as % of Shares Outstanding, fully diluted



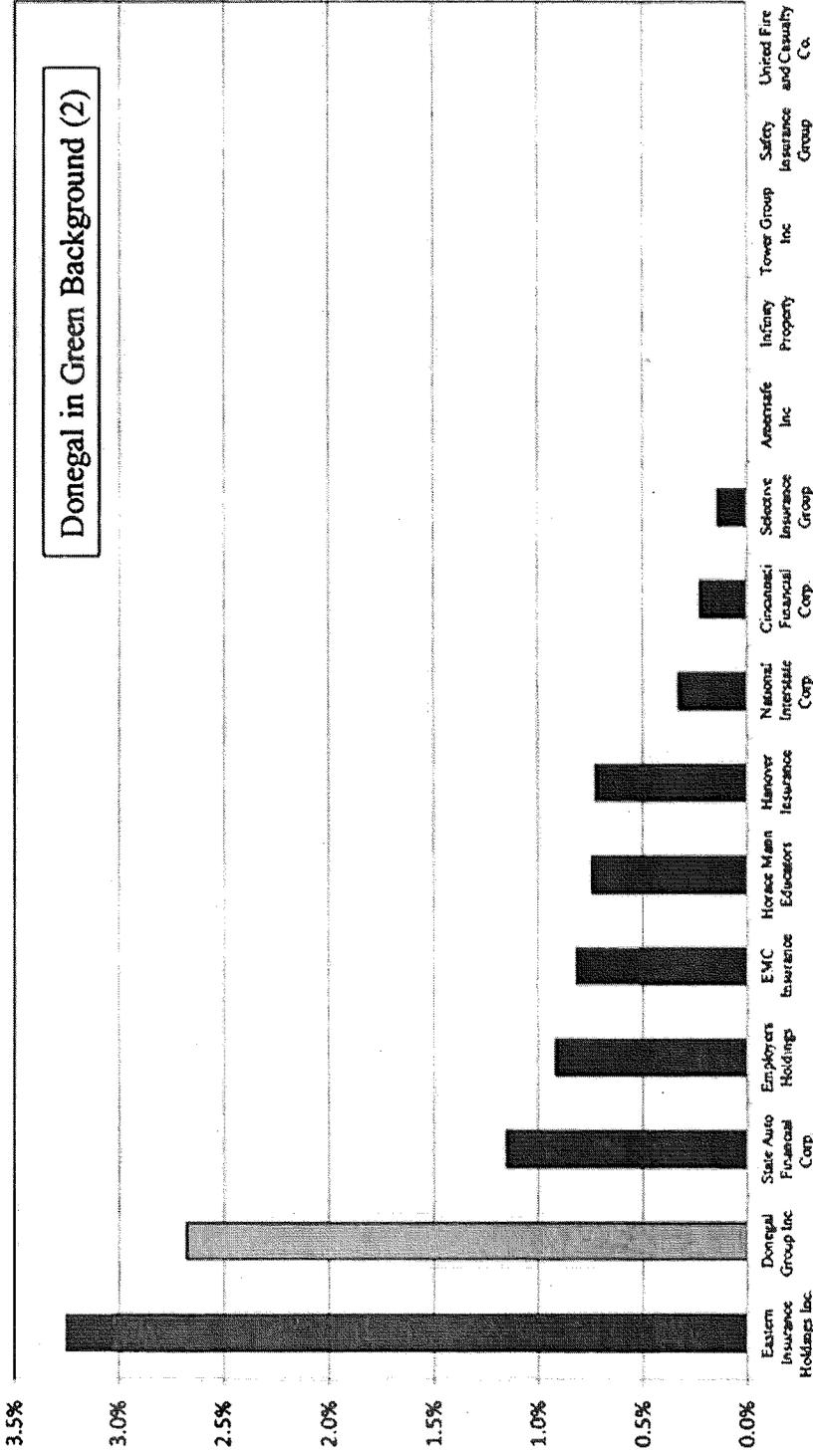
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Granted Options from 3 Yr Period (2010-2012) as % of Shares Outstanding, fully diluted



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Value of Granted Options as % of Market Cap (1)



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(1) Option value denotes the fair value (Black-Scholes value) of the granted options as of the grant date. Granted options include vested and unvested options.

