WESCO FINANCIAL CORPORATION

Annual Report 2004

Form 10-K Annual Report 2004

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated net ''operating'' income (i.e., before realized investment gains shown in the table below) for the calendar year 2004 increased to $47,427,000 ($6.66 per share) from $39,958,000 ($5.61 per share) in the previous year.

Consolidated net income decreased to $47,427,000 ($6.66 per share) from $74,711,000 ($10.49 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 (''Kansas Bankers''), 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)[1]:

	Year Ended			
	December 31, 2004		December 31, 2003	
	Amount	Per Wesco Share[2]	Amount	Per Wesco Share[2]
Operating earnings:				
Wesco-Financial and Kansas Bankers insurance businesses —				
Underwriting	$14,618	$2.05	$15,711	$ 2.21
Investment income	26,302	3.69	30,925	4.34
CORT furniture rental business	5,022	.71	(6,257)	(.88)
Precision Steel businesses	1,094	.15	(860)	(.12)
All other ''normal'' net operating earnings[3]	391	.06	439	.06
	47,427	6.66	39,958	5.61
Realized investment gains	—	—	34,753	4.88
Wesco consolidated net income	$47,427	$6.66	$74,711	$10.49

(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) 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 investment income. Following is a summary of these figures as they pertain to all insurance operations (in 000s).

	Year Ended December 31,	
	2004	2003
Premiums written	$45,042	$ 86,962
Premiums earned	$54,589	$106,651
Underwriting gain	$22,490	$ 24,171
Dividend and interest income	36,035	44,118
Income before income taxes	58,525	68,289
Income taxes	17,605	21,653
Total operating income — insurance businesses	$40,920	$ 46,636

Following is a breakdown of premiums written (in 000s):

	2004	2003
Wes-FIC —		
Aviation pools	$26,655	$ 36,652
Property-casualty pool	(2,342)	30,390
Other	—	70
Kansas Bankers	20,729	19,850
Premiums written	$45,042	$ 86,962

Following is a breakdown of premiums earned (in 000s):

	2004	2003
Wes-FIC —		
Aviation pools	$27,944	$ 44,316
Property-casualty pool	6,244	42,021
Other	29	119
Kansas Bankers	20,372	20,195
Premiums earned	$54,589	$106,651

Following is a breakdown of after-tax results (in 000s):

	2004	2003
Underwriting gain —		
Wes-FIC	$11,144	$ 11,158
Kansas Bankers	3,474	4,553
	14,618	15,711
Net investment income —		
Wes-FIC	24,567	28,998
Kansas Bankers	1,735	1,927
	26,302	30,925
Total operating income — insurance businesses	$40,920	$ 46,636

As shown above, operating income includes significant net investment income, representing dividends and interest earned from marketable securities. However, operating income excludes investment gains of $34.8 million, net of income taxes, realized in 2003. No investment gains or losses were realized in 2004. The discussion below will concentrate on insurance underwriting, not on the results from investments.

Wes-FIC engages in the reinsurance business, occasionally insuring against loss from rare but horrendous ‘‘super-catastrophes.’’ In much reinsurance sold by us, other Berkshire subsidiaries have 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. In some cases, other Berkshire subsidiaries act as reinsurers at higher levels than the level at which Wes-FIC is reinsuring; terms of the reinsurance are considered by Wes-FIC to be fair or advantageous to Wes-FIC.

For the past several years Wes-FIC's reinsurance activity has consisted of the participation in two arrangements:

(1) Participation in four risk pools managed by an insurance subsidiary of Berkshire Hathaway, our 80%-owning parent, 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, with satellite exposures effective June 1; for 2002, 13% of the hull and liability pools, increasing to 15.5% in August, and 3% of the workers' compensation pool (satellite exposures were not renewed in June); and, for 2003 and 2004, 10% of the hull and liability pools only. The Berkshire subsidiary provides a portion of the upper-level reinsurance protection to these aviation risk pools, and therefore to Wes-FIC, on terms that could result in the Berkshire subsidiary having a different interest from that of Wes-FIC under certain conditions, e.g., in settling a large loss.

