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WESCO FINANCIAL CORPORATION

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Annual Report 1987

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WESCO FINANCIAL CORPORATION LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all unusual operating income and all net gains from sales of securities) for the calendar year 1987 increased to \$16,612,000 (\$2.33 per share) from \$11,934,000 (\$1.68 per share) in the previous year.

Consolidated net income (i.e., after unusual operating losses and all net gains from sales of securities) decreased to \$15,213,000 (\$2.14 per share) from \$16,524,000 (\$2.32 per share) in the previous year.

Wesco has three major subsidiaries, Mutual Savings, in Pasadena, Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses, and Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged in the reinsurance business. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts) ⁽¹⁾:

	Year Ended			
	December 31, 1987		December 31, 1986	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income (loss) of:				
Mutual Savings	\$ 2,895	\$.41	\$ 2,159	\$.30
Precision Steel's businesses	2,450	.34	1,701	.24
Wesco-Financial insurance business —				
Underwriting	(1,394)	(.19)	(1,469)	(.21)
Investment activity	10,853	1.52	8,084	1.14
	9,459	1.33	6,615	.93
All other "normal" net operating income ⁽²⁾ ...	1,808	.25	1,459	.21
	16,612	2.33	11,934	1.68
Writeoff by Mutual Savings of prepaid FSLIC insurance premiums ⁽³⁾	(1,935)	(.27)	—	—
Flood loss at Precision Steel	(672)	(.09)	—	—
Net gains on sales of securities	1,208	.17	4,590	.64
Wesco consolidated net income	<u>\$15,213</u>	<u>\$2.14</u>	<u>\$16,524</u>	<u>\$2.32</u>

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries.

(3) Necessitated by the Federal Home Loan Bank's elimination of the savings and loan industry's nearly \$1-billion secondary insurance reserve, consisting of deposit insurance premiums prepaid to FSLIC, the U.S. agency which insures accounts in savings and loan associations.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

Mutual Savings

Mutual Savings' "normal" net operating income of \$2,895,000 in 1987 represented an increase of 34% from the \$2,159,000 figure the previous year.

However, this "normal" figure of \$2,895,000 for Mutual Savings' 1987 earnings is created by ignoring as abnormal an after-tax charge of \$1,935,000 from writeoff of prepayments of deposit-insurance premiums. The premiums had been prepaid in previous years to FSLIC, the U.S. agency which insures accounts in savings and loan associations. Since FSLIC has been grievously impaired by widespread failure of insured associations and continues to be insolvent, and since its long-term source of support is collection of premiums which the savings and loan industry is compelled to pay, it may well be questioned whether FSLIC-related charges far in excess of past experience should on that account now be excluded from the "normal" as we do in this explanatory letter. Mutual Savings' position, relative to FSLIC, is like that of the owner of a concrete pier, mostly underwater, compelled to buy fire insurance on a pooled-rate basis with a group of oily-rag collectors, many of whom have already had but not reported their fires, with the result that no provision for such fires has yet been made in pooled-basis premium rates. Such an owner probably has not yet had his last unpleasant surprise from his insurance costs. Even so, we chose "unusual" classification for the FSLIC special charge in 1987, because it is not certain to be repeated.

Separate balance sheets of Mutual Savings at yearend 1986 and 1987 are set forth at the end of this annual report. They show (1) total savings accounts rising to \$287 million from \$282 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (probably the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, and (4) a loan portfolio (mostly real estate mortgages) of about \$139 million at the end of 1987, up 76% from the \$79 million at the end of 1986.

The loan portfolio at the end of 1987, although containing almost no risk of loss from defaults, bore an average interest rate of only 8.38%, probably near the lowest among U.S. savings and loan associations, but up sharply from 7.48% at the end of 1986. There is now no significant unrealized depreciation in the loan portfolio, while unrealized appreciation in Mutual Savings' interest-bearing securities and preferred stocks at December 31, 1987 was about \$9 million.