(2) This analysis excludes certain competitors whose Market Capitalization was greater than \$750 million or less than \$250 million as of 12/31/2012.

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Denegal Group Inc.
 Stock Option Analysis
 For years ending December 31, 2012 to 2012

Company (1)	Market Cap		Market Cap		Market Cap		Market Cap		Market Cap		Market Cap		Market Cap		Market Cap		Market Cap		Market Cap	
	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011
Amcor Inc	317.9	317.9	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%
EMC Insurance	313.4	313.4	0.0%	0.0%	0.22	0.22	1.0%	1.0%	0.78	0.78	2.1%	2.1%	0.26	0.26	0.8%	0.8%	1.23	1.23	3.9%	3.9%
Empire One Holdings	633.2	633.2	0.0%	0.0%	0.41	0.41	1.0%	1.0%	0.36	0.36	1.0%	1.0%	0.20	0.20	0.6%	0.6%	1.60	1.60	5.0%	5.0%
Hallmark Financial	103.6	103.6	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.60	0.60	1.8%	1.8%
McInnes Property	324.0	324.0	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.21	0.21	0.6%	0.6%
National Instruments Corp	381.2	381.2	0.0%	0.0%	0.10	0.10	0.3%	0.3%	0.18	0.18	0.5%	0.5%	0.10	0.10	0.3%	0.3%	0.80	0.80	2.1%	2.1%
RLI Corp	1,460.0	1,460.0	0.0%	0.0%	0.20	0.20	0.7%	0.7%	0.20	0.20	0.7%	0.7%	0.10	0.10	0.3%	0.3%	1.20	1.20	0.8%	0.8%
Outboard Industries Group	1,048.0	1,048.0	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%
Emerson Insurance Holdings Inc	1,161.7	1,161.7	0.0%	0.0%	0.20	0.20	0.6%	0.6%	0.44	0.44	1.2%	1.2%	0.24	0.24	0.7%	0.7%	0.80	0.80	2.2%	2.2%
Receptor Bioscience	1,750.0	1,750.0	0.0%	0.0%	0.40	0.40	0.9%	0.9%	0.30	0.30	0.7%	0.7%	0.16	0.16	0.4%	0.4%	2.00	2.00	5.6%	5.6%
Home & Auto Insurance	862.9	862.9	0.0%	0.0%	0.40	0.40	1.0%	1.0%	0.30	0.30	0.8%	0.8%	0.16	0.16	0.4%	0.4%	2.00	2.00	5.6%	5.6%
Inter Acad Financial Corp	648.4	648.4	0.0%	0.0%	0.60	0.60	1.5%	1.5%	0.60	0.60	1.5%	1.5%	0.30	0.30	0.8%	0.8%	1.60	1.60	4.0%	4.0%
United Fire and Casualty Co	6,492.0	6,492.0	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%
Continental Financial Corp	46.1	46.1	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%
Tower Capital Inc	1,000.0	1,000.0	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%
Business Management Group	732.0	732.0	0.0%	0.0%	0.11	0.11	0.3%	0.3%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%
Safety Insurance Group	232.2	232.2	0.0%	0.0%	0.20	0.20	0.5%	0.5%	0.20	0.20	0.5%	0.5%	0.10	0.10	0.3%	0.3%	0.20	0.20	0.5%	0.5%
Endorsight Holdings	178.7	178.7	0.0%	0.0%	1.70	1.70	4.5%	4.5%	1.30	1.30	3.7%	3.7%	0.30	0.30	0.8%	0.8%	1.60	1.60	4.5%	4.5%
Corporate Insurance Holdings	286.8	286.8	0.0%	0.0%	1.80	1.80	4.7%	4.7%	2.30	2.30	6.1%	6.1%	1.30	1.30	3.7%	3.7%	1.60	1.60	4.5%	4.5%
Ballantyne Group Inc	146.30	146.30	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%	0.00	0.00	0.0%	0.0%
Index (4)	6,492.0	6,492.0	0.0%	0.0%	1.00	1.00	2.6%	2.6%	2.00	2.00	5.3%	5.3%	1.00	1.00	2.6%	2.6%	1.00	1.00	2.6%	2.6%
Average	593.16	593.16	0.0%	0.0%	0.20	0.20	0.5%	0.5%	0.20	0.20	0.5%	0.5%	0.10	0.10	0.3%	0.3%	0.20	0.20	0.5%	0.5%
Median	653.19	653.19	0.0%	0.0%	0.20	0.20	0.5%	0.5%	0.20	0.20	0.5%	0.5%	0.10	0.10	0.3%	0.3%	0.20	0.20	0.5%	0.5%

(1) - Fiscal 2012 - "Empire One"
 (2) - No data information available - United Fire & Casualty Company
 (3) - Information per 2012 - 2012 (4) - Not available
 (4) - Not available in base for use with Denegal Group Software for analysis of the company as

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Donogal Group Inc.

