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WESCO FINANCIAL CORPORATION

Annual Report 1995
Form 10-K Annual Report 1995

**WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS**

To Our Shareholders:

Consolidated "normal" net operating income (i.e., before irregularly occurring items shown in the table below) for the calendar year 1995 increased to \$30,208,000 (\$4.24 per share) from \$24,659,000 (\$3.46 per share) in the previous year.

Consolidated net income (i.e., after irregularly occurring items shown in the table below) increased to \$34,541,000 (\$4.85 per share) from \$18,972,000 (\$2.66 per share) in the previous year.

Wesco has two major subsidiaries: Wesco-Financial Insurance Company ("Wes-FIC"), headquartered in Omaha and 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, 1995		December 31, 1994	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income of:				
Wesco-Financial Insurance business	\$26,496	\$3.72	\$21,582	\$3.03
Precision Steel businesses	2,386	.33	2,900	.40
All other "normal" net operating income ⁽²⁾	1,326	.19	177	.03
	<u>30,208</u>	<u>4.24</u>	<u>24,659</u>	<u>3.46</u>
Net gain on sales of marketable securities	4,333	.61	163	.02
Decline in value of USAir preferred stock	—	—	(5,850) ⁽³⁾	(.82)
Wesco consolidated net income	<u>\$34,541</u>	<u>\$4.85</u>	<u>\$18,972</u>	<u>\$2.66</u>

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses and costs and expenses associated with delinquent loans and foreclosed real estate previously charged against Wesco's former Mutual Savings and Loan Association subsidiary. Income was from ownership of the Wesco headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiary.

(3) Represents writedown of investment in preferred stock of USAir Group, Inc., explained in section "Convertible Preferred Stockholdings" below.

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.

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

Wes-FIC's normal net income for 1995 was \$26,496,000, versus \$21,582,000 for 1994. The profitability to date on its super-catastrophe ("super-cat") reinsurance business, which it entered in 1994, was responsible for this increase.

At the end of 1995 Wes-FIC retained about \$33 million in invested assets, offset by claims reserves, from its former reinsurance arrangement with Fireman's Fund Group. This arrangement was terminated August 31, 1989. However, it will take a long time before all claims are settled, and, meanwhile, Wes-FIC is being helped over many years by proceeds from investing "float."

We previously informed shareholders that Wes-FIC had entered into the business of super-cat reinsurance through retrocessions from National Indemnity Company ("NICO"), a wholly owned insurance company subsidiary of Berkshire Hathaway, Wesco's ultimate parent. Wes-FIC's entry into the super-cat reinsurance business early in 1994 followed the large augmentation of its claims-paying capacity caused by its merger with Mutual Savings, the former savings and loan subsidiary of Wesco. In 1994, in recognition of Wes-FIC's sound financial condition, Standard and Poor's Corporation assigned to Wes-FIC the highest possible claims-paying-ability rating: AAA.

The super-cat reinsurance business, in which Wes-FIC is engaged, continues to be a very logical business for Wes-FIC. After all, Wes-FIC has a large net worth in relation to annual premiums being earned. And this is exactly the condition rationally required for any insurance company planning to be a "stand alone" reinsurer covering super-catastrophe risks it can't safely pass on to others sure to remain solvent if a large super-catastrophe comes. Such a "stand alone" reinsurer must be a kind of Fort Knox, prepared occasionally, without calling on any other reinsurers for help, to pay out in a single year many times more than premiums coming in, as it covers losses from some super catastrophe worse than Hurricane Andrew. In short, it needs a balance sheet a lot like Wes-FIC's.

In connection with the retrocessions of super-cat reinsurance from NICO to Wes-FIC the nature of the situation as it has evolved is such that Berkshire Hathaway, owning 100% of NICO and only 80% of Wesco and Wes-FIC, does not, for some philanthropic reason, ordinarily retrocede to Wes-FIC any reinsurance business that Berkshire Hathaway considers desirable and that is available only in amounts below what Berkshire Hathaway wants for itself on the terms offered. Instead, retrocessions occur only occasionally, under limited conditions and with some compensation to Berkshire Hathaway. Such retrocessions ordinarily happen only (1) when Berkshire Hathaway, for some reason (usually a policy of overall risk limitation), desires lower amounts of business than are available on the terms offered and (2) Wes-FIC has adequate capacity to bear the risk assumed and (3) Wes-FIC pays a fair ceding commission designed to cover part of the cost of getting and managing insurance business.

