WESCO FINANCIAL CORPORATION

Annual Report 1992

Form 10-K Annual Report 1992

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" net operating income (i.e., before all net gains or losses from sales of marketable securities and foreclosed property and unusual charges associated with a proposed give-up of Mutual Savings' status as a regulated savings and loan association) for the calendar year 1992 decreased to $22,500,000 ($3.16 per share) from $22,872,000 ($3.21 per share) in the previous year.

Consolidated net income (i.e., after net gains or losses from sales of marketable securities and foreclosed property and unusual income tax charges associated with the proposed give-up of Mutual Savings' status as a regulated savings and loan association) decreased to $5,001,000 ($.70 per share) from $29,522,000 ($4.15 per share) in the previous year.

Wesco has three major subsidiaries: Mutual Savings, currently engaged in the savings and loan business 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, 1992		Year Ended December 31, 1991	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income of:				
Mutual Savings	$ 3,746	$ .52	$ 3,644	$ .51
Wesco-Financial Insurance business	13,146	1.85	13,986	1.96
Precision Steel's businesses	2,075	.29	1,414	.20
All other "normal" net operating income[2]	3,533	.50	3,828	.54
	22,500	3.16	22,872	3.21
Net gain on sales of marketable securities	147	.02	5,825	.82
Net gain (loss) on sales of foreclosed property	(146)	(.02)	825	.12
Charges associated with the proposed give-up of Mutual Savings' status as a regulated savings and loan association[3]	(17,500)	(2.46)	—	—
Wesco consolidated net income	$ 5,001	$ .70	$29,522	$4.15

(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.

(3) Consists of income tax provision on about $47 million of Mutual Savings' net worth considered bad debt reserve for income tax (not financial statement) purposes, required to be recorded at 1992 yearend as a result of the decision to give up Mutual Savings' status as a regulated savings and loan association and thereby trigger recapture, for income tax purposes, of the bad debt reserve.

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

We have decided that Mutual Savings will shortly give up its status as a regulated savings and loan association. To achieve this objective, Mutual Savings is negotiating to sell to another financial institution, subject to regulatory approval, the leaseholds and related tangible personal property necessary to operate Mutual Savings' deposit-gathering offices. We expect that the buyer will assume all deposits and receive cash and other assets amounting, at Mutual Savings' book value, to slightly less than Mutual Savings' book value for the deposits assumed. After provision for costs, including some employee-severance payments, Wesco will probably report in 1993 a modest after-tax gain from the sale, measured from a point after the unusual income tax charge from bad debt reserve recapture in 1992.

At roughly the same time, Mutual Savings will transfer its real estate (including but not limited to its Santa Barbara seaside property) to a newly formed Wesco subsidiary which will thereafter manage the real estate and make such dispositions as seem appropriate.

After these transactions, Mutual Savings will retain a majority (at market value) of its former assets (consisting mostly of stock of Federal Home Loan Mortgage Corporation ["Freddie Mac"] and indirect loans in the form of securitized mortgages). Mutual Savings will then be merged into another long-existing Wesco subsidiary, Wesco-Financial Insurance Company, which will thereafter continue the portion of Mutual Savings' business that in recent years has employed the majority of its assets. However, the continuation of this business, including investment in mortgages, will be regulated by the Nebraska Department of Insurance, replacing the many different state and federal officials who now govern institutions like Mutual Savings.

We anticipate that future operating costs of the merged business will be very much lower than Mutual Savings' present costs as a heavily regulated institution. At the same time, asset deployment options will be greatly increased.

The 1992 earnings figures of Wesco include an unusual charge of $17.5 million caused by our decision to leave the regulatory scheme governing savings and loan associations. The figure consists of income tax provision on the $47 million of Mutual Savings' shareholders' equity that has never heretofore been taxed because it has been considered a bad debt reserve for income tax purposes.

Under conservative and reasonable accounting principles, when we first firmly planned to discontinue qualifying for that special bad-debt-reserve tax treatment which is given only to regulated savings and loan associations, we were required to accrue income tax provision as we have.

The financial impact on Wesco shareholders of the large new income tax provision at yearend 1992 is likely to be minimally negative over the short term and positive over the long term. After all, there are practical advantages in moving hundreds of millions of dollars of assets (at market value) from a high-cost, low-flexibility environment to a low-cost, high-flexibility environment.

Separate balance sheets of Mutual Savings at yearend 1991 and 1992 are set forth at the end of this annual report. They show (1) total savings accounts decreasing to $251 million from $289 million the year before and (2) a very high ratio of shareholders' equity to savings account liabilities (near the highest for any mature U.S. savings and loan association) even after the unusual 1992 yearend income tax charge of $17.5 million.

We reserved $200,000 for loan losses in 1991 and $650,000 more in 1992. These provisions constitute the only loan losses recorded in over a decade. They were caused by some bonehead errors we made in 1988-89, combined with the effects of the worst Southern California real estate recession in many years. On loans made after 1989, experience has reverted to wonderful.

Our prediction of future profit from disposition of foreclosed Santa Barbara seaside property goes down every year. Last year was no exception, but we still expect a small eventual profit, amounting approximately to compound interest on capital employed over the long development period.

At yearend 1992, Mutual Savings' carrying value of its holding of Freddie Mac common stock, traded on the New York Stock Exchange, was $71.7 million. The unrealized pre-tax appreciation was $276.6 million. If Mutual Savings' Freddie Mac holdings had been liquidated at market value on December 31, 1992, the after-tax profit would have been about $162.4 million, or $22.82 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.