Stock Option Analysis

For year ended December 31, 2012

Exercise Price (1)	Remaining Contractual Life	Share Price as of 12/31/2011	\$	14.01
\$ 12.50	9.0 yrs	2,184,542	\$	3,364,195
14.00	5.0 yrs	1,110,943		68,437
14.50	10.0 yrs	1,593,000		-
15.00	8.0 yrs	3,000		-
17.50	0.5 yrs	1,196,500		-
18.70	0.3 yrs	3,000		-
21.00	0.3 yrs	1,500		-
		6,790,825	\$	3,472,632
		3,892,225		1,841,970
		2,897,600		1,211,660
		6,790,825		3,072,678

of in-the-money options
of out-of-the-money options
Total Number of options

Exercise Price (1)	Options Outstanding	Exercise Value of Options Period (2)	Options Unvested	Exercise Value of Options Unvested (2)
\$ 12.50	2,184,542	\$ 27,811	1,456,361	\$ 2,242,796
14.00	1,110,943	1,133,789	576,894	29,078
14.50	1,593,000	0	1,593,000	-
15.00	3,000	2,000	1,000	-
17.50	1,196,500	1,198,500	0	-
18.70	3,000	3,000	0	-
21.00	1,500	7,500	0	-
	6,790,825	3,072,678	3,627,855	2,261,874
	3,892,225	1,841,970	2,053,255	-
	2,897,600	1,211,660	1,594,600	-
	6,790,825	3,072,678	3,627,855	2,261,874

(1) Information per Donogal's 10% for period ending September 30, 2012.

(2) Calculated as the difference between share price and exercise price times the number of options outstanding (for in-the-money options)

(3) Calculated as the difference between share price and exercise price times the number of options vested (for in-the-money options)

Donegal Group Inc.

Stock Option Analysis

For years ended December 31, 2007-2012

	2007	2008	2009	2010	2011	2012	2013 (proposed) (2)	2013 (proposed) (2)
Net Income (1)	\$ 30,514,000	\$ 20,404,000	\$ 15,049,000	\$ 9,183,000	\$ 390,000	\$ 18,455,000	\$ 18,455,000	\$ 24,100,000
Class A Shares Outstanding (1)	19,685,674	19,866,099	19,903,069	19,961,274	19,997,146	20,031,455	30,050,649	30,050,649
Basic EPS	\$ 1.55	\$ 1.03	\$ 0.76	\$ 0.46	\$ 0.02	\$ 0.92	\$ 0.61	\$ 0.80

Analysis of Donegal's Share / Voting Structure

Class A Shares Outstanding (1)	20,050,649	30,050,649	30,050,649	30,050,649
Class B Shares Outstanding (1)	5,576,755	5,576,755	5,576,755	5,576,755
Class A Shares Votes per Share	10.0%	10.0%	10.0%	10.0%
Class B Shares Votes per Share	100.0%	100.0%	100.0%	100.0%
Class A Votes	2,005,065	3,005,065	3,005,065	3,005,065
Class B Votes	5,576,755	5,576,755	5,576,755	5,576,755
Total Voting Shares	7,581,820	8,581,820	8,581,820	8,581,820