Generally, Berkshire Hathaway, in dealing with partly owned subsidiaries, tries to lean over a little backward in an attempt to observe what Justice Cardozo called "the punctilio of an honor the most sensitive," but it cannot be expected to make large and plain giveaways of Berkshire Hathaway assets or business to a partially owned subsidiary like Wes-FIC.

Given Berkshire Hathaway's unwillingness to make plain giveaways to Wes-FIC and reductions in opportunities in the super-cat reinsurance market in recent years, prospects are often poor for Wes-FIC's acquisition of retroceded super-cat reinsurance. Nonetheless, in February 1994, Wes-FIC was offered by NICO participations in four very unusual super-cat reinsurance contracts. Considering its other exposures to the same risks, NICO was willing to retrocede to Wes-FIC 20% of what was then available to NICO under each contract in return for a ceding commission amounting to 3% of Wes-FIC's premiums to be received. The remaining 80% of the risk was to be retained by NICO. A little later, a fifth retrocession was offered: 10% of a one-year NICO property loss contract with a maximum loss amount of \$50 million. The annual premium was 5% of the maximum possible loss. Then, in June, a sixth contract became available.

Wes-FIC promptly accepted all of these six unusual super-cat reinsurance participations offered by NICO in 1994.

In the first four contracts, in aggregate, Wes-FIC thus became exposed, during a single year, to either winning about \$4 million pre-tax or losing about \$20 million pre-tax. In addition, there is some slight possibility of a huge "long tail" loss for Wes-FIC and NICO many years after the four contracts ended, because a minority part of the insurance was liability insurance written on an "occurrence" basis. This is not the first time such "long tail" risks have been accepted by Wes-FIC. There are also, it should be remembered, possibilities for unpleasant surprises involving similar possible large "long tail" losses, many years hence, from Wes-FIC's long-terminated reinsurance arrangement with Fireman's Fund Group. Wes-FIC, now as then, is willing to run such "long tail" risks, carefully weighed against prospects for gain, provided it is much better capitalized than other insurance companies more influenced by animal spirits and institutional momentums.

In the fifth super-cat retrocession to Wes-FIC from NICO, which covered only property loss, there was no possibility of a surprising "long tail" loss. However, for the year covered, Wes-FIC had a very small chance of losing \$5 million pre-tax, while it could gain only \$250,000, less 3%, leaving Wes-FIC's net proceeds \$242,500, pre-tax.

In the sixth retrocession from NICO, Wes-FIC participated to the extent of 5% in a \$400 million contract with 20th Century Industries, a California insurer currently attempting to recover from devastating effects of the Northridge, California earthquake. The amount of reinsurance under the contract (covering what was mostly earthquake risk) declined monthly over the term, and expired early in 1995 as 20th Century withdrew from the homeowners and earthquake insurance markets in California. Wes-FIC earned a premium of approximately \$1 million in 1995 under the contract.

Needless to say, NICO does not believe that the average yearly loss to be expected from writing over many years a great series of super-cat reinsurance contracts like those it has retroceded in part to Wes-FIC would be as high as the one-year premiums to be received. But such super-cat reinsurance, like other super-cat reinsurance, is not for the faint of heart. A huge variation in annual results, with some very unpleasant years, is inevitable.

But it is precisely what must, in the nature of things, be associated with these bad possibilities, with their huge and embarrassing adverse consequences in occasional years, that makes Wes-FIC like its way of being in the super-cat business. Buyers (particularly wise buyers) of super-cat reinsurance often want to deal with wholly owned Berkshire Hathaway subsidiaries (possessing as they do the highest possible credit ratings and a reliable corporate personality) instead of other reinsurers less cautious, straightforward and well endowed. And many competing sellers of super-cat reinsurance are looking for a liberal "intermediary's" profit, hard to get because they must find a "layoff" reinsurer both (1) so smart that it is sure to stay strong enough to pay possible losses yet (2) so casual about costs that it is not much bothered by a liberal profit earned by some intermediary entity not willing to retain any major risk. Thus the forces in place can rationally be expected to cause acceptable long-term results for well-financed, disciplined decision makers, despite horrible losses in some years and other years of restricted opportunity to write business. And, again, we wish to repeat that we expect only acceptable long-term results. We see no possibility for bonanza.