As pointed out in Note 10 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings (\$56.6 million at December 31, 1987) overstates the amount realizable, after taxes, from sale or liquidation at book value. If all Mutual Savings' assets, net of liabilities, were to be sold, for the \$56.6 million reported as book value, the parent corporation would receive much less than \$56.6 million after substantial income taxation imposed because about \$47 million of what is designated shareholders' equity for accounting purposes is considered bad debt reserves for most tax purposes.

Mutual Savings has not only a buried plus value in unrealized appreciation of securities, but also a buried plus value in real estate. The foreclosed property on hand (mostly 22 largely oceanfront acres in Santa Barbara) has become worth over a long holding period much more than its \$2.0 million balance sheet carrying cost. Reasonable, community-sensitive development of this property has been delayed over 12 years in the course of administration of land-use laws. But, miraculous to report, grading is now actually under way on the property for an authorized development into 31 houses interspersed with large open areas. Mutual Savings plans to make the development first rate in every respect, and unique in the quality of its landscaping.

The buried plus value in real estate is limited by the small number of houses allowed (31) and by the fact that only a minority of such houses (11) will have any significant ocean view. Additional limitation will come from prospective high cost of private streets, sewage and utility improvements and connections, and landscaping. And, most important of all, various charges and burdens, including heavy archaeological obligations imposed by governmental bodies, will drastically reduce our potential recovery from what it would have been had the zoning and development climate of the early 1970s continued into 1988.

Mutual Savings is now a "qualified thrift lender" under the Federal regulatory definition requiring 60% of assets in various housing-related categories. Substantially all loans receivable have either short expected lives or bear interest rates which fluctuate with the market to 25% per annum or more.

While the "spread" between Mutual Savings' average interest rates paid on savings and received on loans remains too low to provide respectable profits, such spread is improving. Moreover, the disadvantage from inadequate spread continues to be offset to a considerable degree by the effect of various forms of tax-advantaged investment, primarily preferred stock. The negative side of this tax-advantaged antidote to inadequate interest rate margin on loans is the risk that preferred stock, with its fixed dividend and long life, will decline in value and not provide enough income to cover Mutual Savings' interest costs, if the general level of interest rates should sharply rise. In view of this risk, Mutual Savings' total commitment to preferred stock is kept conservative, relative to the amount of its net worth.

All in all, Mutual Savings continues to be a mediocre business, albeit one which is both (1) improving slightly and (2) expected to produce an average return of at least 10% per annum on the after-tax proceeds which could be realized from its liquidation. And, of course, we are making needed loans in our community while we try to behave as if there were no federal deposit-insurance system. Such an institution may find a bigger role as the years go by.

Precision Steel

The businesses of Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, contributed \$2,450,000 to "normal" net operating income in 1987, up 44% compared with \$1,701,000 in 1986. The increase in 1987

profit occurred in spite of only a modest increase in revenues (up 5% to \$54,843,000).

The "normal" net operating income figure does not include the adverse effect of an after-tax charge of \$672,000 from a flood loss following a severe rainstorm in August, during which nine inches of rain fell in a twenty-four hour period. We consider such a flood a once-in-a-hundred-years type of occurrence, and have no hesitation as we exclude the item from "usual" results in our explanatory letter.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1987 provided an extraordinary return even without taking into account the financial leverage put into Wesco's consolidated picture incident to their acquisition.

The good financial results have an underlying reason. Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses. Many customers of Precision Steel, needing dependable supply on short notice of specialized grades of high-quality, cold-rolled strip steel, reasonable prices, technical excellence in cutting to order, and remembrance when supplies are short, rightly believe that they have no fully comparable alternative in Precision Steel's market area. Indeed, many customers at locations remote from Chicago and Charlotte (for instance, Los Angeles) seek out Precision Steel's service.

Wesco-Financial Insurance Company

A new business was added to the Wesco group in 1985, in co-venture with Wesco's 80% owner and ultimate parent corporation, Berkshire Hathaway Inc.