(2) A multi-year contract entered into in 2000 through another Berkshire insurance subsidiary, as intermediary without profit, covering certain multi-line property and casualty risks of a large, unaffiliated insurer. This contract was commuted (terminated) in the fourth quarter of 2004, at which time Wes-FIC paid the ceding company $43.1 million, cash, representing all unearned premiums, reduced by unamortized costs and expenses. After the commutation, Wes-FIC's obligation to indemnify any further insurance losses under the contract ceased. Under that contract, there was a net reduction in written premiums of $2.3 million for 2004, compared with written premiums of $30.4 million for 2003; earned premiums were $6.4 million for 2004 and $42.0 million for 2003.

Underwriting results of Wes-FIC in both 2004 and 2003 were weirdly favorable, causing the underwriting gains of $14.6 million for 2004 and $15.7 million for 2003. Such weirdly favorable results are not to be expected over the long term. It should be recalled that Wes-FIC reported an underwriting loss of $8.1 million as recently as 2001. However, we do try to create some underwriting gain as results are averaged out over many years.

Kansas Bankers was purchased by Wes-FIC in 1996 for approximately $80 million in cash. Its tangible net worth now exceeds its acquisition price, and it has been a very satisfactory acquisition, reflecting the sound management of President Don Towle and his team.

Kansas Bankers 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 30 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 insurance agents professional errors and omissions indemnity policies and Internet banking catastrophe theft insurance.

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 14%. 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 74.9% for 2004 and 65.0% for 2003. We continue to expect volatile but favorable long-term effects from increased insurance retained.

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 $354 million for calendar 2004, versus $360 million for calendar 2003. Of these amounts, furniture rental revenues were $275 million and $276 million, furniture sales revenues were $68 million each year, and apartment locator fees of Relocation Central Corporation, a business CORT started up in 2001, were $11 million and $16 million. CORT operated at an after-tax profit of $5.0 million for 2004; its operations resulted in an after-tax loss of $6.3 million for 2003; it contributed $2.4 million and $13.1 million to Wesco's consolidated operating income for 2002 and 2001. Recent results have been significantly worse than CORT's $29 million of after-tax operating profits for the ten months that we owned it in 2000. The figures are before (1) goodwill amortization of $6.0 million for 2001 and $5.1 million for 2000 (see discussion below), and (2) realized securities losses of $.7 million in 2000, but include Relocation Central's after-tax losses of $7.4 million for 2004, $9.0 million for 2003, $8.3 million for 2002 and $7.0 million for 2001. Excluding the operating losses of Relocation Central, CORT, at the parent company level, contributed $12.4 million to Wesco's consolidated after-tax operating earnings for 2004, versus $2.7 million for 2003 and $10.7 million for 2002.

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 a protracted slowdown in new business formation, CORT's operations have been hammered, reflecting generally bad results in the ''rent-to-rent'' segment of the furniture rental business. 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. It now appears that CORT's business has begun to rebound. Furniture rental revenues for the fourth quarter of 2004 exceeded those for the comparable quarter of 2003 by 13%, and, during the year the number of furniture leases outstanding grew by 2%.

CORT started up a new subsidiary during 2001, Relocation Central Corporation, which provides the nation's largest apartment locator service through its websites, (www.relocationcentral.com and www.myrelocationcentral.com), customer call centers and walk-in locations. This start-up venture did not progress as rapidly as CORT expected and caused losses followed by some downsizing. More than 350 apartment communities now refer their tenants to CORT. Relocation Central was reorganized to become a division of CORT as of yearend 2004; it now relies more on Internet traffic and less on separate, fully-staffed facilities than previously. The integration of Relocation Central into CORT was begun in 2003 as part of a program to reduce CORT's costs and thus enhance its operating results. CORT still likes the idea of having relocation services in its product mix.

We expect to report in due course that CORT's operations have become more satisfactory. Even through the crash, CORT has operated at a positive cash flow, and the general distress in its field has permitted various small expansions. During the past four years it invested $74 million in business expansion through acquisitions of several small businesses and reduced its line-of-credit and other debt by $33 million. CORT remains the national leader in its market segment and we believe that these acquisitions will prove to be satisfactory expansions of a fundamentally sound 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 $267 million in goodwill (including $27 million from Wesco's 1996 purchase of KBS). The Financial Accounting Standards Board adopted a rule which became effective in 2002 that no longer requires automatic amortization of acquired goodwill. (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, in which event the intangible would be written down or written off, as appropriate.) Earnings we have reported since 2002 more closely reflect microeconomic reality as we appraise it.

