# WESCO FINANCIAL CORPORATION

Annual Report 2006

Form 10-K Annual Report 2006

# 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 2006 increased to $92,033,000 ($12.93 per share) from $77,973,000 ($10.95 per share) in the previous year.

Consolidated net income decreased, from $294,579,000 ($41.37 per share) in 2005, to $92,033,000 ($12.93 per share) in the current 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 thousands except for per-share amounts)[1]:

| | Year Ended | | | |
|---|---|---|---|---|
| | December 31, 2006 | | December 31, 2005 | |
| | Amount | Per Wesco Share[2] | Amount | Per Wesco Share[2] |
| Operating earnings: | | | | |
| Wesco-Financial and Kansas Bankers insurance businesses — | | | | |
| Underwriting | $ 5,164 | $ .73 | $ 11,798 | $ 1.66 |
| Investment income | 58,528 | 8.22 | 39,068 | 5.49 |
| CORT furniture rental business | 26,884 | 3.78 | 20,676 | 2.90 |
| Precision Steel businesses | 1,211 | .17 | 1,198 | .17 |
| All other ''normal'' net operating earnings[3] | 246 | .03 | 5,233 | .73 |
| | 92,033 | 12.93 | 77,973 | 10.95 |
| Realized investment gains[4] | — | — | 216,606 | 30.42 |
| Wesco consolidated net income | $92,033 | $12.93 | $294,579 | $41.37 |

(1) All figures are net of income taxes.

(2) Per-share data are based on 7,119,807 shares outstanding. Wesco has 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.

(4) Includes $216,112,000 ($30.35 per share) from the tax-free exchange of Wesco's common shares in The Gillette Company for common shares in The Procter & Gamble Company in connection with the merger of Gillette with Procter & Gamble. Although no cash was received, generally accepted accounting principles required that the gain be recorded. Because Wesco's balance sheet reflects investments carried at market value, with unrealized gains, after applicable income tax effect, included in shareholders' equity, the transaction did not affect Wesco's shareholders' equity. It merely resulted in a reclassification from unrealized gains to retained earnings, another component of shareholders' equity.

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 (premiums earned, less insurance losses, loss adjustment expenses and underwriting expenses) with their investment income. Following is a summary of these figures as they pertain to all insurance operations (in 000s).

| | Year Ended December 31, | |
|---|---|---|
| | 2006 | 2005 |
| Premiums written | $55,510 | $50,253 |
| Premiums earned | $54,149 | $49,482 |
| Underwriting gain | $ 7,944 | $14,566 |
| Dividend and interest income | 83,441 | 55,889 |
| Income before income taxes | 91,385 | 70,455 |
| Income taxes | 27,693 | 19,589 |
| Total operating income — insurance businesses | $63,692 | $50,866 |

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

| | | |
|---|---|---|
| Wes-FIC — | | |
| Aviation pools | $35,714 | $29,118 |
| Other | (4) | (64) |
| Kansas Bankers | 19,800 | 21,199 |
| Premiums written | $55,510 | $50,253 |

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

| | | |
|---|---|---|
| Wes-FIC — | | |
| Aviation pools | $33,326 | $28,391 |
| Other | (3) | (53) |
| Kansas Bankers | 20,826 | 21,144 |
| Premiums earned | $54,149 | $49,482 |

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

| | | |
|---|---|---|
| Underwriting gain — | | |
| Wes-FIC | $ 1,650 | $ 6,787 |
| Kansas Bankers | 3,514 | 5,011 |
| | 5,164 | 11,798 |
| Net investment income — | | |
| Wes-FIC | 53,732 | 36,032 |
| Kansas Bankers | 4,796 | 3,036 |
| | 58,528 | 39,068 |
| Total operating income — insurance businesses | $63,692 | $50,866 |

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 $216.6 million, net of income taxes, realized in 2005. No investment gains or losses were realized in 2006. The discussion below will concentrate on insurance underwriting, not on the results from investments.

Wes-FIC engages in the reinsurance business. For the past several years, its reinsurance activity has consisted of the participation in several risk pools managed by an insurance subsidiary of Berkshire Hathaway, our 80%-owning parent. The arrangement became effective in 2001 and most recently covered hull, liability and workers' compensation exposures relating to the aviation industry, as follows: for 2005, to the extent of 10% in the hull and liability pools and 5% of a workers' compensation pool; for 2006, 12½% of the hull and liability pools and 5% of the workers' compensation pool. For 2007, participation in the hull and liability pools has increased to 16.67%. The Berkshire subsidiary provides a portion of the upper-level reinsurance protection to these aviation risk pools 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.