It should also be noted that Wes-FIC, in the arrangements recently made with NICO, receives a special business-acquisition advantage from using Berkshire Hathaway's general reputation. Under all the circumstances, a 3% ceding commission seems more than fair to Wes-FIC. Certainly and obviously, Berkshire Hathaway would not offer terms so good to any other entity outside the Berkshire Hathaway affiliated group.

Finally, we repeat an important disclosure about Wes-FIC's super-cat-reinsurance-acquisition mechanics. It is impractical to have people in California make complex accept-or-reject decisions for Wes-FIC when retrocessions of reinsurance are offered by Berkshire Hathaway insurance subsidiaries. But, happily, the Berkshire Hathaway insurance group executives making original business-acquisition decisions are greatly admired and trusted by the writer and will be "eating their own cooking." Under such circumstances, Wesco's and Wes-FIC's boards of directors, on the writer's recommendation, have simply approved automatic retrocessions of reinsurance to Wes-FIC as offered by one or more wholly owned Berkshire Hathaway subsidiaries. Each retrocession is to be accepted forthwith in writing in Nebraska by agents of Wes-FIC who are at the same time salaried employees of wholly owned subsidiaries of Berkshire Hathaway. Moreover, each retrocession will be made at a 3%-of-premiums ceding commission. Finally, two conditions must be satisfied: (1) Wes-FIC must get 20% or less of the risk (before taking into account effects from the ceding commission) and (2) wholly owned Berkshire Hathaway subsidiaries must retain at least 80% of the identical risk (again, without taking into account effects from the ceding commission).

We will not ordinarily describe individual super-cat reinsurance contracts in full detail to Wesco shareholders. That would be contrary to our competitive interest. Instead, we will try to summarize reasonably, more or less as we have done here.

Will more reinsurance be later available to Wes-FIC through Berkshire Hathaway subsidiaries on the basis and using the automatic procedure we have above described? Well, we have often proved poor prognosticators. We can only say that we hope so and that more reinsurance should come, albeit irregularly and with long intermissions, if buyers of super-cat coverage are rational. However, in 1995 no entirely new super-cat contracts were retroceded to Wes-FIC.

We continue to examine other possible insurance-writing opportunities, and also insurance company acquisitions, not involving Berkshire Hathaway.

Wes-FIC is now a very strong insurance company, with very low costs, and, one way or another, in the future as in the past, we expect to continue to find and seize at least a few sensible insurance opportunities.

On super-cat reinsurance accepted by Wes-FIC to date (March 8, 1996) there has been no loss whatsoever that we know of. Underwriting profit of \$6.3 million, before taxes, benefited 1995 earnings. In contrast, no underwriting profit flowed through Wesco's books in 1994 because none of its super-cat contracts expired in 1994, and our accounting policy requires contract expiration before super-cat underwriting profit is recognized. Needless to say, we would not have similar reluctance to report losses before contract expirations. Our super-cat accounting policy is not irrationally super-conservative, although it may amount to "best-practice" accounting.

Precision Steel

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, contributed \$2,386,000 to normal net operating income in 1995, down 18% compared with \$2,900,000 in 1994. The decrease in 1995 profit occurred as pounds of product sold decreased 9%. Revenues were up only 0.2%, reflecting the pounding which competition gave to prices.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1995 continued to provide an excellent return on resources employed.

Tag Ends from Savings and Loan Days

All that now remains outside Wes-FIC but within Wesco as a consequence of Wesco's former involvement with Mutual Savings, Wesco's long-held savings and loan subsidiary, is a small real estate subsidiary, MS Property Company, that holds tag ends of assets and liabilities with a net book value (after writedowns considered adequate) of about \$25 million. Operations (including writedowns) of MS Property Company caused an after-tax loss to Wesco in 1995 of about \$700,000. Sooner or later Wesco is expected to realize at least a little more than \$25 million from MS Property Company's net assets, after earning modest returns until that time on the \$25 million of book value involved. MS Property Company's 1995 loss, immaterial versus Wesco's present size, is included in the foregoing breakdown of earnings within "all other 'normal' net operating income."