With the enthusiastic approval of all Wesco's directors, including substantial Wesco shareholders in the Peters and Caspers families, without whose approval such action would not have been taken, Wesco in 1985 invested \$45 million in cash equivalents in a newly organized, wholly owned insurance company, Wesco-Financial Insurance Company ("Wes-FIC"). Another \$45 million was invested in 1986 and 1987.

The new subsidiary, Wes-FIC, has reinsured, through another Berkshire Hathaway insurance company subsidiary as intermediary-without-profit, 2% of the entire book of insurance business of the long-established Fireman's Fund Corp. (listed on the NYSE). Wes-FIC thereby assumed the benefits and burdens of Fireman's Fund's prices, costs and losses under a contract covering all insurance premiums earned by Fireman's Fund during a four-year period commencing September 1, 1985. The arrangement puts Wes-FIC in almost exactly the position it would have been in if it, instead of Fireman's Fund, had directly written 2% of the business. Differences in results should occur only from the investment side of insurance, as Wes-FIC, instead of Fireman's Fund, invests funds from "float" generated. Wes-FIC's share of premiums earned in 1987 exceeded \$73 million.

Wes-FIC's net income for 1987 was \$9,468,000, versus \$6,567,000 for 1986. The net income figures included securities gains, net of income taxes, of \$9,000 in 1987 and \$352,000 in 1986. Wes-FIC's 1987 net income benefitted by about

\$1 million because of an unusual adjustment to its income tax provision caused by the Tax Reform Act of 1986.

It is in the nature of even the finest casualty insurance businesses that in keeping their accounts they must estimate and deduct all future costs and losses from premiums already earned. Uncertainties inherent in this undertaking make financial statements more mere "best honest guesses" than is typically the case with accounts of non-insurance-writing corporations. And the reinsurance portion of the casualty insurance business, because it contains one or more extra links in the loss-reporting chain, usually creates more accounting uncertainty than the non-reinsurance portion. Wesco shareholders should remain aware, not only of the inherent imperfections of Wes-FIC's accounting, but also of the inherent cyclicity of its business.

However, Wesco hopes for: (1) a reasonable return on its investment over the four years of the Fireman's Fund reinsurance contract, and (2) possible future reinsurance contracts with other insurers.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, increased to \$1,808,000 in 1987 from \$1,459,000 in 1986. Sources were (1) rents (\$2,272,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant) and (2) interest and dividends from cash equivalents and marketable securities held by Precision Steel and its subsidiaries and at the parent company level.

Net Gains On Sales Of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, decreased to \$1,208,000 in 1987 from \$4,590,000 in 1986.

Bowery Savings Bank

In 1985 Wesco, in another co-venture with its parent corporation, approved by Wesco's directors in the same manner as the Wes-FIC co-venture, joined a group which invested \$100,000,000 cash in a newly organized, New York-chartered savings bank. The new bank then took over the name, assets and liabilities of the insolvent Bowery Savings Bank in the city of New York. The takeover received (1) much needed assistance from FDIC, the federal agency, akin to FSLIC, which insures deposits in banks, and (2) the blessing of New York bank regulators. Wesco invested \$9,000,000, other Berkshire Hathaway subsidiaries invested \$12,384,000, and other unrelated investors invested the balance of the \$100,000,000.

The terms of the FDIC assistance were extremely complex but can be fairly summarized as far from adequate to assure that the investors would make a profit. This is as it should be when \$100 million buys a highly-leveraged residual equity position in a \$5 billion bank, albeit one with many problems.

The investment continued to be carried at cost in Wesco's accompanying year-end financial statements, but it was sold, as part of a friendly acquisition of Bowery

by a large and reputable company, on January 31, 1988, at an after-tax profit for Wesco of about \$5 million.

Richard Ravitch was the organizing leader in the group which revitalized Bowery Savings Bank, acted as its CEO and negotiated its sale. We take this opportunity to doff our hat to him for a job well done. We have similar admiration for our other co-investors, particularly the Tisch family and Richard Rosenthal. Mr. Rosenthal was a former Salomon partner (see below) who died in a tragic air crash in the midcourse of our venture.

