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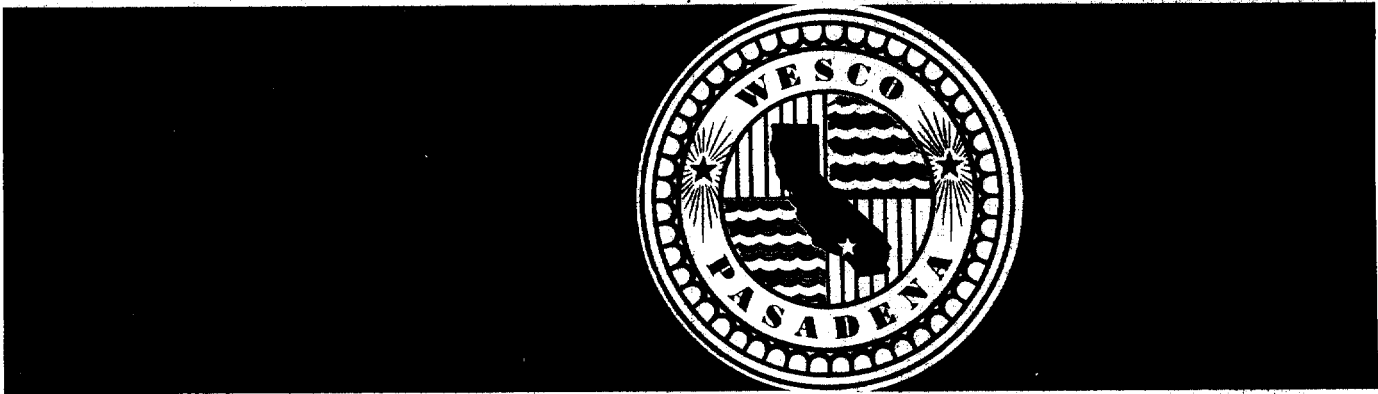
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# WESCO FINANCIAL CORPORATION

*Annual Report 1996*

*Form 10-K Annual Report 1996*

**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 1996 increased to \$30,734,000 (\$4.32 per share) from \$30,208,000 (\$4.24 per share) in the previous year.

Consolidated net income (i.e., after irregularly occurring items shown in the table below) decreased to \$30,619,000 (\$4.30 per share) from \$34,541,000 (\$4.85 per share) in the previous year.

Wesco has three major subsidiaries: (1) Wesco-Financial Insurance Company ("Wes-FIC"), headquartered in Omaha and engaged principally in the reinsurance business, (2) The Kansas Bankers Surety Company ("KBS"), purchased by Wes-FIC in July 1996 and specializing in insurance products tailored to midwestern banks, and (3) 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) <sup>(1)</sup>:

	Year Ended			
	December 31, 1996		December 31, 1995	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income of:				
Wes-FIC and KBS insurance businesses .....	\$27,249	\$3.83	\$26,496	\$3.72
Precision Steel businesses .....	3,033	.43	2,386	.33
All other "normal" net operating income <sup>(2)</sup> .....	452	.06	1,326	.19
	<u>30,734</u>	<u>4.32</u>	<u>30,208</u>	<u>4.24</u>
Net gain (loss) on sales of marketable securities .....	(115)	(.02)	4,333	.61
Wesco consolidated net income .....	<u>\$30,619</u>	<u>\$4.30</u>	<u>\$34,541</u>	<u>\$4.85</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 subsidiaries.

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 1996 was \$27,249,000, versus \$26,496,000 for 1995. The 1996 figure includes \$2,288,000 contributed by The Kansas Bankers Surety Company ("KBS") following its purchase by Wes-FIC early in the third

quarter. The purchase of KBS is discussed in the section, "The Kansas Bankers Surety Company," below.

At the end of 1996 Wes-FIC retained about \$31 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 the Insurance Group 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. 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 to Wes-FIC from the Berkshire Hathaway Insurance Group, the nature of the situation as it has evolved is such that Berkshire Hathaway, owning 100% of its Insurance Group 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.