Of course, the main tag end from Wesco's savings and loan days is 7,200,000 shares of Federal Home Loan Mortgage Corporation ("Freddie Mac"), purchased by Mutual Savings for \$71.7 million at a time when Freddie Mac shares could be lawfully owned only by a savings and loan association. This holding, with a market value of \$601.2 million at yearend 1995, now reposes in Wes-FIC. And, in the years following our initial purchase, Freddie Mac and its similar cousin, "Fannie Mae," have made matters pretty miserable for the savings and loan industry by taking over most financing of low-to-moderate-cost homes.

For us, at least, our experience in shifting from savings and loan operation to ownership of Freddie Mac shares tends to confirm a long-held notion that being prepared, on a few occasions in a lifetime, to act promptly in scale in doing some simple thing will often be enough to make the financial results of that lifetime quite satisfactory.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, increased to \$1,326,000 in 1995 from \$177,000 in 1994. Sources were (1) rents (\$2,954,000 gross) from Wesco's Pasadena office property (leased almost entirely to outsiders and with CenFed Bank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiary, mostly offset in both years by costs and expenses (including additions to loss reserves) of liquidating tag-end delinquent loans and foreclosed real estate. The 1995 and 1994 figures also include intercompany charges for interest expense (\$965,000 and \$826,000 after taxes, respectively) on borrowings from Wes-FIC principally made late in 1993 to facilitate the transfer of loans and foreclosed properties to MS Property Company. This intercompany interest expense does not affect Wesco's consolidated net income inasmuch as the same amount is included as interest income in Wes-FIC's "normal" net operating income.

Net Securities Gains and Losses

Wesco's aggregate net gains on sales of securities, combined, amounted to \$4,333,000, after income taxes, in 1995, and included \$4,192,000 realized on the conversion to common stock and sale of Wesco's investment in cumulative convertible preferred stock of Champion International Corporation. Wesco's earnings for 1994 contained securities gains of \$163,000, after income taxes, and also reflected the after-tax effect of a writedown of an investment in preferred stock of USAir Group, Inc. by \$5,850,000, described in the following section entitled "Convertible Preferred Stockholdings."

Convertible Preferred Stockholdings

At the end of 1995, Wesco and its subsidiaries owned \$92 million, at original cost, in convertible preferred stocks of Salomon Inc ("Salomon") and USAir Group, Inc. ("USAir"), both requiring redemption at par value within ten years or so from date of acquisition.

The investments are carried on Wesco's consolidated balance sheet at fair market value, with any difference between historical cost and market value as to Salomon, and between adjusted cost and market value as to USAir, included in shareholders' equity, net of income tax effect, without affecting reported net income, according to accounting convention. The investment in USAir was written down to fair market value of \$3 million effective December 31, 1994, and this \$3 million figure is now treated as adjusted cost; the \$5.9 million after-tax loss on the writedown to the new adjusted cost was shown as a separate charge on Wesco's 1994 statement of income. Following is a summary of these investments at yearend 1995:

<u>Security</u>	<u>Preferred Dividend Rate</u>	<u>Par Value of Holding</u>	<u>Conversion Price at which Par Value may be Exchanged for Common Stock</u>	<u>Market Price of Common Stock on 12/31/95</u>	<u>12/31/95 Yearend Carrying Value of Holding</u>
Salomon Inc.	9.00%	\$80 Million	\$38.00	\$35.38	\$ 84 Million
USAir Group, Inc.	9.25%	12 Million	38.74	13.25	7.2 Million

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. On October 31, 1995, in accordance with the terms of its convertible preferred stock, Salomon redeemed \$20 million par value of its shares owned by Wesco at cost plus accrued dividends.

In previous years we noted that "few, if any, investors have ever prospered mightily from investing in convertible preferred stocks of leading corporations." Our two holdings at yearend 1995 appear to bear this out. We estimate that (1) our \$80 million Salomon holding was worth about \$4 million more than we paid for it, and (2) our \$12 million USAir holding, written down to an adjusted cost of \$3 million at yearend 1994, was worth about \$4.2 million more than such adjusted cost, but \$4.8 million less than we paid for it. These figures when combined created \$8.2 million in pre-tax appreciation above adjusted cost, and \$0.8 million less than actual cost, considering the \$9 million pre-tax loss realized in 1994 on the USAir Group writedown. Readers should bear in mind, however, that Wesco's experience to date has been much better in an investment in convertible preferred stock of The Gillette Company, made in 1989 at cost of \$40 million, and converted into Gillette common stock in 1991. This investment is carried at a \$166.8 million yearend market value in Wesco's consolidated 1995 balance sheet, \$126.8 million higher than the investment cost. Also, as discussed above, Wesco realized an after-tax gain of \$4.2 million in 1995 on the conversion to common stock and sale of its \$23 million investment in preferred stock of Champion International Corporation. However, even with all good experience factored in, our overall investment returns from convertible preferred stockholdings have been unexciting, just as we have predicted.