Salomon Inc

On October 1, 1987 Wesco and certain of its wholly owned subsidiaries purchased 100,000 newly issued shares of Series A Cumulative Convertible Preferred Stock, without par value, of Salomon Inc ("Salomon"), at a cost of \$100 million. Salomon's primary business is transacted by its subsidiary, Salomon Brothers, a leading securities firm. Our investment was part of a \$700 million transaction in which other subsidiaries of Berkshire Hathaway Inc., Wesco's parent, invested \$600 million. Principal terms of the transaction include the following: (1) the new preferred stock will pay dividends at the annual rate of 9%; (2) each preferred share, purchased at a cost of \$1,000, will be convertible into 26.31579 shares of Salomon common stock on or after October 31, 1990, or earlier if certain extraordinary events occur; and (3) the preferred stock is subject to mandatory redemption provisions requiring the retirement, at \$1,000 per share plus accrued dividends, of 20% of the issue on each October 31, beginning in 1995, so long as any shares of preferred stock remain outstanding.

At the stated conversion price of the preferred stock, a profit (subject to certain procedural requirements) will be realizable whenever, after October 31, 1990, the common stock of Salomon (listed NYSE) trades at over \$38 per share. At the time of our commitment to buy the new preferred, the common stock of Salomon was selling in the low 30s. However, shortly after the ink dried on Wesco's new stock certificates, the October 19, 1987 "Black Monday" stock market crash occurred, which caused temporary but substantial operating losses plus a lowered credit rating at Salomon. Although Salomon, among securities firms, suffered only its rough share of the general debacle, its common stock at one time after the crash traded as low as 16%.

Fortunately, as the conversion privilege we had bargained for declined in value along with the price of Salomon common stock, interest rates also declined, which made our fixed 9% annual preferred stock dividend more valuable. We believe that, all factors considered, at December 31, 1987 our \$100 million investment in preferred stock of Salomon was still worth about \$98 million.

We much admire the way Salomon and its leader, John Gutfreund, are adjusting operations to cope with new and adverse conditions. They seem ahead of the game to us, compared with competitors, and they work from the sound base of an honored name, affixed to an organization deep in talent and known for hard work.

Berkshire Hathaway's Chairman, Warren Buffett, and the undersigned joined the board of Salomon on October 28, 1987, and are very pleased with the new association.

Consolidated Balance Sheet and Related Discussion

Wesco's consolidated balance sheet (1) retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others and (2) reflects a continuing slow pace of acquisition of additional businesses because few are found available, despite constant search, at prices deemed rational from the standpoint of Wesco shareholders.

As indicated on the accompanying consolidated balance sheet, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate carrying value at December 31, 1987 by about \$6 million, down significantly from about \$13 million one year earlier. The consolidated aggregate market value of all marketable securities, including bonds and other fixed-income securities, exceeded aggregate carrying value by about \$12 million. As earlier noted, about \$9 million of this unrealized appreciation lies within the savings and loan subsidiary.

Wesco's Pasadena real estate, a full block (containing (1) about 125,000 first-class net rentable square feet, including Mutual Savings' space, in a modern office building, plus (2) an additional net rentable 34,000 square feet of economically marginal space in old buildings requiring expensive improvement), has a market value substantially in excess of carrying value, demonstrated by (1) mortgage debt (\$4,850,000 at 9.25% fixed) against this real estate now exceeding its depreciated carrying value (\$3,164,000) in Wesco's balance sheet at December 31, 1987, and (2) substantial current net cash flow (about \$1 million per year) to Wesco after debt service on the mortgage. The modern office building is 99% rented, despite a glut of vacant office space in Pasadena. We charge just-below-standard rents and run the building as a sort of first-class club for tenants we admire. With these practices, a prime location and superior parking facilities, we anticipate future increases in cash flow, but at no better rate than the rate of inflation.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity, however, requires patience, as suitable opportunities are not always present.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and reinsurance subsidiaries and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in very few places. Through this practice of concentration of investments, better understanding is sought with respect to the few decisions made.

