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# WESCO FINANCIAL CORPORATION

*Annual Report 2002*  
*Form 10-K Annual Report 2002*

## WESCO FINANCIAL CORPORATION LETTER TO SHAREHOLDERS

### To Our Shareholders:

Consolidated net income for the calendar year 2002 was \$52,718,000 (\$7.40 per share), essentially the same as \$52,536,000 (\$7.38 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 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, 2002		December 31, 2001	
	Amount	Per Wesco Share <sup>(2)</sup>	Amount	Per Wesco Share <sup>(2)</sup>
Operating earnings:				
Insurance businesses . . . . .	\$49,471	\$6.95	\$45,254	\$6.36
CORT furniture rental business . . . . .	2,442	.34	13,076	1.84
Precision Steel businesses . . . . .	250	.03	388	.05
Goodwill amortization <sup>(3)</sup> . . . . .	—	—	(6,814)	(.96)
Other <sup>(4)</sup> . . . . .	555	.08	632	.09
Wesco consolidated net income <sup>(3)</sup> . . . . .	<u>\$52,718</u>	<u>\$7.40</u>	<u>\$52,536</u>	<u>\$7.38</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 discontinued goodwill amortization at the beginning of 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 The requirement for such amortization has been replaced by a standard that requires an annual assessment to determine whether the value of goodwill has been impaired, at which time the intangible would be written down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. Had the new accounting standard been in effect for 2001, Wesco would have reported after-tax income of \$59,350,000 or \$8.34 per share, exclusive of goodwill amortization. **Thus, Wesco's 2002 after-tax net income, on a pro forma basis, actually decreased in 2002 by \$6,632,000, or \$.94 per share.**

(4) Represents income 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, less interest and other corporate expenses.

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	
	2002	2001	2002	2001
Underwriting gain (loss) .....	\$ 92,000	\$(12,403,000)	\$(1,926,000)	\$(8,062,000)
Net investment income .....	64,484,000	64,529,000	44,030,000	44,001,000
Operating income .....	<u>\$64,576,000</u>	<u>\$ 52,126,000</u>	<u>\$42,104,000</u>	<u>\$35,939,000</u>

As shown above, operating income includes significant net investment income, representing dividends and interest earned from marketable securities. Our discussion will concentrate on insurance underwriting, not on the results from investments.

Results for 2002 from insurance underwriting, other than at KBS, were sharply improved from those for 2001. Results for 2001 were the worst since we entered the insurance business in 1985. Results for 2002 were satisfactory.

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, in 2001 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 2002 we retained about \$15 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 2002 and 2001 by \$.8 million each year.

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.

Following is a summary of Wes-FIC's current reinsurance activity:

- A three-year arrangement entered into in 2000 through an insurance subsidiary of Berkshire Hathaway, our 80%-owning parent, as intermediary without ceding commission, for participation to the extent of 3.3% in certain property and casualty exposure ceded by a large, unaffiliated insurer. The terms of this arrangement are identical to those accepted by that Berkshire subsidiary except as to the amount of the participation.
- Participation in four risk pools managed by a Berkshire insurance subsidiary (also acting as intermediary without ceding commission) covering hull, liability, workers' compensation and satellite exposures relating to the aviation industry as follows: with respect to 2001, to the extent of 3% for each pool; for 2002, 13% of the hull and liability pools, 3% of the workers' compensation pool and, effective mid-year, 15.5% of the satellite pool; and, for 2003, 10% of the hull and liability pools only. The Berkshire subsidiary provides a portion of the reinsurance protection to these aviation risk pools, and therefore to Wes-FIC.

In much reinsurance sold by us, other Berkshire subsidiaries sold several times as much reinsurance to the same customers on the same terms. In certain instances but not always, 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.

KBS, purchased by Wes-FIC in 1996 for approximately \$80 million in cash, contributed \$7.4 million to the after-tax operating earnings of the insurance businesses in 2002 and \$9.3 million in 2001. The 2001 figure is before goodwill amortization of \$.8 million; there was no goodwill amortization for 2002. Prior to 2002 goodwill was amortized mainly on a straight-line basis over 40 years. As explained above, as of the beginning of 2002, Wesco discontinued amortization of goodwill and became subject to other changes in goodwill accounting, as required by the Financial Accounting Standards Board. 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 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. Also, KBS has recently begun offering Internet banking catastrophe theft insurance.

Beginning in 2003, KBS revised the allocation of its reinsurance between a Berkshire insurance subsidiary and a non-affiliate: Under the previous program, the Berkshire subsidiary and the non-affiliate each reinsured 50% of the per-occurrence risks of \$3 million in excess of \$2 million, and the non-affiliate also reinsured 70% of the per-occurrence risks up to \$10 million above \$5 million, all for approximately 5% of KBS's premiums. Beginning in 2003, the Berkshire subsidiary has replaced the non-affiliate on the second layer, and total reinsurance costs are expected to aggregate 10%-12% of premiums. Reinsurance costs have risen greatly throughout the insurance industry, and the revised arrangement is considered fair by all involved, all factors considered. (Indeed, we believe that our combined insurance arrangements through Berkshire constitute a net advantage to Wes-FIC that would not be available from Berkshire in the absence of its 80% ownership of Wesco, and such combined insurance arrangements have worked out well so far, even after taking into account our September 11 loss in 2001.)