CORT has long been headed by Paul Arnold, age 58, 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. 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, operated at an after-tax profit of $1.1 million in 2004, versus an after-tax loss of $.9 million in 2003. The 2004 figure reflects an after-tax LIFO inventory accounting adjustment decreasing after-tax income by $1.8 million. In 2003 the LIFO adjustment was insignificant. Precision Steel's operating results for 2004 and 2003 also reflect expenses of $.1 million and

$.7 million, after taxes, in connection with environmental cleanup of an industrial park where a Precision Steel subsidiary has operated alongside approximately 15 other manufacturers for many years. Had it not been for the LIFO accounting adjustment or the environmental matter, Precision Steel would have reported operating income of $3.0 million, after taxes, for 2004, versus an operating loss of $.2 million, after taxes, for 2003.

Prior to 2004, Precision Steel suffered from a significant reduction in demand for steel combined with intensified competition for quite some time. Some of the sales reduction was caused by customers' (or former customers') unsuccessful competition with manufacturers outside the United States. Although the 2004 figures appear to signal improvement, the severity of the domestic downturn is demonstrated by the fact that Precision Steel's average annual steel service revenues for the years 2001 through 2003 were down 27% from those reported for 1998 through 2000. Even after improved 2004 results, Precision Steel has not reported satisfactory operating results in recent years. Its approximately-break-even after-tax operations for the most recent four years compare unfavorably with operating profits which averaged $2.3 million, after taxes, for the years 1998 through 2000.

Precision Steel endured a difficult and chaotic year in 2004. At the beginning of 2004, a shortage of raw materials from domestic mills produced near chaos in the domestic steel service industry. Prices of those raw materials were sharply increased and the price of finished steel also increased sharply. Fortunately, the impact to date on Precision Steel has been favorable. Its 2004 revenues increased 31.2%, from those of 2003; pounds of steel products sold increased 14.5%. At present, domestic steel mills have been operating at capacity and imported steel has not been readily available. These and other factors have enabled steel mills to raise prices, place limits on order quantities and extend delivery times. Precision Steel has reacted to these pressures by passing the price increases, plus normal mark-ups, on to customers, and favoring long-term customer relationships. However, we are concerned that the favorable 2004 operating results may have been anomalous and temporary and that the steel warehouse business may revert to difficult times.

Terry Piper, who became Precision Steel's President and Chief Executive Officer late in 1999, has done an outstanding job in leading Precision Steel through very 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 appreciated real estate assets with a net book value of about $8.6 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 $.4 million in 2004, unchanged from the $.4 million earned in 2003. Sources were (1) rents ($3.4 million gross in 2004) 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.

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 $2.12 billion ($297 per Wesco share) at yearend 2004 from $2.08 billion ($292 per Wesco share) at yearend 2003. The main cause of increase was net income after deduction of dividends paid to shareholders.

The foregoing $297-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 $32 per Wesco share at yearend 2004.

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 $32 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than $32 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 unchanged two years after Warren Buffett wrote the following, in his 2002 annual report 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 congenital. We love owning common stocks — if they can be purchased at attractive prices. In [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 2004 is that, as in 2003, 2002 and 2001, Wesco found *no* new common stocks for our insurance companies to buy.

Shareholders should note that the recently announced sale of The Gillette Company to The Procter and Gamble Company, subject to shareholder approval later in 2005, is expected to result in Wesco's recognition of an investment gain of about $190 million, after income taxes. No income taxes will be paid in cash, and all of Wesco's Gillette shares will be converted into Procter and Gamble shares. Although we will be pleased to become owners of shares of Procter and Gamble, we do not regard this ''mere accounting'' gain as significant to Wesco shareholders.

The Board of Directors recently increased Wesco's regular dividend from 34½ cents per share to 35½ cents per share, payable March 2, 2005, to shareholders of record as of the close of business on February 2, 2005.

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.

Shareholders can access much Wesco information, including printed annual reports, earnings releases, SEC filings, and the websites of Wesco's subsidiaries and parent, Berkshire Hathaway, from Wesco's website: www.wescofinancial.com.

We regret the pending retirement of Wesco's President, Bob Bird, who is not standing for reelection. He has been, in effect, my partner for over 35 years and has never failed in giving wise and diligent service.

Charles T Munger

Charles T. Munger
Chairman of the Board

March 9, 2005