Moreover, Wesco shareholders should continue to realize that super-cat reinsurance is not for the faint of heart. A huge variation in annual results, with some very unpleasant future years for Wes-FIC, 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 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 with the Insurance Group of Berkshire Hathaway, receives a special business-acquisition advantage from using Berkshire Hathaway's general reputation. Under all the circumstances, the 3% ceding commission now being paid 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 the Berkshire Hathaway Insurance Group. 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 any items of very large importance.

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. However, only three new contracts became available and were taken on by Wes-FIC in 1996, with one of these not being a super-cat contract and another becoming effective starting in January 1997. Moreover, all Wes-FIC's super-cat policies written before 1996 had expired by yearend 1996.

We continue to examine other possible insurance-writing opportunities, and also insurance company acquisitions, like and unlike the purchase of our recently acquired KBS.

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 7, 1997) there has been no loss whatsoever that we know of. Underwriting profit of \$3.9 million, before taxes, benefited 1996 earnings, versus \$6.3 million in 1995. 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.

### **The Kansas Bankers Surety Company ("KBS")**

KBS, purchased by Wes-FIC early in the third quarter of 1996 for approximately \$80 million in cash, contributed \$2,288,000 to the normal net operating income of the insurance businesses, after adjustments under consolidated accounting convention. The results of KBS have been combined with those of Wes-FIC, and are included in the foregoing table in the category, "'normal' net operating income of Wes-FIC and KBS insurance businesses."

The acquisition of KBS became available to, and was accepted by, Wesco following an agreement entered into with KBS by Berkshire Hathaway, under which Berkshire agreed to acquire the stock of the surety company with the intention of having the transaction completed by Wesco or its insurance subsidiary. If you deduct the \$63.9 million of cash, cash-equivalent investments, investments in obligations

backed by the Federal government and its agencies, and state and municipal bonds owned by KBS as of the purchase date, this left Wesco with approximately \$16 million less in net investable assets after the acquisition. This reduction in investable assets was considered worth accepting, given the likely future underwriting profit of KBS.

KBS was chartered in 1909 to underwrite deposit insurance for Kansas banks. Its offices are in Topeka, Kansas. Over the years its service has continued to adapt to the changing needs of the banking industry. Today its customer base, consisting mostly of small and medium-sized community banks, is spread throughout 22 mainly midwestern states. In addition to bank deposit guaranty bonds which insure deposits in excess of FDIC coverage, KBS also offers directors and officers indemnity policies, bank employment practices policies, bank annuity and mutual funds indemnity policies and bank insurance agents professional errors and omissions indemnity policies.

KBS is run by Donald Towle, President, assisted by 13 dedicated officers and employees.

### **Precision Steel**

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, contributed \$3,033,000 to normal net operating income in 1996, up 27% compared with \$2,386,000 in 1995. However, the substantial improvement in 1996 earnings was due mainly to LIFO inventory accounting adjustments, which increased after-tax earnings approximately \$250,000 in 1996 after reducing such earnings by \$460,000 in 1995. We do not regard earnings changes from LIFO accounting adjustments, up or down, as material in predicting future earning power. The increase in 1996 profit occurred as pounds of product sold increased 7%. Revenues were up only 2.2%.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1996 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 \$24 million. Operations (including writedowns, of which there were none in 1996) of MS Property Company caused an after-tax loss to Wesco in 1996 of about \$400,000. Sooner or later Wesco is expected to realize at least a little more than \$24 million from MS Property Company's net assets, after earning modest returns until that time on the \$24 million of book value involved. MS Property Company's 1996 loss, immaterial versus Wesco's present size, is included in the foregoing breakdown of earnings within "all other 'normal' net operating income."

It is anticipated that in 1997 Wesco will be able to make a substantial net withdrawal, in cash, from MS Property Company following sale of various real estate assets.

Of course, the main tag end from Wesco's savings and loan days is 28,800,000 shares (reflecting a 4-for-1 split distributed shortly after yearend 1996) 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 \$794.7 million at yearend 1996, 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.

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 and logical thing will often dramatically improve the financial results of that lifetime. A few major opportunities, clearly recognizable as such, will usually come to one who continuously searches and waits, with a curious mind, loving diagnosis involving multiple variables. And then all that is required is a willingness to bet heavily when the odds are extremely favorable, using resources available as a result of prudence and patience in the past.