Wes-FIC's underwriting results have fluctuated from year to year, but have been satisfactory. When stated as a percentage, the sum of insurance losses, loss adjustment expenses and underwriting expenses, divided by premiums, gives the combined ratio. The combined ratios of Wes-FIC have been much better than average for insurers. Wes-FIC's combined ratios were 94.0% for 2006 and 75.9% for 2005. We try to create some underwriting gain as results are averaged out over many years. We expect this to become increasingly difficult.

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.

When Wesco purchased KBS, it had been ceding almost half of its premium volume to reinsurers. Now it reinsures only about 14%. Effective in 2006, insurance subsidiaries of Berkshire Hathaway became KBS's sole reinsurers. Previously, an unaffiliated reinsurer was also involved. The increased volume of business retained comes, of course, with increased irregularity in the income stream. KBS's combined ratios were 73.8% for 2006 and 58.8% for 2005. 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 Enterprise, 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 $400 million for calendar 2006, versus $384 million for calendar 2005. Of these amounts, furniture rental revenues were $324 million and $304 million, furniture sales revenues were $70 million and $72 million, and apartment locator fees of its relocation division were $6 million and $8 million. CORT operated at an after-tax profit of $26.9 million for 2006, up satisfactorily from its $20.7 million of after-tax profit for 2005 (versus $5.0 million for 2004). These results reflect the favorable effects of several ''tuck-in'' acquisitions made between the years 2001 and 2004.

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 were 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.

CORT started up a new service during 2001. Originally a subsidiary named Relocation Central, and now its CORTline division, it was conceived mainly to supplement CORT's furniture rental business by providing apartment locator and ancillary services to relocating individuals. Long CORT's star CEO, Paul Arnold is in process of expanding CORTline's operations and redirecting its marketing, with the expectation that it will become a financial success. CORTline, originally conceived to assist relocating individuals, has recently expanded its services and capabilities and has begun to market itself toward the needs of businesses and governmental agencies who require a skilled and able partner to provide the full gamut of seamless relocation services for the temporary relocation of employees. With several websites, principally, www.cortline.com, www.relocationcentral.com and www.apartmentsearch.com, professionals in more than 80 domestic metropolitan markets, affiliates in more than 50 countries, almost twenty thousand apartment communities referring their tenants to CORT, many ancillary services, and its entrée to the business community as a Berkshire Hathaway company, CORTline now seems to be moving in the right direction.

We are pleased with the progress CORT made in the past two years. We are cautiously optimistic that, in future years, we will be able to look back to the recent past and consider it merely a cyclical aberration in CORT's growth. We note, however, that the number of furniture leases outstanding has been slightly declining in each of the past two years.

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 asset would be written down or written off, as appropriate.) Earnings, not reduced by goodwill amortization, that we have reported since 2002 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.

**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 after-tax profits of $1.2 million in both 2006 and 2005. These figures reflect after-tax LIFO inventory accounting adjustments decreasing after-tax income by $.6 million for 2006 and $.2 million for 2005. Precision Steel's operating results for 2006 also reflect expenses, net of insurance recoveries, of $.3 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 adjustments or the environmental matter, Precision Steel would have reported after-tax operating income of $2.1 million for 2006 and $1.4 million for 2005.

Precision Steel's business has been subject to economic cycles. Although the fiercely competitive, chaotic pressures affecting its steel service center business (which we described at length in last year's shareholders' letter) have recently abated, Precision Steel is continuing to suffer the ongoing effects of a long-term reduction in demand caused by customers' (or former customers') unsuccessful competition with manufacturers outside the United States. Precision Steel's revenues increased 2.8% in 2006, approximately half of which was due to an extraordinary order of shimstock and other industrial supplies from a customer of its Precision Brand Products subsidiary. Revenues for 2005 increased by 1.4% from those of 2004. In 2006, Precision Steel's service center volume was 46 million pounds, down from 69 million pounds sold as recently as 1999. This decline in physical volume is a serious reverse, not likely to disappear in some "bounce back" effect. Nor do we expect another sharp rise in prices like the approximately 40% rise that recently occurred, holding dollar volume roughly level despite a precipitous drop in physical volume.

Although Precision Steel's recent after-tax operating earnings of approximately $1 million per year may signal improvement when compared with its after-tax operating loss of $.9 million for 2003, we do not consider present operating results to be a satisfactory investment outcome. Recent earnings of Precision Steel compare unfavorably with operating earnings which averaged $2.3 million, after taxes, for the years 1998 through 2000. Because the steel warehouse business may revert to even more difficult conditions, more decline for Precision Steel may lie ahead.

