



# WESCO FINANCIAL CORPORATION

*Annual Report 2001*  
*Form 10-K Annual Report 2001*

## 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 2001 decreased to \$52,536,000 (\$7.38 per share) from \$70,087,000 (\$9.84 per share) in the previous year.

Consolidated net income decreased to \$52,536,000 (\$7.38 per share) from \$922,470,000 (\$129.56 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)<sup>(1)</sup>:

	Year Ended			
	December 31, 2001		December 31, 2000	
	Amount	Per Wesco Share <sup>(2)</sup>	Amount	Per Wesco Share <sup>(2)</sup>
Operating earnings:				
Insurance businesses .....	\$45,254	\$6.36	\$ 45,518	\$ 6.39
CORT furniture rental business .....	13,076	1.84	28,988	4.07
Precision Steel businesses .....	388	.05	1,281	.18
Goodwill amortization <sup>(3)</sup> .....	(6,814)	(.96)	(5,867)	(.82)
Other <sup>(4)</sup> .....	632	.09	167	.02
	<u>52,536</u>	<u>7.38</u>	<u>70,087</u>	<u>9.84</u>
Realized net securities gains .....	—	—	<u>852,383</u>	<u>119.72</u>
Wesco consolidated net income .....	<u>\$52,536</u>	<u>\$7.38</u>	<u>\$922,470</u>	<u>\$129.56</u>

(1) All figures are net of income taxes.

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

(3) In accordance with a new pronouncement of the Financial Accounting Standards Board, Wesco will no longer be required to amortize goodwill beginning in 2002. The requirement for such amortization has been replaced by a standard that requires an annual assessment to determine whether the value of goodwill has been impaired, at which time the intangible would be written down or written off, as appropriate.

(4) 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.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The foregoing supplementary breakdown is furnished because it is considered useful to

shareholders. The total consolidated net income shown above is, of course, identical to the total in our audited financial statements.

### Insurance Businesses

Consolidated operating earnings from insurance businesses 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 all insurance operations except The Kansas Bankers Surety Company (“KBS”), which is separately discussed below.

	Pre-Tax Operating Earnings		After-Tax Operating Earnings	
	2001	2000	2001	2000
Underwriting loss .....	\$ (12,403,000)	\$ (616,000)	\$ (8,062,000)	\$ (400,000)
Net investment income .....	64,529,000	53,412,000	44,001,000	38,958,000
Operating income .....	<u>\$ 52,126,000</u>	<u>\$ 52,796,000</u>	<u>\$ 35,939,000</u>	<u>\$ 38,558,000</u>

As shown above, operating income includes significant net investment income, representing dividends and interest earned from marketable securities. However, operating income excludes realized net securities gains, net of income taxes, of \$853.1 million in 2000. There were no such gains in 2001. Our discussion will concentrate on insurance underwriting, not on the results from investments.

Results for 2001 from insurance underwriting, other than at KBS, were the worst since we entered into the insurance business in 1985.

The nature of our non-KBS insurance business was roughly described in our year 2000 Annual Report wherein we reported to shareholders that we were not currently active in super-catastrophe reinsurance and had never suffered a super-catastrophe loss, but that shareholders should continue to realize that Wes-FIC’s marvelous underwriting results were sure to be followed, sometime, by one or more horrible underwriting losses.

When we said that, we had in mind a natural catastrophe. But, instead, we were clobbered by a man-made catastrophe on September 11 — an event that delivered the insurance industry its largest loss in history. Fortunately, we recorded a loss of only \$10 million, before income taxes (\$6.5 million, after taxes) in connection with that event. The \$10 million is an estimate and is subject to considerable estimation error. It will literally take years to resolve complicated coverage issues, as well as to develop an accurate estimation of insured losses that will ultimately be incurred. That \$10 million, however, was the principal cause of our substantial underwriting loss in 2001.

At the end of 2001 we retained about \$17 million in invested assets, offset by claims reserves, from our 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 in 2001 and 2000 by \$.8 million each.

We engage 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 detail in previous annual reports, which Wesco shareholders should re-read each year.

In almost 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.

KBS, purchased by Wes-FIC in 1996 for approximately \$80 million in cash, contributed \$9.3 million to the after-tax operating earnings of the insurance businesses in 2001 and \$7.0 million in 2000. 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 of "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 27 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. Now it 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.

The combined ratio of an insurance company represents the percentage that its underwriting losses and expenses bear to its premium revenues. KBS's combined ratio has been much better than average for insurers, at 55.1% for 2001 and 73.9% for 2000, and we continue to expect volatile but favorable long-term effects from increased insurance retained.

KBS is ably 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.

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.

CORT’s revenues totaled \$395 million for calendar 2001, versus \$361 million for the ten months that we owned it in the year 2000. Of these amounts, furniture rental revenues were \$329 million and \$306 million, and furniture sales revenues were \$66 million and \$55 million. CORT contributed \$13.1 million to Wesco’s consolidated operating income for the entire year of 2001, versus \$29.0 million for the ten months of 2000. These figures are before (1) goodwill amortization of \$6.0 million for 2001 and \$5.1 million for 2000, and (2) realized securities losses of \$.7 million in 2000.

