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WESCO FINANCIAL CORPORATION

Annual Report 1991
Form 10-K Annual Report 1991

**WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS**

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all net gains from sales of marketable securities and foreclosed property) for the calendar year 1991 decreased to \$22,872,000 (\$3.21 per share) from \$25,038,000 (\$3.52 per share) in the previous year.

Consolidated net income (i.e., after net gains from sales of marketable securities and foreclosed property) increased to \$29,522,000 (\$4.15 per share) from \$25,429,000 (\$3.57 per share) in the previous year.

Wesco has three major subsidiaries, Mutual Savings, in Pasadena, Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged principally in the reinsurance business, and Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. 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, 1991		December 31, 1990	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income of:				
Mutual Savings.....	\$ 3,644	\$.51	\$ 4,099	\$.58
Wesco-Financial Insurance business.....	13,986	1.96	14,924	2.10
Precision Steel's businesses	1,414	.20	1,985	.28
All other "normal" net operating income ⁽²⁾	3,828	.54	4,030	.56
	<u>22,872</u>	<u>3.21</u>	<u>25,038</u>	<u>3.52</u>
Net gain on sales of marketable securities	5,825	.82	391	.05
Net gain on sales of foreclosed property.....	825	.12	—	—
Wesco consolidated net income	<u>\$29,522</u>	<u>\$4.15</u>	<u>\$25,429</u>	<u>\$3.57</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, interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries, and the electrical equipment manufacturing business, 80%-owned by Wesco since yearend 1988.

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 \$3,644,000 in 1991 represented a decrease of 11% from the \$4,099,000 figure the previous year.

As usual, these "normal-income" figures come from an abnormal savings and loan association.

Separate balance sheets of Mutual Savings at yearend 1990 and 1991 are set forth at the end of this annual report. They show (1) total savings accounts increasing to \$289 million from the \$286 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (near 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, including over \$129 million invested in high quality, rapidly maturing mortgage-backed securities, and (4) a loan portfolio (mostly real estate mortgages) of about \$101 million at the end of 1991, down moderately from \$107 million at the end of 1990.

As pointed out in Note 9 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings overstates the amount realizable, after taxes, from sale or liquidation at book value. Wesco would get only about \$31.3 million, after paying income taxes, from the liquidation at book value of the \$48 million portion of Mutual Savings' shareholders' equity which is considered bad debt reserves for income tax purposes. The \$3.6 million Mutual Savings earned (ignoring capital gains) in 1991 is an inadequate return (7.6%) on the \$48 million amount at which we try to maintain shareholders' equity. It is an even more inadequate return on the somewhat higher amount of capital actually employed within Mutual Savings last year.

The loan portfolio at the end of 1991 bore an average interest rate of only 8.53%, probably the lowest rate on any collection of sound loans in the savings and loan industry. Nonetheless, we believe that the loan portfolio is worth approximately the book value at which it is carried. This appraisal seems right despite some unwise loans we made a couple of years ago, which caused us to reduce carrying value of home loans (and one foreclosed home, so far) by \$200,000 in 1991.

Mutual Savings continues cheerfully to make a large number of fixed-rate loans to persons with low-to-moderate income, frequently in minority groups. We loan at below-market interest rates, intending to suffer considerable disadvantage as a matter of community service. But last year we couldn't suffer much disadvantage, despite our best efforts, because interest rates continually declined, making our inventory of loans in process rise in value. Next year we will do better at obtaining the disadvantage we seek, causing a worse outcome for shareholders. We will sell off most of these fixed-rate loans above a "pipe-line" inventory, because we don't like the interest-rate risks implicit in a loan-and-hold policy.

Generally (meaning without effect from unusual sources), Mutual Savings' future earning power during the short-term future has been impaired, exactly as we predicted, by recent revisions in savings and loan laws generally known under the acronym: "FIRREA".