Precision Steel

The businesses of Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, contributed $2,075,000 to normal net operating income in 1992, up 47% compared with $1,414,000 in 1991. The increased 1992 profit was achieved in spite of a 2% decrease in pounds of product sold, and was attributable largely to some favorable quantity-order prices on steel purchased and a change in mix of product. Revenues were up only 1% to $58,048,000.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1992 continued, during one more year, to provide an extraordinary return on resources employed.

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

Wes-FIC's net income for 1992 was $13,146,000, versus $13,986,000 for 1991.

At the end of 1992 Wes-FIC retained $45 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."

Wes-FIC entered into another reinsurance arrangement in 1992 with National Indemnity Company ("NICO"), a wholly owned subsidiary of Berkshire Hathaway, Wesco's ultimate parent, whereby NICO retroceded to it 50% of certain personal lines reinsurance it had assumed. This arrangement was responsible for almost the entire $19.6 million of Wes-FIC's earned premiums for 1992.

After Wes-FIC's capital and claims-paying capacity have been greatly augmented by the merger into Wes-FIC of Mutual Savings, Wes-FIC plans, through subcontracts with the Berkshire Hathaway Insurance Group, to enter the business of super-catastrophe ("super-cat") reinsurance. In such event, we believe: (1) Wes-FIC will thereafter report earnings with very wide fluctuations as it sometimes gets hit by big losses caused by super-catastrophes such as 1992's Hurricane Andrew and sometimes realizes large underwriting profits in years in which no super-catastrophes occur, and (2) Wes-FIC will thereafter have somewhat improved prospects for long-term prosperity.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to $3,533,000 in 1992 from $3,828,000 in 1991. Sources were (1) rents ($2,816,000 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, decreased to $147,000 in 1992 from $5,825,000 in 1991. All the gains were realized by Mutual Savings. Those realized in 1991 resulted from sales forced by Federal regulation.

Convertible Preferred Stockholdings

At the end of 1992, Wesco and its subsidiaries owned $135 million, at cost, in convertible preferred stocks, all requiring redemption at par value within ten years or so from date of acquisition:

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 12/31/92
Salomon Inc	9.00%	$100 Million	$38.00	$38.12
USAir Group, Inc.	9.25%	12 Million	44.28	12.75
Champion International Corporation	9.25%	23 Million	38.00	28.75

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 holdings are probably worth a little more than we paid for them. We estimate that (1) the $100 million Salomon holding is worth about 8% more than we paid for it, (2) the $12 million USAir holding is now worth about 25% less than was paid for it, and (3) the $23 million Champion holding is worth about 3% more than we paid for it. These figures when combined create $5.7 million in net appreciation at the 1992 yearend, attributable principally to the effect that the general decline in interest rates has had on values of fixed-rate investments.

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 $195,000 in 1992, up from a loss of $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 loss was $119,000 in 1992 versus income of $36,000 in 1991.

Balance sheet liquidity remained steady. Wesco's 80% share of New America Electric's cash at the end of 1992 remained unchanged from the $2.5 million reported at the end of 1991.

If you deduct from Wesco's cost ($8.2 million) Wesco's share of cash ($2.5 million), this 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 be associated with Glen Mitchel, John Medel and Jeff Mowry.

Consolidated Balance Sheet and Related Discussion

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, 1992 by about $278 million, up moderately from about $259 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 $280 million. As earlier emphasized, $276.6 million of this unrealized appreciation lies within the savings and loan subsidiary in the form of appreciation in stock of Freddie Mac. None of the foregoing figures includes the net unrealized appreciation, per our appraisal, of $5.7 million in our holdings of convertible preferred stocks.

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, 1992 had about $163 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.

Under this same peculiar accounting convention applicable only to insurance companies, Wesco's audited consolidated net worth is about to go up sharply. This will happen because unrealized appreciation in Freddie Mac stock, after provision for income tax as if sold, will count as net worth after Mutual Savings has been merged out of the savings and loan system and into the Wes-FIC insurance business. Sophisticated Wesco shareholders will not take this accounting quirk very seriously.

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 ($4,251,000 at 9.25% fixed) against this real estate exceeding its depreciated carrying value ($3,446,000) in Wesco's balance sheet at December 31, 1992, and (2) substantial current net cash flow (about $750 thousand per year) to Wesco after debt service on the mortgage. The modern office building is 97% 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. Instead, we expect continuing modest decreases. We are catching some share of bad effects from glut conditions in the office building segment of the commercial real estate market.

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. Indeed, it hopes to get the best credit rating possible, only one notch up, after giving up status as a savings and loan holding company.

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 has been slow because our 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 7% in 1990-92 (9% before the unusual income tax charge of $17.5 million relating to the proposed give-up of Mutual Savings' status as a regulated savings and loan association), was dependent to a significant extent on securities gains, irregular by nature.

Wesco's record looks much better when changes in unrealized appreciation of marketable securities (held principally in its savings and loan and insurance subsidiaries) are taken into account. For instance, compare status at yearends 1989 and 1992:

	Book Value of Common Equity, Before Any Unrealized Appreciation in Marketable Securities	Unrealized Appreciation, Before Any Provision for Income Tax, in Marketable Securities
1989	$262 million	$127 million
1992	$304 million	$441 million

Wesco, as it manages its affairs, makes no effort to remove fluctuations, even extreme fluctuations, from reported earnings. All it cares about are long-term results.

On January 28, 1993, Wesco increased its regular quarterly dividend from 22½ cents per share to 23½ cents per share, payable March 10, 1993, to shareholders of record as of the close of business on February 11, 1993.

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 25, 1993