CORT’s after-tax operating income (before goodwill amortization) for the entire calendar year 2000 was \$33.4 million compared to only \$13.1 million for 2001, a decline of 61%.

When we purchased CORT early in 2000, its furniture rental business was rapidly growing, reflecting the strong U.S. economy, phenomenal business expansion and explosive growth of IPOs and the high-tech sector. Beginning late in 2000, however, new business coming into CORT began to decline. With the burst of the dot-com bubble, continued weakness in the economy and the events of September 11, CORT’s operations were hammered in 2001.

Moreover, CORT started up a new subsidiary during the year, Relocation Central Corporation, whose \$12 million in expenses far exceeded its \$1 million in revenues. The results of its operations have been consolidated with those reported for CORT, shown above. Relocation Central has developed a virtual call center which carries out an internet-based furniture and apartment leads operation ([www.relocationcentral.com](http://www.relocationcentral.com)), and it has begun marketing CORT’s furniture rental services to real estate investment trusts, owners of many major apartment communities. CORT is hopeful that, through Relocation Central, it will ultimately become the principal source of rental furniture to the apartment industry.

We hope to report in due course that all CORT operations have become more satisfactory, but prospects for 2002 do not thrill us. However, there is good news along with bad. CORT operates at a positive cash flow. During 2001 it reduced its line-of-credit debt by \$32 million and invested an additional \$20 million in business expansion through acquisitions of several small businesses. We happily tolerate a

poor part of the business cycle when we turn it to our advantage by expanding business through cash acquisition at sound prices. We continue to believe that CORT's operations will remain profitable in any likely recession-related decline in the rent-to-rent segment of the furniture business.

When Wesco paid \$386 million for CORT, about 60% of the purchase price was attributable to goodwill, an intangible balance sheet asset.

Wesco's consolidated balance sheet now contains about \$264 million in goodwill (including \$27 million from Wesco's 1996 purchase of KBS). Wesco's reported earnings were reduced by about \$7 million of mostly-non-tax-deductible amortization of goodwill for 2001 and \$6 million for 2000. The Financial Accounting Standards Board has recently adopted a rule that will no longer require automatic amortization of acquired goodwill beginning in 2002. Thus, earnings we report in the future 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 55, 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, despite adverse developments in 2001, and we hope to see a considerable expansion of CORT's business and earnings in future years.

### **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 \$.4 million to Wesco's net operating earnings in 2001, down from \$1.3 million in 2000 and \$2.5 million in 1999. Had it not been for LIFO inventory accounting adjustments, Precision Steel would have reported no income at all for the year 2001, versus \$1.7 million, after taxes, for 2000.

Last year we reported that the U.S. steel industry was generally a disaster in 2000, and that Precision Steel suffered worse effects than occurred for it in previous general declines in the U.S. steel business. The year 2001 was much worse. The absence of Precision Steel's operating earnings for 2001, before the effect of the LIFO adjustment, was due principally to a significant reduction in demand for steel, combined with intensified competition above the fierce level encountered in the prior year. This resulted in a 29.7% decrease in pounds of product sold. Sales revenues declined 25.6%.

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 difficult years.

## **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 \$5.8 million, consisting mainly of the nine-story commercial office building in downtown Pasadena, where Wesco is headquartered. 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 \$.6 million in 2001 and \$.2 million in 2000. Sources were (1) rents (\$3.2 million gross in 2001) 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 no gains or losses realized in 2001.

Although the realized gain had a material impact on Wesco's reported earnings for 2000, *it had a very minor impact on Wesco's shareholders' equity*. Inasmuch as the greater portion of the realized gain had previously been reflected in the unrealized gain component of Wesco's shareholders' equity, the amount was 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, decreased to \$1.91 billion (\$269 per Wesco share) at yearend 2001 from \$1.98 billion (\$278 per Wesco share) at yearend 2000.

The foregoing \$269-per-share book value approximates liquidation value assuming that all Wesco's non-security assets would liquidate, after taxes, at book value. Perhaps 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 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 was principally responsible for the reduction of that interest-free "loan" from \$705 million as of yearend 1999 to \$199 million as of yearend 2001. This interest-free "loan" from the government is at this moment working for Wesco shareholders and amounted to about \$28 per Wesco share at year end 2001.

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 \$28 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than \$28 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 thing that should interest Wesco shareholders most with respect to 2001 is that we found no new common stocks for our insurance companies to buy. We are not excited by general prospects for common stocks.

The Board of Directors recently increased Wesco's regular dividend from 31½ cents per share to 32½ cents per share, payable March 6, 2002, to shareholders of record as of the close of business on February 6, 2002.



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.

A handwritten signature in black ink that reads "Charles T. Munger". The signature is written in a cursive, flowing style.

Charles T. Munger  
Chairman of the Board

March 5, 2002