



# WESCO FINANCIAL CORPORATION

*Annual Report 1999*  
*Form 10-K Annual Report 1999*

## 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 1999 increased to \$45,904,000 (\$6.44 per share) from \$37,622,000 (\$5.28 per share) in the previous year.

Consolidated net income (i.e., after irregularly occurring items shown in the table below) decreased to \$54,143,000 (\$7.60 per share) from \$71,803,000 (\$10.08 per share) in the previous year.

Wesco had three major subsidiaries at yearend 1999: (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)<sup>(1)</sup>:

	Year Ended			
	December 31, 1999		December 31, 1998	
	Amount	Per Wesco Share <sup>(2)</sup>	Amount	Per Wesco Share <sup>(2)</sup>
"Normal" net operating income of:				
Wes-FIC and KBS insurance businesses .....	\$43,610	\$6.12	\$34,654	\$ 4.87
Precision Steel businesses .....	2,532	.35	3,154	.44
All other "normal" net operating income (loss) <sup>(3)</sup> ....	<u>(238)</u>	<u>(.03)</u>	<u>(186)</u>	<u>(.03)</u>
	45,904	6.44	37,622	5.28
Realized net securities gains .....	7,271	1.02	33,609	4.72
Gain on sales of foreclosed properties .....	<u>968</u>	<u>.14</u>	<u>572</u>	<u>.08</u>
Wesco consolidated net income .....	<u>\$54,143</u>	<u>\$7.60</u>	<u>\$71,803</u>	<u>\$10.08</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 1999, the reduction of loss reserves provided in prior years against possible losses on sales of loans and 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 1999 was \$43,610,000, versus \$34,654,000 for 1998. The figures include \$6,415,000 in 1999 and \$4,987,000 in 1998 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 1999 Wes-FIC retained about \$21 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."

In addition, Wes-FIC has been engaged for several years in super-cat reinsurance, described in great detail in our pre-1999 annual reports, which Wesco shareholders should re-read each year. Wes-FIC also engages in other reinsurance business, including large and small quota share arrangements similar and dissimilar to our previous reinsurance contract with Fireman's Fund Group.

In all recent reinsurance sold by us, other subsidiaries of our 80%-owning parent, Berkshire Hathaway, sold four times as much reinsurance to the same customers on the same terms, except that such subsidiaries usually take from us a 3%-of-premiums ceding commission on premium volume passed through them to Wes-FIC. Excepting this ceding commission, Wes-FIC has virtually no insurance-acquisition or insurance administration costs.

Early in the current year (2000) Wes-FIC made an intracompany loan that funds a large majority of the purchase price of CORT Business Services Corporation, discussed below.

Wes-FIC remains 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 3, 2000) 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 a year, before taxes, benefited earnings in 1999 and 1998. The balance of pre-tax underwriting profit amounted to \$3.0 million for 1999 and \$1.9 million for 1998. These figures came mostly from favorable revision of loss reserves on the old Fireman's Fund contract.

Wesco shareholders should continue to realize that recent marvelous underwriting results are sure to be followed, sometime, by one or more horrible underwriting losses from super-cat or other insurance written by Wes-FIC.

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

KBS, purchased by Wes-FIC in 1996 for approximately \$80 million in cash, contributed \$6,415,000 to the normal net operating income of the insurance businesses in 1999 and \$4,987,000 in 1998, 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.

A significant change in KBS’s operations occurred in 1998 and consisted of a large reduction in insurance premiums ceded to reinsurers. The increased volume of business retained (95% in 1999 and 94% in 1998 compares with 58% in 1997) accompanied slightly higher underwriting income for 1999 after a reduction in the amount for 1998. KBS’s combined ratio remained much better than average for insurers, at 59.4% for 1999 and 62.2% for 1998, versus 37.2% for 1997, 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.

### **CORT Business Services Corporation (“CORT”)**

In February 2000, Wesco purchased 100% of CORT Business Services Corporation (“CORT”) for \$384 million in cash. In addition, CORT retains about \$45 million of previously existing debt.

CORT is a very long established company that is the country’s leader in rentals of furniture that lessees have no intention of buying. In the trade, people call CORT’s activity “rent-to-rent” to distinguish it from “lease-to-purchase” businesses that are, in essence, installment sellers of furniture.

However, just as Hertz, as a rent-to-rent auto lessor in short-term arrangements, must be skilled in selling used cars, CORT must be and is skilled in selling used furniture.

In 1999, CORT had total revenues of \$354 million. Of this, \$295 million was furniture rental revenue and \$59 million was furniture sales revenue. CORT’s pre-tax earnings in 1999 were \$46 million.

Thus, in essence, Wesco paid \$384 million for \$46 million in pre-tax earnings. About 60% of the purchase price was attributable to goodwill, an intangible balance sheet asset.