Prodded by FIRREA, all Mutual Savings' preferred stocks in public utility companies have been sold at a considerable profit, and its \$26 million holding of Salomon Inc convertible preferred stock (with a tax-equivalent yield of 12.6%) has been transferred at cost to another Wesco subsidiary. Soon, all extra-high-yielding assets

will be gone. Meanwhile, regulatory costs have increased, and deposit-insurance costs will increase after exhaustion of a temporary exemption now in place. Short-term, this will probably lower our return on capital employed. But, long term, we will probably get back all the extra-high-tax-equivalent yield we once had, and more. This will happen if Federal Home Loan Mortgage Corporation ("Freddie Mac") continues to increase the dividend on our large holding of its stock as it last did a few days before this letter was written.

Moreover, despite FIRREA, Mutual Savings has reasonable prospects for doing much better than "all right" for a considerable number of years, because of potential assistance from two unusual sources.

A first (and small) source of potential assistance is the probability that we will make an overall profit, despite occasional quarterly losses, from disposition of foreclosed Santa Barbara real estate. This profit is now expected to be somewhat lower than the \$12 million in unrealized land appreciation which we believe existed before we started development. The factors which have caused continuous reductions in our profit expectation are (1) the delays and indignities, even larger and more costly than expected, imposed by local laws, and (2) slow sales of houses and lots as California receives, for a change, more than its pro-rata share of a nationwide recession.

A second (and large) source of potential assistance is the probability that we will eventually realize gains from sales of portions of Mutual Savings' holding of 2,400,000 shares of Freddie Mac, traded on the New York Stock Exchange. At year-end 1991, Mutual Savings' carrying value of this holding was \$71.7 million, and the unrealized pre-tax appreciation was \$258.3 million. If Mutual Savings' Freddie Mac holdings had been liquidated at market value on December 31, 1991, the after-tax profit would have been about \$152.1 million, or \$21.37 per Wesco share outstanding.

As we have stated in previous annual reports, Freddie Mac has a much better basic business than Mutual Savings. That is why we did the logical thing and redeployed capital to reflect realities. Freddie Mac and its rough equivalent, "Fannie Mae," now perform most of the former function of the savings and loan industry in support of essential housing.

We continue to expect future changes in banking and savings and loan laws, combined with continuing troubles in many insured institutions, including some large ones. In such a climate, we continually explore expansion-by-acquisition options for Mutual Savings. We are not restricted to planning for a reasonable sort of future on the assumption that no large expansion will prove feasible.

Precision Steel

The businesses of Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, contributed \$1,414,000 to normal net operating income in 1991, down 29% compared with \$1,985,000 in 1990. The decrease in

1991 profit occurred as pounds of product sold increased 12%. Revenues were up only 1% to \$57,484,000, reflecting the pounding which competition gave to prices.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1991 handled a strong recessionary downdraft with skill. Profits were lower because of tough conditions, not poor management.

Wesco-Financial Insurance Company ("Wes-FIC")

Wes-FIC's "normal" net income for 1991 was \$13,986,000, versus \$14,924,000 for 1990. The "normal" income figures excluded securities gains, net of income taxes, of \$391,000 in 1990 versus none in 1991. These items are reported as "Net Gains on Sales of Securities," below.

At the end of 1991 Wes-FIC retained \$54 million in invested assets, offset by claims reserves, from its former reinsurance arrangement with the Fireman's Fund Group. This arrangement was terminated August 31, 1989, but it will take years before all claims are settled. Meanwhile Wes-FIC is helped by proceeds from investing "float."

The rest of Wes-FIC's insurance business is disappointingly small, but we continue to explore various options.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to \$3,828,000 in 1991 from \$4,030,000 in 1990. Sources were (1) rents (\$2,801,000 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), (2) interest and dividends from cash equivalents and marketable securities held outside the savings and loan and insurance subsidiaries, and (3) results from New America Electrical Corporation.

Net Gains On Sales Of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, increased to \$5,825,000 in 1991 from \$391,000 in 1990. All the gains last year were realized by Mutual Savings, in sales forced by FIRREA.

Convertible Preferred Stockholdings

At the end of 1991, Wesco and its subsidiaries owned \$135 million, at cost, in convertible preferred stocks, all requiring redemption at par value within 10 years or so from date of acquisition, all at par value:

Security	Preferred Dividend Rate	Par Value of Holding	Conversion Price at which Par Value may be Exchanged for Common Stock	Market Price of Common Stock on 12/31/91
Salomon Inc	9.00%	\$100 Million	\$8.00	\$30.62
USAir Group, Inc.	9.25%	12 Million	52.35	12.12
Champion International Corporation	9.25%	23 Million	38.00	24.00

These preferred stocks were purchased at the same time Wesco's parent corporation, Berkshire Hathaway, purchased additional amounts of the same stocks at the same price per share.

