



WESCO FINANCIAL CORPORATION

Annual Report 1998
Form 10-K Annual Report 1998

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 1998 decreased to \$37,622,000 (\$5.28 per share) from \$38,262,000 (\$5.38 per share) in the previous year.

Consolidated net income (i.e., after irregularly occurring items shown in the table below) decreased to \$71,803,000 (\$10.08 per share) from \$101,809,000 (\$14.30 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"), owned by Wes-FIC 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)⁽¹⁾:

	Year Ended			
	December 31, 1998		December 31, 1997	
	Amount	Per Wesco Share ⁽²⁾	Amount	Per Wesco Share ⁽²⁾
"Normal" net operating income of:				
Wes-FIC and KBS insurance businesses	\$34,654	\$ 4.87	\$ 33,507	\$ 4.71
Precision Steel businesses	3,154	.44	3,622	.51
All other "normal" net operating income (loss) ⁽³⁾	(186)	(.03)	1,133	.16
	<u>37,622</u>	<u>5.28</u>	<u>38,262</u>	<u>5.38</u>
Realized net securities gains	33,609	4.72	62,697	8.80
Gain on sales of foreclosed properties	572	.08	850	.12
Wesco consolidated net income	<u>\$71,803</u>	<u>\$10.08</u>	<u>\$101,809</u>	<u>\$14.30</u>

(1) All figures are net of income taxes.

(2) Per-share data is based on 7,119,807 shares outstanding. Wesco has had no dilutive capital stock equivalents.

(3) After deduction of interest and other corporate expenses, and costs and expenses associated with 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, interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiaries, and, in 1997, the reduction of loss reserves provided in prior years against possible losses on sales of foreclosed real estate.

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 1998 was \$34,654,000, versus \$33,507,000 for 1997. The figures include \$4,987,000 in 1998 and \$6,044,000 in 1997 contributed by The Kansas Bankers Surety Company (“KBS”), owned by Wes-FIC since 1996. KBS is discussed in the section, “The Kansas Bankers Surety Company,” below.

At the end of 1998 Wes-FIC retained about \$24 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 when (1) 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. No new contracts became available to Wes-FIC in 1998. As of 1998 yearend, the one remaining super-cat contract, plus one other contract, not a super-cat contract, represented Wes-FIC's active reinsurance business.

We continue to examine other possible insurance-writing opportunities, and also insurance company acquisitions, like and unlike the purchase of 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 8, 1999) there has been no loss whatsoever that we know of, but some "no-claims" contingent commissions have been paid to original cessors of business (i.e., cessors not including Berkshire Hathaway). Super-cat underwriting profit of \$1.4 million, before taxes, benefited 1998 earnings, versus \$2.3 million in 1997. The balance of pre-tax underwriting profit amounted to \$1.9 million for 1998 and \$2.8 million for 1997. These figures came mostly from favorable revision of loss reserves on the old Fireman's Fund contract.

The Kansas Bankers Surety Company ("KBS")

KBS, purchased by Wes-FIC in 1996 for approximately \$80 million in cash, contributed \$4,987,000 to the normal net operating income of the insurance businesses in 1998 and \$6,044,000 in 1997, after reductions for goodwill amortization under consolidated accounting convention of \$782,000 each year. 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."

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 25 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.

The principal change in KBS's operations in 1998 was a large reduction in insurance premiums ceded to reinsurers, effective January 1, 1998. The increased volume of business retained (94% in 1998 versus 58% in 1997) accompanied reduced underwriting income during 1998. However, KBS's combined ratio remained much better than average for insurers, at 62.2% for 1998, versus 37.2% for 1997 and 29.3% for 1996, and we expect volatile but favorable long-term effects from increased insurance retained. Part of KBS's continuing insurance volume is now ceded through reinsurance to other Berkshire subsidiaries under reinsurance arrangements whereunder such other Berkshire subsidiaries take 50% and unrelated reinsurers take the other 50%.

KBS is run by Donald Towle, President, assisted by 15 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 \$3,154,000 to normal net operating income in 1998, compared with \$3,622,000 in 1997. The decrease in profit occurred as revenues decreased 2%, despite a 5% increase in pounds of product sold, and was attributable mainly to expenditures necessitated to upgrade computers and computer systems to ensure that Precision Steel's order-taking and other data processing systems continue to function accurately beyond December 31, 1999.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1998 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 of about \$13 million. MS Property Company's results of operations, immaterial versus Wesco's present size, are included in the foregoing breakdown of earnings within "all other 'normal' net operating income (loss)."

Of course, the main tag end from Wesco's savings and loan days is 28,800,000 shares of Freddie Mac, purchased by Mutual Savings for \$72 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 \$1.9 billion at yearend 1998, now reposes in Wes-FIC.