#### **All Other "Normal" Net Operating Income**

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to \$452,000 in 1996 from \$1,326,000 in 1995. Sources were (1) rents (\$2,917,000 gross) from Wesco's Pasadena office property (leased almost entirely to outsiders, including CenFed Bank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiaries, mostly offset in both years by costs and expenses of liquidating tag-end delinquent loans and foreclosed real estate. The 1996 and 1995 figures also include intercompany charges for interest expense (\$298,000 and \$965,000 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 earnings for 1996 contained securities losses of \$115,000, after income taxes, versus net gains of \$4,333,000, after income taxes, in 1995. The latter figure included \$4,192,000 realized on the conversion to common stock and sale of Wesco's investment in convertible preferred stock of Champion International Corporation.

## Convertible Preferred Stockholdings

At the end of 1996, Wesco and its subsidiaries owned \$72 million, at original cost, in convertible preferred stocks of Salomon Inc ("Salomon") and USAir Group, Inc. ("USAir"), both requiring redemption at par value or conversion to common stock within the next few years.

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 a 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 in convertible preferred stocks at yearend 1996:

<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 12/31/96</u>	<u>12/31/96 Yearend Carrying Value of Holding</u>
Salomon Inc. ....	9.00%	\$60 Million	\$38.00	\$47.125	\$ 66 Million
USAir Group, Inc. ....	9.25%	12 Million	38.74	23.375	10.8 Million

These convertible 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 preferred shares owned by Wesco at cost plus accrued dividends. One year later, on October 31, 1996, Wesco converted \$20 million par value of its remaining preferred shares of Salomon to 526,314 shares of common stock of Salomon. Market value of these common shares, carried in the category "marketable equity securities" in Wesco's financial statements, was \$24.8 million at yearend 1996.

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 1996 appear to bear this out. We estimate that (1) our \$60 million Salomon holding was worth about \$6 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 at yearend 1996 worth about \$7.8 million more than such adjusted cost, but \$1.2 million less than we paid for it. These figures when combined created \$13.8 million in pre-tax appreciation above adjusted cost, and \$4.8 million more than actual cost, considering the \$9 million pre-tax loss shown in 1994 on the USAir Group writedown. Readers should bear in mind, however, that Wesco's experience to date has been very 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 \$248.8 million yearend market value in Wesco's consolidated 1996



balance sheet. This is \$200.8 million more than the investment cost. Also, as discussed above, Wesco realized an after-tax gain of \$4.2 million in 1995 on 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, although somewhat better than we 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 \$1.25 billion (\$176 per Wesco share) at yearend 1996 from \$957 million (\$134 per Wesco share) at yearend 1995.

The \$293 million increase in reported net worth in 1996 was the result of two factors: (1) \$270 million resulting from continued net appreciation of investments after provision for future taxes on capital gains; and (2) \$23 million from retention of 1996 net income after deduction of dividends paid.

The foregoing \$176-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 \$66 per Wesco share at yearend 1996.

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 \$66 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than \$66 per Wesco share. In the writer's judgment, the value of Wesco's advantage from its temporary, interest-free "loan" was probably about \$20 per Wesco share at yearend 1996.

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 \$20 per Wesco share at yearend 1996, and after-tax liquidating value was then about \$176 per share (figures that seem rational to the writer), Wesco's intrinsic value per share would become about \$196 per share at yearend 1996, up 32% from intrinsic value as guessed in a similar calculation at the end of 1995. And, finally, this reasonable-to-this-writer, \$196-per-share figure for intrinsic per share value of Wesco stock should be compared with the \$187 per share price at which Wesco stock was selling on December 31, 1996. This comparison indicates that Wesco stock was then selling about 5% below intrinsic value.

As Wesco's unrealized appreciation has continued to grow, it should be remembered that it is subject to market fluctuation, with no guaranty as to its ultimate full realization. Unrealized after-tax appreciation represents 70% of Wesco's shareholders' equity at 1996 yearend, versus 63% and 51% one and two years earlier.

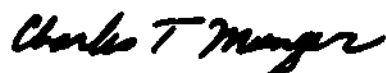
Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value 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 15, 1997 Wesco increased its regular dividend from 26½ cents per share to 27½ cents per share, payable March 5, 1997, to shareholders of record as of the close of business on February 5, 1997.

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 7, 1997