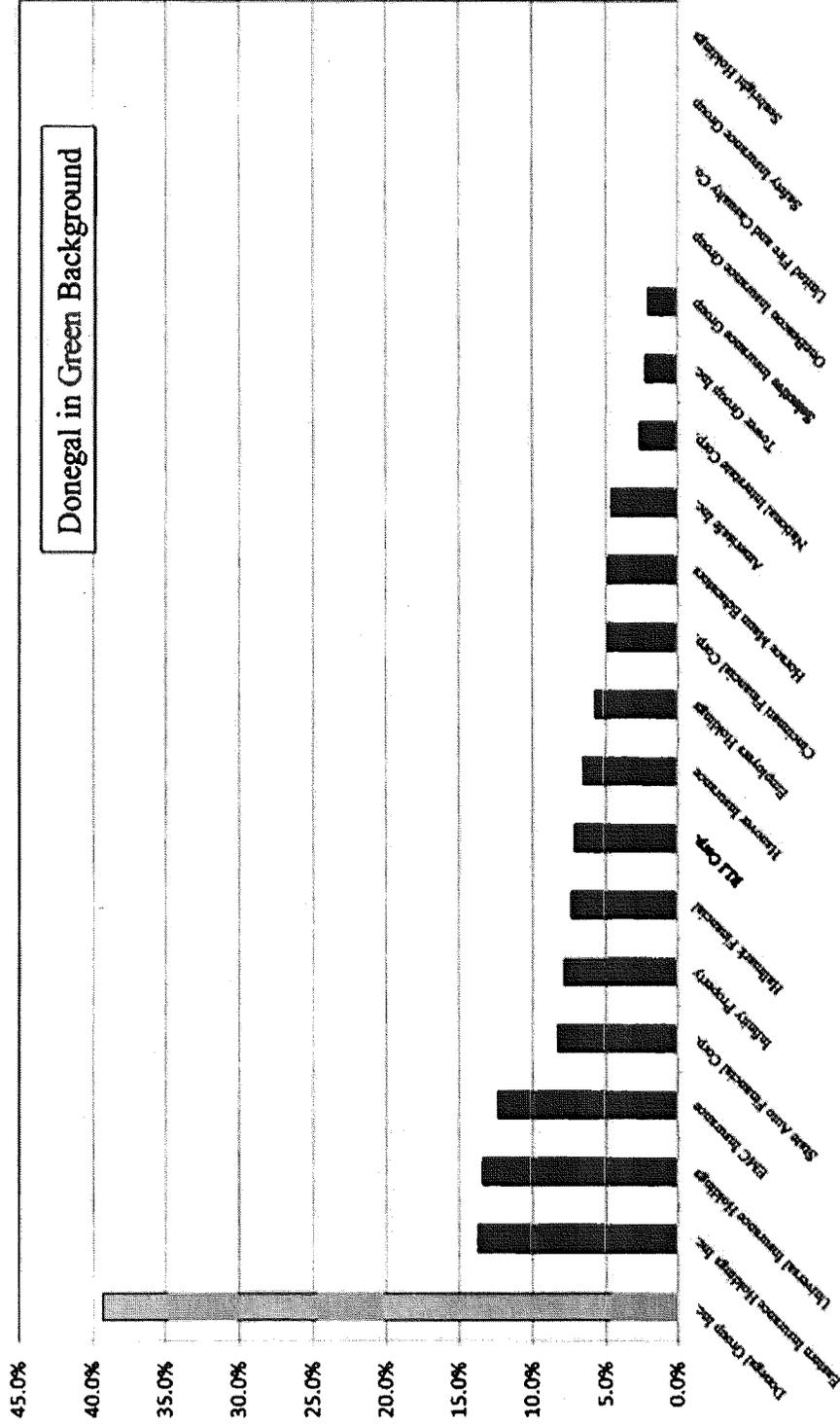
Analysis of Shepard's Share / Voting Structure

Class A Shares Owned by Shepard	3,602,900	3,602,900	3,602,900	3,602,900
Class B Shares Owned by Shepard	397,000	397,000	397,000	397,000
Class A Shares Votes per Share for Shepard	10.0%	10.0%	10.0%	10.0%
Class B Shares Votes per Share for Shepard	100.0%	100.0%	100.0%	100.0%
Class A Votes for Shepard	360,290	360,290	360,290	360,290
Class B Votes for Shepard	397,000	397,000	397,000	397,000
Total Voting Shares for Shepard	757,290	757,290	757,290	757,290

Voting rights as % of Total Votes (3)	9.99%	8.82%	8.82%	8.82%
Earnings attributable to Shepard	\$ 3,274,548	\$ 2,192,648	\$ 2,192,648	\$ 2,863,334

(1) Information per Donegal's 10K's.
 (2) The first approach for 2013 assumes the same net income as 2012, while the second approach uses analyst estimates from Thomson Reuters.
 (3) Calculation for Voting Rights as % of Total Votes divides the Total Voting Shares for Shepard by the Total Voting (e.g. the 2012 % of 9.99% divides the 757,290 Total Voting Shares for Shepard by the 7,581,820 Total Voting Shares).
 (4) Assumes that 10 million shares are issued in 2013.