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%. 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 71.3% for 2002 and 55.1% for 2001, 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 \$389 million for calendar 2002, versus \$395 million for calendar 2001. Of these amounts, furniture rental revenues were \$316 million and \$329 million, and furniture sales revenues were \$73 million and \$66 million. CORT contributed \$2.4 million and \$13.1 million to Wesco's consolidated operating income for 2002 and 2001, versus \$29.0 million for the ten months that we owned it in 2000. These figures are before (1) goodwill amortization of zero for 2002 (see discussion above), \$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 \$2.4 million for 2002 and \$13.1 million for 2001. 2002 was a terrible year in the "rent-to-rent" segment of the furniture rental business.

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, the events of September 11, and continued weakness in the economy, CORT's operations have been hammered. Obviously, when we purchased CORT we were poor predictors of near-term industry-wide prospects of the "rent-to-rent" sector of the furniture business.

Moreover, CORT started up a new subsidiary during 2001, Relocation Central Corporation, whose operations should be considered as still in a "start-up" phase and, so far, have generated pre-tax losses amounting to \$12.8 million in 2002 and \$10.8 million in 2001. 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 markets CORT's furniture rental services to real estate investment trusts, owners of many major apartment communities. As a result of the acquisition of its largest competitor in December 2002, Relocation Central operates in 20 metropolitan cities in sixteen states. CORT is hopeful that, through Relocation Central, it will ultimately become the principal source of rental furniture to the apartment industry, but this outcome is far from certain.

We expect to report in due course that all CORT operations have become more satisfactory, but prospects for 2003 do not seem good. However, there is good news along with bad. CORT has operated at a positive cash flow and the general distress in its field permitted various small expansions. During the past two years it invested \$57 million in business expansion through acquisitions of several small businesses and reduced its line-of-credit debt by \$30 million. CORT would not be making these acquisitions if we believed its furniture rental business prospects were permanently impaired.

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 \$266 million in goodwill (including \$27 million from Wesco's 1996 purchase of KBS). The Financial Accounting Standards Board recently adopted a rule which became effective in 2002 that no longer requires automatic amortization of acquired goodwill. Thus, earnings we report more closely reflect microeconomic reality as we appraise it. As above shown in the first page of this letter, Wesco's reported earnings were reduced by about \$7 million of mostly-non-tax-deductible amortization of goodwill for 2001, versus no such amortization for 2002.

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 56, 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, and are pleased with CORT's progress under his leadership, despite adverse developments in 2001 and 2002. We continue to expect a considerable expansion of CORT's business and earnings at some future time.

### **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 \$.3 million to Wesco's net operating earnings in 2002, down from \$.4 million in 2001 and \$1.3 million in 2000. Had it not been for LIFO inventory accounting adjustments, Precision Steel would have reported \$.1 million for 2002 and no income at all for the year 2001, versus \$1.7 million 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 both 2002 and 2001. Sources were (1) rents (\$3.3 million gross in 2002) from Wesco's Pasadena office property (leased almost entirely to outsiders, including Citibank 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.

## **Corporate Governance**

Two of our long-standing directors, Jim Gamble and Dave Robinson, are not standing for reelection. At practically no pay, they have been wise and honorable protectors of Wesco shareholders for many decades going back to a time before Berkshire Hathaway had any interest in Wesco. During their long tenure the value of Wesco stock appreciated about 5,000 percent. We will much miss their directorial service, but will not lose touch. They both retain offices in our building and will surely be in our offices from time to time.

## **Consolidated Balance Sheet and Related Discussion**

Wesco carries its investments at market value, with unrealized appreciation, after income tax effect, included as a separate component of shareholders' equity, and related taxes included in income taxes payable, in its consolidated balance sheet. As indicated in the accompanying financial statements, Wesco's net worth, as accountants compute it under their conventions, increased to \$1.96 billion (\$275 per Wesco share) at yearend 2002 from \$1.91 billion (\$269 per Wesco share) at yearend 2001. The main cause of increase was net income after deduction of dividends paid to shareholders.

The foregoing \$275-per-share book value approximates liquidation value assuming that all Wesco's non-security assets would liquidate, after taxes, at book 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. This interest-free "loan" from the government is at this moment



working for Wesco shareholders and amounted to about \$28 per Wesco share at yearend 2002.

However, some day, parts of the interest-free “loan” may be removed as securities are sold. 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, but, alternatively, in marketable securities to be purchased by Wesco’s insurance subsidiaries. Our views regarding the general prospects for investment in common stocks are contained in the following excerpt from Warren Buffett’s recent letter to shareholders of our parent company:

“We continue to do little in equities. [We] are increasingly comfortable with our holdings in [our] major investees because most of them have increased their earnings while their valuations have decreased. But we are not inclined to add to them. Though these enterprises have good prospects, we don’t yet believe their shares are undervalued.


“In our view, the same conclusion fits stocks generally. Despite three years of falling prices, which have significantly improved the attractiveness of common stocks, we still find very few that even mildly interest us. That dismal fact is testimony to the insanity of valuations reached during The Great Bubble. Unfortunately, the hangover may prove to be proportional to the binge.

“The aversion to equities that [we] exhibit today is far from congenial. We love owning common stocks — if they can be purchased at attractive prices. In [(Warren states:) my] 61 years of investing, 50 or so years have offered that kind of opportunity. There will be years like that again. Unless, however, we see a very high probability of at least 10% pre-tax returns (which translates to 6½-7% after corporate tax), we will sit on the sidelines. With short-term money returning less than 1% after-tax, sitting it out is no fun. But occasionally successful investing requires inactivity.”

In fact, the one thing that should interest Wesco shareholders most with respect to 2002 is that, as in 2001, Wesco found *no* new common stocks for our insurance companies to buy.

The Board of Directors recently increased Wesco's regular dividend from 32½ cents per share to 33½ cents per share, payable March 5, 2003, to shareholders of record as of the close of business on February 5, 2003.

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 6, 2003