After the transaction, Wesco's consolidated balance sheet will contain about \$260 million in goodwill (including \$29 million from Wesco's 1996 purchase of Kansas Bankers Surety). On a full year basis, Wesco's future reported earnings will be reduced by about \$6 million on account of mostly-non-tax-deductible amortization of goodwill. We do not believe, however, that this accounting deduction reflects any real deterioration in earnings-driving goodwill in place.

More details with respect to the CORT transaction are contained in Note 8 to the accompanying financial statements, and on the last page of this annual report, to which careful attention is directed.

CORT has long been headed by Paul Arnold, age 53, who is a star executive as is convincingly demonstrated by his long record as CEO of CORT. Paul will continue as CEO of CORT, with no interference from Wesco headquarters. We would be crazy to second-guess a man with his record in business. We are absolutely delighted to have Paul and CORT within Wesco and hope to see a considerable expansion of CORT's business and earnings in future years.

### **Precision Steel**

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, contributed \$2,532,000 to normal net operating income in 1999, compared with \$3,154,000 in 1998. The \$622,000 decrease in 1999 net income occurred despite a 2.5% increase in pounds of product sold, and reflects mainly the pounding which competition gave to prices as costs of principal raw materials declined. Fewer dollars of gross profit were available to absorb operating expenses. Precision Steel's operations for 1999 and 1998 also reflect after-tax expenditures of approximately \$225,000 and \$350,000, respectively, 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.

It is with mixed emotions that we report that David Hillstrom, President and Chief Executive officer of Precision Steel for more than twenty years, retired in the latter part of 1999 and that Terry Piper was elected to replace him. Terry is a very able man and is no stranger to Precision Steel. He joined it as a salesman approximately forty years ago, steadily advanced, and served as President and General Manager of Precision Steel's Precision Brand Products subsidiary for the last thirteen years. Terry now has the responsibility of carrying on the leadership of his predecessor; and, under their combined skills, Precision Steel's businesses in 1999 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 \$15 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 an investment in Freddie Mac common stock, 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. The 28,800,000 shares owned by Wes-FIC at yearend 1999 had a market value of \$1.4 billion.

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

All other "normal" net operating income or loss, net of interest paid and general corporate expenses, amounted to after-tax losses of \$238,000 in 1999 and \$186,000 in 1998. Sources were (1) rents (\$2,862,000 gross in 1999) 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. The loss widened in 1999 because fewer dividends were received during the year after forced conversion of preferred stock of Citigroup Inc. ("Citigroup") into lower-dividend-paying common stock. The "other 'normal' net operating income or loss" figures for 1999 and 1998 also include intercompany charges for interest expense (\$353,000 and \$102,000 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. "Other 'normal' net operating income or loss" benefited in 1999 by about \$800,000 caused by reversals of reserves for possible losses on sales of loans and tag-end real estate, expensed in prior years.

## **Net Securities Gains and Losses**

Wesco's earnings contained securities gains of \$7,271,000, after income taxes, for 1999, versus \$33,609,000, after taxes, for 1998.

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.



## Consolidated Balance Sheet and Related Discussion

As indicated in the accompanying financial statements, Wesco's net worth decreased, as accountants compute it under their conventions, to \$1.90 billion (\$266 per Wesco share) at yearend 1999 from \$2.22 billion (\$312 per Wesco share) at yearend 1998.

The \$328.4 million decrease in reported net worth in 1999 was the result of (1) \$54.1 million from 1999 net income; less (2) a \$374.1 million decrease in the market value of investments after provision for future taxes on capital gains; and (2) \$8.4 million in dividends paid.

The foregoing \$266-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 \$99 per Wesco share at yearend 1999.

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 \$99 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than \$99 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 1999.

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" was \$20 per Wesco share at yearend 1999, and after-tax liquidating value was then about \$266 per share (figures that seem rational to the writer), Wesco's intrinsic value per share would become about \$286 per share at yearend 1999, down 16% from intrinsic

value as guessed in a similar calculation at the end of 1998. And, finally, this reasonable-to-this-writer, \$286-per-share figure for intrinsic per share value of Wesco stock should be compared with the \$245 per share price at which Wesco stock was selling on December 31, 1999. This comparison indicates that Wesco stock was then selling about 14% below intrinsic value.

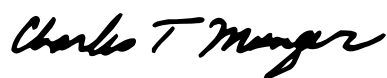
Wesco's investment portfolio suffered more than its commensurate share of decline in market value in 1999. Last year, we said "as Wesco's unrealized appreciation has continued to grow in frothy markets for securities, it should be remembered that it is subject to market fluctuation, possibly dramatic on the downside, with no guaranty as to its ultimate full realization." The stock of several of our largest investees lagged the market in 1999 by a large margin. It's no sure thing that the value of our marketable securities will quickly recover. Unrealized after-tax appreciation represented 69% of Wesco's shareholders' equity at 1999 yearend, versus 76% and 73% 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.

The Board of Directors recently increased Wesco's regular dividend from 29½ cents per share to 30½ cents per share, payable March 8, 2000, to shareholders of record as of the close of business on February 9, 2000.

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 3, 2000