**Cumulative Granted Options as % of Shares Outstanding, fully diluted
Assumes additional 10.0 million shares and 5.1 million options granted in 2013**



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Shepard Blasts Donegal Group CEO Nikolaus for Outrageous Potential Dilution of Shareholders

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BRADENTON, Fla., April 11, 2013 /PRNewswire/ -- (NASDAQ: "DGICB") – Gregory M. Shepard announced today that he has sent a letter to Donegal Group Inc.'s ("Donegal") CEO and President, Don Nikolaus , demanding that he explain the extraordinarily high number of options granted to himself and other Donegal insiders and employees relative to industry peers at Donegal's upcoming Annual Meeting of Shareholders on April 18, 2013. The letter is available on the SEC's website at www.sec.gov, under Donegal Group or under Gregory Mark Shepard , as an attachment to Mr. Shepard's Schedule TO amendment filed today.

According to Mr. Shepard, "The number of Donegal Class A shares issuable upon the exercise of options granted through December 31, 2012, is approximately 33% of Donegal's total number of Class A shares outstanding, calculated on a fully diluted basis." Mr. Shepard continued, "I hired Duff & Phelps to assist me in compiling the numbers. The results show a staggering disregard on the part of Don Nikolaus and the Donegal Board of Directors for their shareholders, in my opinion. Don Nikolaus and the Board members have enriched themselves at the expense of shareholders."

According to Mr. Shepard, "The potential dilution to Donegal shareholders because of option grants far exceeds that of the peer companies listed by Donegal in its 2012 10-K. The peer companies listed by Donegal are Cincinnati Financial Corp. ("CINF"), Eastern Insurance Holdings Inc. ("EIH"), EMC Insurance Group Inc. ("EMCI"), The Hanover Insurance Group, Inc. ("THG"), Horace Mann Educator's Corp. ("HMN"), Selective Insurance Group, Inc. ("SIGI"), State Auto Financial Corp. ("STFC"), Tower Group International, Ltd. (formerly Tower Group Inc.) ("TWGP") and United Fire and Casualty Co. ("UFCS"). The shares issuable upon the exercise of options granted through December 31, 2012 by these peer companies amount to 4.8%, 13.7%, 12.3%, 6.5%, 4.8%, 2.0%, 8.2%, and 2.2% of their respective total outstanding shares (data unavailable for United Fire)."

"In comparison, the Donegal Class A shares issuable upon the exercise of options granted as of December 31, 2012, are an astounding 33% of the total outstanding Class A shares – almost three times as high as the next closest peer group company," said Mr. Shepard.

Mr. Shepard continued, "Shame on Don Nikolaus and the Donegal Board of Directors. At the upcoming Annual Meeting of Shareholders, Don Nikolaus and the Board want shareholders to approve a new Class A stock option plan that would authorize the granting of options for yet another 4.5 million Class A shares, plus options for an additional 600,000 Class A shares to the Donegal directors, including the directors of Donegal Mutual. This is on top of the previously granted options for 6,700,825 Class A shares. Donegal currently has only approximately 20.1 million Class A shares and 5.6 million Class B shares outstanding."

"It is particularly ironic that Donegal declined to recommend my tender offer to Class B stockholders, in part because Donegal wants these new stock option plans approved," said Mr. Shepard.

Mr. Shepard added, "I first became a Donegal stockholder in 2005. At year-end 2005, Donegal had granted options for 735,802 Class A shares, representing approximately 5.2% of the 14,258,646 then-outstanding Class A shares and 4.0% of the 18,440,663 then-outstanding Class A and Class B shares combined. At the <http://www.printthis.clickability.com/pt/cpt?expire=&title=Shepard+Blasts+Donegal+Group+CEO+Niko...> 4/11/2013

end of 2012, Donegal has granted options for 6,700,825 Class A shares, representing 33.5% of the 20,025,199 outstanding Class A Shares and 26.2% of the 25,601,974 outstanding Class A and Class B shares combined. The options have increased by 655% (i.e., 26.2% / 4.0%) in 7 years. That is outrageous. By comparison, Donegal's book value has only increased by a total of 13% in the last 5 years."