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 15% in 1985-87, was dependent to a very large extent on securities gains, irregular by nature. This recent ratio is almost certain to continue to decline, probably sharply, as it did in 1987. Neither possible future acquisitions of other businesses nor possible future securities gains appear likely to help much in the short term. The business acquisition game continues to be crowded with optimistic players who usually force prices for low-leverage acquirers like Wesco to levels where return-on-investment prospects are modest. And future securities gains are likely to prove harder to come by for very simple reasons. Because securities generally traded lower several years ago than they do now, relative to the intrinsic values of the businesses represented by the securities, creating more obviously sound investments than than now, and because prospects for above-average returns tend to go down as assets managed go up, it is now, early in 1988, even easier than it was early in 1986, to predict less desirable future results. It is also easy for any sophisticated Wesco shareholder, reviewing either (1) this virtual reprint of last year's letter or (2) Wesco's marketable securities disclosed herein, to diagnose (correctly) that the decision-makers are now even more dry of good ideas than they were two years earlier.

The considerable, and higher than desired, liquidity of Wesco's consolidated financial position as this is written does not result from our forecast that business conditions are about to worsen, or that interest rates are about to rise, or that common stock prices are about to fall. Wesco's condition results, instead, from our simply not finding opportunities for more aggressive use of capital with which we are comfortable.

Wesco continues to try more to profit from always remembering the obvious than from grasping the esoteric (including much modern "strategic planning" and "portfolio theory"). Such an approach, while it has worked fairly well on average in the past and will probably work fairly well over the long-term future, is bound to encounter periods of dullness and disadvantage as it limits action.

Moreover, our approach is being applied to no great base position. Wesco has only a tiny fraction of its total intrinsic value in businesses with enough commercial advantage in place to assure permanent high future returns on capital employed. In contrast, Berkshire Hathaway, Wesco's parent corporation, has a larger proportion of its intrinsic value in durable high-return businesses.

Some historical explanation for the current situation becomes appropriate here. When Wesco's parent corporation acquired control, Wesco's activities were almost entirely limited to holding (1) some surplus cash, plus (2) a multi-branch savings and loan association which had many very long-term, fixed-rate mortgages, offset by interest-bearing demand deposits. The acquisition of this intrinsically disadvantageous position was unwisely made, alternative opportunities considered, because the acquirer was overly influenced by a price considered to be moderately below liquidating value. Under such circumstances, acquisitions have a way of producing, on average, for acquirers who are not quick-turn operators, low to moderate long-term results. This happens because any advantage from a starting "bargain" gets

swamped by effects from change-resistant mediocrity in the purchased business. Such normal effects have not been completely avoided at Wesco, despite some successful activities, including recent investment in General Foods.

Over the long term, a corporation like Wesco, with no significant proportion of intrinsic value in great businesses, is like a tortoise in a race of hares. And, as noted above, this particular tortoise faces the race with an unoriginal and conservative approach.

However, there are respectable precedents for our approach. The novelist Hardy, who believed that the natural outcome of ambition was getting clobbered, advocated the logical preventative of aiming low. And people known for outcomes far too good to have been expected by Hardy have mined a branch of the same vein. Consider this statement from Newton: "If I have seen further than other men, it is by standing on the shoulders of giants". And this from Mozart (as approvingly quoted by the distinguished advertising creator, David Ogilvy): "I never tried to compose anything original in my life".

It is occasionally possible for a tortoise, content to assimilate proven insights of his best predecessor, to outrun hares which seek originality or don't wish to be left out of some crowd folly which ignores the best work of the past. This happens as the tortoise stumbles on some particularly effective way to apply the best previous work, or simply avoids standard calamities. Anyway, we hope so. And so should recent purchasers of Wesco stock who have not only bet on a tortoise but also, by paying prices in the mid forties, given odds.

On January 28, 1988, Wesco increased its regular quarterly dividend from 17½ cents per share to 18½ cents per share, payable March 15, 1988, to shareholders of record as of the close of business on February 26, 1988.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.



Charles T. Munger
Chairman of the Board

February 26, 1988