In a previous year we described these convertible preferred stock investments as "sound but not exciting," noting that "few, if any, investors have ever prospered mightily from investing in convertible preferred stocks of leading corporations." Our ideas have not changed. In aggregate our remaining holdings are probably worth a little less than we paid for them. (We estimate that (1) the \$12 million USAir holding is now worth about 35% less than was paid for it, (2) the \$100 million Salomon holding is worth about 2% more than we paid for it, and (3) the \$23 million Champion holding is worth about cost.) More than offsetting an overall shrinkage in value of retained holdings which is quite minor (\$2.2 million), we last year converted a \$40 million holding of Gillette convertible preferred stock into Gillette common stock worth \$89.8 million at year end. See comments below under the title "Consolidated Balance Sheet and Related Discussion."

New America Electrical Corporation ("New America Electric")

The financial results from Wesco's \$8.2 million payment, made at the end of 1988, for 80% of the stock of New America Electric are included in our residual category: "All Other "Normal" Net Operating Income." New America Electric caused this category to lose \$40,000 in 1991 after adjustments under consolidated accounting convention.

Ignoring adjustments under consolidated accounting convention, Wesco's 80% share of New America Electric's earnings was \$36,000 in 1991 versus \$234,000 in 1990.

Balance sheet liquidity declined slightly. Wesco's 80% share of New America Electric's cash at the end of 1991 was \$2.5 million, versus \$2.8 million at the end of 1990, -- but New America purchased a new line of business last year, which more than accounts for the small reduction in cash.

If you deduct from Wesco's cost (\$8.2 million) Wesco's share of cash (\$2.5 million), there leaves Wesco at risk for \$5.7 million, on which it is earning an inadequate return.

The people at New America Electric continue to respond superbly to a difficult environment, the worst since the 1930s, in commercial construction. It remains a pleasure to watch Glen Mitchel, Thomas Vogeles, John Medel and Jeff Mowry meet challenge.

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 in the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate carrying value at December 31, 1991 by about \$259 million, up significantly from about \$55 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 \$263 million. As earlier emphasized, about \$258 million of this unrealized appreciation lies within the savings and loan subsidiary in the form of appreciation in stock of Freddie Mac.

The foregoing paragraph deals only with unrealized appreciation of securities above "carrying value." Wesco also has some unrealized appreciation in securities that is already in "carrying value." This has happened because Wesco's insurance subsidiary at December 31, 1991 had about \$153 million in appreciation in common stocks (mostly stocks of The Coca-Cola Company and The Gillette Company). Under a peculiar accounting convention applicable only to insurance companies, this appreciation, minus the income taxes that would be due if the stocks were sold, is already included in Wesco's audited net worth, even though the gain has never passed through any audited report of income.

Wesco's Pasadena real estate comprises 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, which it would probably be wiser to destroy than improve. Despite a sharp, nationwide reduction in value for office buildings, this real estate retains some market value in excess of carrying value. The existence of unrealized appreciation is demonstrated by (1) mortgage debt (\$4,394,000 at 9.25% fixed) against this real estate exceeding its depreciated carrying value (\$3,365,000) in Wesco's balance sheet at December 31, 1991, 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. Even with these rational-but-not-very-common practices, a prime location and superior parking facilities, we no longer anticipate increases in cash flow during the next five years. We will catch some share of bad effects from glut conditions in the office building segment of the commercial real estate market, no matter how rationally we manage our building.

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 values its AA+ credit rating.

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 requires patience, at least for people like us whose valuable insights are few.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and insurance 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, we seek to better understand the few decisions we make.

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 11% in 1989-91, was dependent to a significant extent on securities gains, irregular by nature.

On January 23, 1992, Wesco increased its regular quarterly dividend from 21½ cents per share to 22½ cents per share, payable March 12, 1992, to shareholders of record as of the close of business on February 28, 1992.

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

March 9, 1992