

Partners Confidential



WESCO FINANCIAL CORPORATION

Annual Report 2000
Form 10-K Annual Report 2000

WESCO FINANCIAL CORPORATION LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated net "operating" income (i.e., before realized securities gains shown in the table below) for the calendar year 2000 increased to \$70,087,000 (\$9.84 per share) from \$46,872,000 (\$6.58 per share) in the previous year.

Consolidated net income increased to \$922,470,000 (\$129.56 per share) from \$54,143,000 (\$7.60 per share) in the previous year.

Wesco has four 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, (3) CORT Business Services Corporation ("CORT"), headquartered in Fairfax, Virginia, purchased in February 2000 and engaged principally in the furniture rental business, and (4) Precision Steel Warehouse, Inc. ("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, 2000 | | December 31, 1999 | |
| | Amount | Per Wesco Share ⁽²⁾ | Amount | Per Wesco Share ⁽²⁾ |
| Operating earnings: | | | | |
| Wes-FIC and KBS insurance businesses | \$ 45,518 | \$ 6.39 | \$44,392 | \$6.23 |
| CORT furniture rental business | 28,988 | 4.07 | — | — |
| Precision Steel businesses | 1,281 | .18 | 2,532 | .35 |
| Goodwill amortization | (5,867) | (.82) | (782) | (.11) |
| Other(3) | 167 | .02 | 730 | .11 |
| | <u>70,087</u> | <u>9.84</u> | <u>46,872</u> | <u>6.58</u> |
| Realized net securities gains | 852,383 | 119.72 | 7,271 | 1.02 |
| Wesco consolidated net income | <u>\$922,470</u> | <u>\$129.56</u> | <u>\$54,143</u> | <u>\$7.60</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, and interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiaries. The 1999 figure also includes net gains on sales of foreclosed real estate and a benefit from 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”)

Consolidated operating earnings of Wes-FIC and KBS represent the combination of the results of their insurance underwriting with their net investment income. Following is a summary of these figures as they pertain to Wes-FIC, excluding its subsidiary, KBS. The operating earnings of Wes-FIC’s KBS subsidiary are discussed in the section, “The Kansas Bankers Surety Company,” below.

| | Pre-Tax Operating Earnings | | After-Tax Operating Earnings | |
|--|-------------------------------|---------------------|---------------------------------|---------------------|
| | 2000 | 1999 | 2000 | 1999 |
| Underwriting gain (loss) | \$ (616,000) | \$ 4,359,000 | \$ (400,000) | \$ 2,833,000 |
| Net investment income..... | 53,412,000 | 44,129,000 | 38,958,000 | 34,362,000 |
| Wes-FIC parent company operating income | <u>\$52,796,000</u> | <u>\$48,488,000</u> | <u>\$38,558,000</u> | <u>\$37,195,000</u> |

As shown above, Wes-FIC’s consolidated operating earnings include significant net investment income, representing dividends and interest earned on its portfolio of marketable securities. Wes-FIC’s consolidated operating earnings exclude its realized net securities gains, net of income taxes, of \$853.1 million in 2000 versus \$7.3 million in 1999. Our discussion will concentrate on Wes-FIC’s insurance underwriting, not on the results of its investments.

At the end of 2000 Wes-FIC retained about \$19 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” and by favorable loss development, which has enabled it to reduce the liability for losses and loss-related expenses, benefiting after-tax operating earnings by \$.8 million in 2000 and \$1.7 million in 1999.

Wes-FIC 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, and, from time to time, in super-cat reinsurance, described in great detail in our pre-1999 annual reports, which Wesco shareholders should re-read each year. Although Wes-FIC was not active in super-cat reinsurance business in 2000, its operating earnings benefited by \$.9 million, after taxes, in 1999. On super-cat reinsurance accepted by Wes-FIC to date (March 5, 2001) 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).

The balance of Wes-FIC’s after-tax underwriting profit or loss not described above, amounted to underwriting loss of \$1.2 million for 2000 and underwriting profit of \$.2 million for 1999.

In all recent reinsurance sold by us, other subsidiaries of our 80%-owning parent, Berkshire Hathaway, sold several times as much reinsurance to the same customers on the same terms. In certain instances, such subsidiaries have taken from us a 3%-

of-premiums ceding commission on premium volume passed through them to Wes-FIC. Excepting this ceding commission, Wes-FIC has had virtually no insurance-acquisition or insurance administration costs with regard to those policies.

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.

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 \$7 million to the consolidated operating earnings of the insurance businesses in 2000 and \$7.2 million in 1999. These figures are before goodwill amortization under accounting convention of \$.8 million each year. The results of KBS have been combined with those of Wes-FIC, and are included in the table on page 1 in the category, “operating earnings 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.

KBS increased the volume of business retained effective in 1998. It had previously ceded almost half of its premium volume to reinsurers; and, it now reinsures only about 5% under arrangements whereby other Berkshire subsidiaries take 50% and unrelated reinsurers take the other 50%. As we indicated last year, the increased volume of business retained comes, of course, with increased irregularity in the income stream.

KBS’s combined ratio remained much better than average for insurers, at 73.9% for 2000 and 59.4% for 1999, versus 37.2% for 1997, and we continue to expect volatile but favorable long-term effects from increased insurance retained.

KBS is run by Donald Towle, President, assisted by 15 dedicated officers and employees.