All Other "Normal" Net Operating Income or Loss

All other "normal" net operating income or loss, net of interest paid and general corporate expenses, decreased to an after-tax loss of \$186,000 in 1998 from an after-tax profit of \$1,133,000 in 1997. Sources were (1) rents (\$2,921,000 gross) from Wesco's Pasadena office property (leased almost entirely to outsiders, including California Federal Bank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiaries, less (3) costs and expenses of liquidating tag-end foreclosed real estate. Income in 1998 was lower because (1) reversals of reserves for possible losses on sales of such tag end real estate, expensed in prior years, benefited earnings by about \$1.1 million in 1997, and (2) lower dividends were received in 1998 after forced conversion of preferred stock of Citigroup Inc. ("Citigroup") into lower-dividend-paying common stock. The 1998 and 1997 "other 'normal' net operating income or loss" figures also include intercompany charges for interest expense (\$102,000 and \$172,000 after taxes, respectively) on borrowings from Wes-FIC. 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 contained securities gains of \$33,609,000, after income taxes, for 1998, versus \$62,697,000, after taxes, for 1997. The entire 1998 figure resulted from sales of marketable securities. Of the 1997 figure, only \$93,000 was realized through the sale of securities; the balance, \$62,604,000, resulted from the exchange of the preferred and common shares of Salomon Inc ("Salomon") owned by Wesco for preferred and common shares of The Travelers Group Inc. ("Travelers") late in 1997 in connection with the merger of Salomon with a subsidiary of Travelers. Accounting standards require that the fair (market) value of shares received in such an exchange be recorded as the new cost basis as of the date of the exchange, with the difference, after appropriate reserves for future income tax on the gain, recognized in the financial statements as a realized after-tax gain. For income tax purposes the exchange is recorded at the original cost of the securities exchanged; no gain is reported on the tax return until the securities are sold.

Although the realized gains materially impacted Wesco's reported earnings for each year, *they had a very minor impact on Wesco's shareholders' equity*. Inasmuch as the greater portion of each year's realized gains had previously been reflected in the unrealized gain component of Wesco's shareholders' equity, those amounts were merely switched from unrealized gains to retained earnings, another component of shareholders' equity.

Convertible Preferred Stockholdings

At the end of 1998, Wesco and its subsidiaries owned \$20,000,000, at original cost, in convertible preferred stock which by merger of Travelers and Citicorp late in 1998 became convertible preferred stock of Citigroup. The Travelers preferred stock, itself, was received in 1997 (see the preceding section) in exchange for the Wesco group's remaining shares of Salomon preferred stock, which originally cost \$20,000,000, and whose cost was adjusted upwards to \$45,000,000 as of the date of the exchange. The issue requires redemption at par value of \$20,000,000 on October 31, 1999, if not converted to 892,105 shares of common stock before that date. The investment is carried on Wesco's consolidated balance sheet at fair value of \$44,000,000 as of December 31, 1998, the approximate market value of the common shares at that date, with the \$1,000,000 difference between *its adjusted* cost and market value deducted from shareholders' equity, net of income tax effect, without affecting reported net income, according to accounting convention. The convertible preferred stock was obtained at the same time Wesco's parent corporation, Berkshire Hathaway, obtained additional amounts of the same stock at the same price per share.

Through yearend 1997, Wesco's consolidated financial statements reflected an investment in 9.25% convertible preferred stock of US Airways Group, Inc., acquired by Wesco at par of \$12,000,000 in 1989; that figure was adjusted down to \$3,000,000 when we decided in 1994 that an other-than-temporary decline in the value of its stock had occurred. Early in 1998, US Airways called the preferred stock for redemption. Prior to the effective date, Wesco converted its preferred stock investment to 309,718 shares of US Airways common stock and sold the latter for \$21,738,000, realizing a gain of \$18,738,000 for financial statement purposes (\$12,180,000 after taxes). For tax return purposes, however, only \$9,738,000 of gain (\$6,330,000 after taxes) will be realized, because the \$9,000,000 writedown in 1994 was not deductible.

Consolidated Balance Sheet And Related Discussion

As indicated in the accompanying financial statements, Wesco's net worth increased, as accountants compute it under their conventions, to \$2.22 billion (\$312 per Wesco share) at yearend 1998 from \$1.76 billion (\$248 per Wesco share) at yearend 1997.

The \$459.5 million increase in reported net worth in 1998 was the result of three factors: (1) \$395.8 million resulting from continued net appreciation of investments after provision for future taxes on capital gains; plus (2) \$71.8 million from 1998 net income; less (3) \$8.1 million in dividends paid.

The foregoing \$312-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 two or three 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) containing only 125,000 net rentable square feet, 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 the 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 \$127 per Wesco share at yearend 1998.

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 \$127 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than \$127 per Wesco share. In the writer's judgment, the value of Wesco's advantage from its temporary, interest-free "loan" was probably about \$30 per Wesco share at yearend 1998.

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 \$30 per Wesco share at yearend 1998, and after-tax liquidating value was then about \$312 per share (figures that seem rational to the writer), Wesco's intrinsic value per share would become about \$342 per share at yearend 1998, up 25% from intrinsic value as guessed in a similar calculation at the end of 1997. And, finally, this reasonable-to-this-writer, \$342-per-share figure for intrinsic per share value of Wesco stock should be compared with the \$354¾ per share price at which Wesco stock was selling on December 31, 1998. This comparison indicates that Wesco stock was then selling about 4% above intrinsic value.

As Wesco's unrealized appreciation has continued to grow in frothy markets for securities, it should be remembered that it is subject to market fluctuation, possibly dramatic on the downside, with no guaranty as to its ultimate full realization. Unrealized after-tax appreciation represents 76% of Wesco's shareholders' equity at 1998 yearend), versus 73% and 70% 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

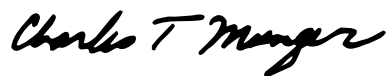
plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway. Moreover, the quality disparity in book value's intrinsic merits has, in recent years, been widening in favor of Berkshire Hathaway.

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 super-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 13, 1999 Wesco increased its regular dividend from 28½ cents per share to 29½ cents per share, payable March 10, 1999, to shareholders of record as of the close of business on February 10, 1999.

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, 1999