Consolidated Balance Sheet And Related Discussion

As indicated in the accompanying financial statements, Wesco increased its net worth, as accountants compute it under their conventions, to \$957.6 million (\$134

per Wesco share) at yearend 1995 from \$678.1 million (\$95 per Wesco share) at yearend 1994.

The \$279.5 million increase in reported net worth in 1995 was the result of two factors: (1) \$252.2 million resulting from continued net appreciation of investments after provision for future taxes on capital gains; and (2) \$27.3 million from retention of 1995 net income after deduction of dividends paid.

The foregoing \$134-per-share book value approximates liquidation value assuming that all Wesco's non-security assets would liquidate, after taxes, at book value. Probably, this assumption is too conservative. But our computation of liquidation value is unlikely to be too low by more than a couple of dollars per Wesco share, because (1) the liquidation value of Wesco's consolidated real estate holdings (where interesting potential now lies almost entirely in Wesco's equity in its office property in Pasadena) is now far below its former high, and (2) unrealized appreciation in other assets (primarily Precision Steel) cannot be large enough, in relation to Wesco's overall size, to change very much the overall computation of after-tax liquidating value.

Of course, so long as Wesco does not liquidate, and does not sell any appreciated assets, it has, in effect, an interest-free "loan" from the government equal to its deferred income taxes on unrealized gains, subtracted in determining its net worth. This interest-free "loan" from the government is at this moment working for Wesco shareholders and amounted to about \$45 per Wesco share at yearend 1995.

However, some day, perhaps soon, major parts of the interest-free "loan" must be paid as assets are sold. Therefore, Wesco's shareholders have no perpetual advantage creating value for them of \$45 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than \$45 per Wesco share. In the writer's judgment, the value of Wesco's advantage from its temporary, interest-free "loan" was probably about \$15 per Wesco share at yearend 1995.

After the value of the advantage inhering in the interest-free "loan" is estimated, a reasonable approximation can be made of Wesco's intrinsic value per share. This approximation is made by simply adding (1) the value of the advantage from the interest-free "loan" per Wesco share and (2) liquidating value per Wesco share. Others may think differently, but the foregoing approach seems reasonable to the writer as a way of estimating intrinsic value per Wesco share.

Thus, if the value of the advantage from the interest-free tax-deferral "loan" present was \$15 per Wesco share at yearend 1995, and after-tax liquidating value was then about \$134 per share (figures that seem rational to the writer), Wesco's intrinsic value per share would become only about \$149 per share at yearend 1995, up 43% from intrinsic value as guessed in a similar calculation at the end of 1994. And, finally, this reasonable-to-this-writer, \$149-per-share figure for intrinsic per share value of Wesco stock should be compared with the \$182 per share price at

which Wesco stock was selling on December 31, 1995. This comparison indicates that Wesco stock was then selling about 22% above intrinsic value.

Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. In this connection, it should be remembered that the writer caused or helped cause (1) a loss on Wesco's former electrical equipment subsidiary, (2) what will now plainly turn out to be a bad financial result from development of foreclosed mostly-seaside land in the Montecito district of Santa Barbara and (3) some recent losses from boom-time mortgage loans on residences. Wesco, under the writer's leadership, managed to be clobbered in three different ways by the California real estate crash, albeit in categories employing a very small portion of Wesco's assets.

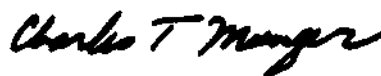
Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway.

All that said, we make no attempt to appraise relative attractiveness for investment of Wesco versus Berkshire Hathaway stock at present stock-market quotations.

We are not now pessimists, on a long-term basis, about business expansion. Despite present ebullient markets for entire businesses, making it hard for Wesco to find attractive opportunities, we do not believe that such opportunities will never come.

On January 17, 1996 Wesco increased its regular dividend from 25½ cents per share to 26½ cents per share, payable March 6, 1996, to shareholders of record as of the close of business on February 7, 1996.

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 8, 1996