CORT Business Services Corporation (“CORT”)

In February 2000, Wesco purchased CORT Business Services Corporation (“CORT”) for \$386 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 the ten months that we have owned CORT, its revenues have totaled \$361 million. Of this, \$306 million was furniture rental revenue and \$55 million was furniture sales revenue. CORT contributed \$29 million to Wesco’s consolidated operating income in 2000, before goodwill amortization of \$5.1 million or realized securities losses of \$.7 million. CORT’s pre-tax operating income (before goodwill amortization) for the entire calendar year 2000 was \$54.3 million.

Thus, in essence, Wesco paid \$386 million for \$54.3 million in pre-tax operating earnings. About 60% of the purchase price was attributable to goodwill, an intangible balance sheet asset.

Wesco’s consolidated balance sheet now contains about \$260 million in goodwill (including \$28 million from Wesco’s 1996 purchase of KBS). On a full year basis, Wesco’s reported earnings for 2000 were reduced by about \$6 million of mostly-non-tax-deductible amortization of goodwill. I am pleased to report that the Financial Accounting Standards Board has recently proposed a rule that, if adopted, will no longer require automatic amortization of acquired goodwill. If this proposed rule change goes into effect, our reported earnings will more closely reflect microeconomic reality as we appraise it.

More details with respect to CORT are contained throughout this annual report, to which your careful attention is directed.

CORT has long been headed by Paul Arnold, age 54, who is a star executive as is convincingly demonstrated by his long record as CEO of CORT. We are absolutely delighted to have Paul and CORT within Wesco, are pleased with CORT’s performance under his leadership in 2000, and hope to see a considerable expansion of CORT’s business and earnings in future years.

Commencing late last year, and continuing to date, new business coming into CORT has declined sharply. We believe that CORT’s operations will remain profitable in any likely recession-related decline in the rent-to-rent segment of the furniture business.

The purchase of CORT has increased Wesco's employee count to approximately 3,000 from 275 one year earlier.

Precision Steel Warehouse, Inc. ("Precision Steel")

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, contributed \$1.3 million to Wesco's net operating earnings in 2000, down from the \$2.5 million contributed in 1999. The 50% decline in 2000 operating earnings was due principally to two factors: (1) LIFO inventory accounting adjustments decreased after-tax earnings approximately \$.4 million in 2000 after increasing such earnings by \$.3 million in 1999, and (2) pounds of product sold decreased 3%, while competition restrained prices as costs of principal raw materials increased, causing fewer dollars of gross profit to be available to absorb operating expenses. Revenues were up only 1%.

Generally, the U.S. steel business was a disaster in 2000, and Precision Steel suffered worse effects than occurred for it in previous general declines in the U.S. steel business.

We do not regard earnings changes from LIFO accounting adjustments, up or down, as material in predicting future earning power.

Terry Piper, who became Precision Steel's President and Chief Executive officer late in 1999, has done an excellent job in leading Precision Steel through a very difficult year.

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 real estate assets with a net book value of about \$6.5 million. MS Property Company's results of operations, immaterial versus Wesco's present size, are included in the breakdown of earnings on page 1 within "other operating earnings."

Other Operating Earnings

Other operating earnings, net of interest paid and general corporate expenses, amounted to \$.2 million in 2000 and \$.7 million in 1999. Sources were (1) rents (\$3 million gross in 2000) 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) general corporate expenses plus minor expenses involving tag-end real estate.

Realized Net Securities Gains

The main tag end from Wesco's savings and loan days was 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. Those shares, carried on Wesco's balance sheet at yearend 1999 at a market value of \$1.4 billion, were sold in 2000, giving rise to the principal portion of the \$852.4 million of after-tax securities gains realized by Wesco in 2000, versus \$7.3 million, after taxes, realized in 1999.

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, as accountants compute it under their conventions, increased to \$1.98 billion (\$278 per Wesco share) at yearend 2000 from \$1.90 billion (\$266 per Wesco share) at yearend 1999.

The foregoing \$278-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 any large percentage 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) possible unrealized appreciation in other assets (primarily CORT and 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 securities, 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. The sale of the Freddie Mac shares in 2000 reduced that interest-free "loan" from \$705 million as of yearend 1999 to \$258 million as of yearend 2000. This interest-free "loan" from the government is at this moment working for Wesco shareholders and amounted only to about \$36 per Wesco share at year end 2000.

However, some day, additional parts of the interest-free "loan" may be removed as securities are sold, as happened to such a large extent with the sale of Freddie Mac stock in 2000. Therefore, Wesco's shareholders have no perpetual advantage creating value for them of \$36 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than \$36 per Wesco share.

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

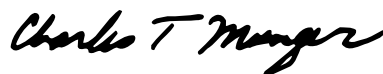
equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway. Moreover, the quality disparity in book value's intrinsic merits has, in recent years, continued to widen 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.

To progress from this point at a satisfactory rate, Wesco plainly needs more favorable investment opportunities, recognizable as such by its management, preferably in whole companies like CORT, but, alternatively, in marketable securities to be purchased by Wesco's insurance subsidiaries.

The Board of Directors recently increased Wesco's regular dividend from 30½ cents per share to 31½ cents per share, payable March 7, 2001, to shareholders of record as of the close of business on February 7, 2001.

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 5, 2001