Terry Piper, who became Precision Steel's President and Chief Executive Officer in 1999, has done an outstanding job in leading Precision Steel through very difficult years. But he has no magic wand with which to compensate for competitive losses among his best customers.

**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 consisting mainly of the nine-story commercial office building in downtown Pasadena, where Wesco is headquartered. Adjacent to that building is a parcel of land on which we are building a multi-story luxury condominium building. We are also seeking city approval of our plans to build another multi-story luxury condominium building on a vacant parcel of land in the next block. For more information, if you want a very-high-end condominium, simply phone Bob Sahm (626-585-6700). 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 2006, versus $5.2 million in 2005. Had it not been for favorable income tax adjustments of $4.9 million recorded in 2005, other operating earnings would have been $.3 million in 2005. The sources of the $.2 million of other operating earnings in 2006 were (1) rents ($3.7 million gross in 2006) principally 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.

**Realized Investment Gains**

There were no realized investment gains in 2006. Wesco's 2005 earnings contained investment gains of $216.6 million, after income taxes. Only $.5 million was realized through the *sale* of investments; the balance, $216.1 million, resulted from the tax-free exchange of common shares of The Gillette Company (''Gillette'') owned by Wesco, for common shares of The Procter & Gamble Company (''PG'') in the fourth quarter of 2005 in connection with the merger of Gillette with PG. Accounting standards promulgated by the Financial Accounting Standards Board require that the fair (market) value of shares received in such an exchange be recorded as the new cost basis as of the date of the exchange, with the difference between the new basis and the historical cost realized in the audited financial statements as an investment gain. For tax return purposes, the securities acquired were recorded at the original cost of the securities exchanged. Thus, no income tax was due or paid.

Although the realized gain had a material impact on Wesco's reported 2005 earnings, *it had no impact on Wesco's shareholders' equity.* Wesco carries its investments at fair value, with unrealized appreciation, after income tax effect, included as a separate component of shareholders' equity, and related taxes included in income taxes payable, on its consolidated balance sheet. Thus, the entire after-tax gain on the non-cash merger had been reflected in the unrealized gain component of Wesco's shareholders' equity as of September 30, 2005. That amount was merely switched from unrealized gain to retained earnings, another component of shareholders' equity. This accounting entry had no economic effect on Wesco, and you should ignore it when you are evaluating Wesco's 2005 earnings.

**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 $2.40 billion ($337 per Wesco share) at yearend 2006 from $2.23 billion ($313 per Wesco share) at yearend 2005. The main causes of the increase were appreciation in fair value of investments, and net operating income after deduction of dividends paid to shareholders.

The foregoing $337-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, including the PG shares Wesco received in connection with PG's acquisition of Gillette in 2005, discussed above in the section, ''Realized Investment Gains,'' Wesco has, in effect, an interest-free ''loan'' from the government equal to its deferred income taxes, 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 $42 per Wesco share at yearend 2006.

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 $42 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than $42 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.

Wesco's consolidated balance sheet reflects total assets of $3.0 billion as of yearend 2006. Of that amount, more than $1 billion has been invested in cash equivalents and fixed-maturity investments since early in 2003. Unless those funds can be attractively reinvested in acquisitions, equity securities or other long-term instruments of the type that helped cause the long-term growth of Wesco's shareholders' equity, future returns on shareholders' equity will probably be less than those of the past. Due to the current size of Wesco and its parent, Berkshire Hathaway, Wesco's opportunities for growing shareholders' equity are unlikely to be as attractive as in the past.

Wesco's shares were listed for many years on both the American Stock Exchange and, since 1963, on a regional exchange previously known as the Pacific Stock Exchange. Following the recent merger of various regional exchanges into the NYSE, the Pacific Exchange became the NYSE Arca exchange. We had happily paid a minimal annual listing fee of $1,000 for the privilege of having our shares listed on the Pacific Exchange. When notified last December that NYSE Arca had decided to increase Wesco's annual listing fee to $30,000, Wesco voted with its feet. Its shares are now listed only on the American Exchange.

The Board of Directors recently increased Wesco's regular dividend from $36\frac{1}{2}$ cents per share to $37\frac{1}{2}$ cents per share, payable March 8, 2007, to shareholders of record as of the close of business on February 1, 2007.

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.

Charles T. Munger
Chairman of the Board
and President

February 27, 2007