Mr Shepard asks stockholders to call Don Nikolaus , at 800-877-0600, and Jeffrey Miller , Senior Vice President and Chief Financial Officer, at 717-426-1931, if they are dissatisfied with the potential dilution to the shareholders.

On March 20, 2013, Gregory M. Shepard announced a tender offer for 962,636 of the outstanding shares of Class B Common Stock of Donegal at a price of \$30 per Class B share (the "Offer"). The Offer represents approximately a 42% premium to the closing price of Donegal Class B shares on NASDAQ on March 19, 2013 – the last full trading day prior to the commencement of the Offer.

The Offer is not subject to any financing contingency. Other conditions apply to the Offer, including the tender of at least 925,000 Class B shares, insurance and bank regulatory approvals, expiration or early termination of the Hart-Scott-Rodino waiting period, and no litigation involving the Offer. Mr. Shepard is also seeking the appointment of three persons selected by him to the Donegal Board and the Board of Donegal Mutual Insurance Company ("Donegal Mutual"), as a condition of the Offer, without an increase in the size of each board from 12 directors.

The Offer will expire on April 19, 2013 at 11:59 p.m., New York City time, unless extended. Tenders of shares of Donegal's Class B Common Stock must be made prior to the expiration of the Offer and may be withdrawn at any time prior to the expiration of the Offer. Only shares properly tendered and not properly withdrawn pursuant to the Offer will be purchased. **The Offer includes withdrawal rights so that a tendering shareholder can freely withdraw any shares prior to acceptance of such shares for payment under the Offer.**

Mr. Shepard is the beneficial owner of 3,602,900 Class A shares and 397,100 Class B shares of Donegal, which he acquired at a total cost of \$58.6 million. Mr. Shepard has been a Class A and a Class B shareholder of Donegal since 2005, and he is now by far Donegal's largest shareholder with the exception of Donegal Mutual.

This press release is neither an offer to purchase nor a solicitation of an offer to sell shares of Donegal. It does not purport to be complete and is qualified in its entirety by reference to the complete text of the Offer to Purchase and the related Letter of Transmittal, which contain important information that should be read carefully before any decision is made with respect to the Offer.

The Offer to Purchase and the related Letter of Transmittal and Notice of Guaranteed Delivery are filed with the SEC and are available through the SEC's website at <http://www.sec.gov/>. Any questions or requests for assistance or for additional copies of the Offer to Purchase, the related Letter of Transmittal and other related tender offer materials may be directed to the Information Agent at its address and telephone numbers set forth below, and copies will be furnished promptly at the Offeror's expense. **The Information Agent for the Offer is: D.F. King & Co., Inc., 48 Wall Street, 22nd Floor, New York, NY 10005.** Banks and Brokerage Firms please call collect: (212) 269-5550. All others call toll-free: (800) 967-5079. Email: information@dfking.com

Duff & Phelps' analysis was provided to Mr. Shepard, at his request and expense, solely for informational purposes. The analysis is derived from data sourced from third parties, and Duff & Phelps takes no responsibility for any inaccuracies, errors or omissions in the third party source data or the analysis, and Duff & Phelps offers no representations, warranties or assurances with respect to, and accepts no liability or responsibility in connection with, either the source data or the analysis.

THE OFFER IS NOT INTENDED TO AND DOES NOT CONSTITUTE (I) A SOLICITATION OF A PROXY, CONSENT OR AUTHORIZATION FOR OR WITH RESPECT TO THE ANNUAL MEETING OR ANY SPECIAL MEETING OF DONEGAL'S STOCKHOLDERS OR (II) A SOLICITATION OF A CONSENT OR

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AUTHORIZATION IN THE ABSENCE OF ANY SUCH MEETING.

SOURCE Gregory M. Shepard

Find this article at:

<http://www.prnewswire.com/news-releases-test/shepard-blasts-donegal-group-ceo-nikolaus-for-outrageous-potential-dilution-of-shareholders-202484901.html>

Check the box to include the list of links referenced in the article.