



WESCO FINANCIAL CORPORATION

Annual Report 2007
Form 10-K Annual Report 2007

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 2007 increased to \$93,405,000 (\$13.12 per share) from \$92,033,000 (\$12.93 per share) in the previous year.

Consolidated net income increased, from \$92,033,000 (\$12.93 per share) in 2006, to \$109,161,000 (\$15.33 per share) in the current year. The 2007 figure included realized investment gains of \$15,756,000, after taxes (\$2.21 per share).

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, 2007		December 31, 2006	
	Amount	Per Wesco Share ⁽²⁾	Amount	Per Wesco Share ⁽²⁾
Operating earnings:				
Wesco-Financial and Kansas Bankers insurance businesses —				
Underwriting	\$ 7,040	\$.99	\$ 5,164	\$.73
Investment income	65,207	9.16	58,528	8.22
CORT furniture rental business	20,316	2.85	26,884	3.78
Precision Steel businesses	915	.13	1,211	.17
All other “normal” net operating earnings (loss) ⁽³⁾	(73)	(.01)	246	.03
	<u>93,405</u>	<u>13.12</u>	<u>92,033</u>	<u>12.93</u>
Realized investment gains	15,756	2.21	—	—
Wesco consolidated net income	<u>\$109,161</u>	<u>\$15.33</u>	<u>\$92,033</u>	<u>\$12.93</u>

(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.

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).

	<u>Year Ended December 31,</u>	
	<u>2007</u>	<u>2006</u>
Premiums written	\$ 54,839	\$55,510
Premiums earned	<u>\$ 54,411</u>	<u>\$54,149</u>
Underwriting gain	\$ 10,831	\$ 7,944
Dividend and interest income	<u>89,716</u>	<u>83,441</u>
Income before income taxes	100,547	91,385
Income taxes	<u>28,300</u>	<u>27,693</u>
Total operating income — insurance businesses	<u>\$ 72,247</u>	<u>\$63,692</u>

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

Wes-FIC reinsurance	\$ 35,346	\$35,710
Kansas Bankers primary insurance	<u>19,493</u>	<u>19,800</u>
Premiums written	<u>\$ 54,839</u>	<u>\$55,510</u>

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

Wes-FIC reinsurance	\$ 34,998	\$33,323
Kansas Bankers primary insurance	<u>19,413</u>	<u>20,826</u>
Premiums earned	<u>\$ 54,411</u>	<u>\$54,149</u>

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

Underwriting gain —		
Wes-FIC	\$ 1,403	\$ 1,650
Kansas Bankers	<u>5,637</u>	<u>3,514</u>
	<u>7,040</u>	<u>5,164</u>
Net investment income —		
Wes-FIC	59,906	53,732
Kansas Bankers	<u>5,301</u>	<u>4,796</u>
	<u>65,207</u>	<u>58,528</u>
Total operating income — insurance businesses	<u>\$ 72,247</u>	<u>\$63,692</u>

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 \$15.8 million, net of income taxes, realized in 2007.

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 2006, to the extent of 12½% of the hull and liability pools and 5% of the workers' compensation pool; for 2007, 16.67% of the hull and liability pools and 5% of the workers' compensation pool. The participation rates remain unchanged for 2008. 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.

Wesco's Board of Directors has recently and enthusiastically approved Wes-FIC's most significant reinsurance contract to date: its participation, since January 1, 2008, in an agreement with National Indemnity Company ("NICO"), another Berkshire Hathaway insurance subsidiary, for the assumption of 10% of NICO's quota-share reinsurance of Swiss Reinsurance Company and its property-casualty affiliates ("Swiss Re"). Under this retrocession agreement, Wes-FIC will effectively assume 2% of all of Swiss Re's property-casualty risks incepting over the next five years on the same terms as NICO's agreement with Swiss Re. If recent years' volumes were to continue over the next five years, the annual written premiums assumed by Wes-FIC under this retrocession agreement would be in the \$300 million range; however, actual premiums assumed over the five-year period could vary significantly depending on market conditions and opportunities.

It is the nature of even the finest casualty insurance businesses that in keeping their accounts they must estimate and deduct all future costs and losses from premiums already earned. Uncertainties inherent in this undertaking make financial statements more mere "best honest guesses" than is typically the case with accounts of non-insurance-writing corporations. The reinsurance portion of the casualty insurance business, because it contains one or more extra links in the loss-reporting chain, usually creates more accounting uncertainty than in the non-reinsurance portion. Wesco shareholders should remain aware of the inherent imperfections of Wes-FIC's accounting, based as it is on forecasts of outcomes in many future years.

Wes-FIC's underwriting results have typically 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 93.9% for 2007 and 94.0% for 2006. We try to create some underwriting gain as results are averaged out over many years. We expect this to become increasingly difficult.

Float is the term for money we hold temporarily, and as long as our insurance underwriting results are break-even or better, it costs us nothing. We expect that the new business venture with NICO will significantly increase Wes-FIC's float from its yearend 2007 balance of \$94 million, thus providing additional opportunities for investment.

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 38 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 15%. 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 55.1% for 2007 and 73.8% for 2006. We continue to expect volatile but favorable long-term results from KBS.

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 \$396 million for calendar 2007, versus \$400 million for calendar 2006. Of these amounts, furniture rental revenues were \$327 million and \$324 million, furniture sales revenues were \$62 million and \$70 million, and rental relocation revenues were \$7 million and \$6 million. CORT operated at after-tax profits of \$20.3 million for 2007 and \$26.9 million for 2006.

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 in 2001. Originally a subsidiary named Relocation Central, and subsequently integrated into CORT's operations, CORT's rental relocation activities were intended mainly to supplement its 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 CORT's rental relocation services and redirecting its

marketing toward the needs of businesses and governmental agencies who require a skilled and able partner to provide comprehensive and seamless relocation services for the temporary relocation of employees, worldwide. With several websites, principally www.cort.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, CORT's rental relocation operations may now be moving in the right direction.

In January 2008, CORT expanded its operations to the United Kingdom through the purchase of Roomservice Group, a small regional provider of furniture rental and relocation services.

CORT's operations are subject to economic cycles. We are pleased with CORT's progress in the past few years; however, we believe that it will likely suffer its share of the downturn as we enter a period of economic contraction. CORT is now a stronger company than it was when acquired by Wesco, helped by several "tuck-in" acquisitions, and poised towards long-term growth despite periodic bumps to be encountered along the way.

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 \$0.9 million in 2007 and \$1.2 million in 2006. These figures reflect after-tax LIFO inventory accounting adjustments decreasing after-tax income by \$1.0 million for 2007 and \$0.6 million for 2006. Precision Steel's operating results for 2006 also reflect expenses, net of insurance recoveries, of \$0.3 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 discussed in Note 9 to the accompanying consolidated financial statements, Precision Steel would have reported after-tax operating income of \$1.9 million for 2007 and \$2.1 million for 2006.

Precision Steel's business has been subject to economic cycles. Although the fiercely competitive, chaotic pressures which affected its steel service center business several years ago have 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 decreased 2.7% in 2007, following an increase of 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. In 2007, Precision Steel's service center volume was 39 million pounds, down from 46 million pounds in 2006 and 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 that ongoing price increases like the approximately 66% rise that has occurred since 1999, holding dollar volume roughly level despite a precipitous drop in physical volume, will continue.

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

\$0.9 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 our construction of a multi-story luxury condominium building is nearing completion. We are also seeking city approval of our plans to build another multi-story luxury condominium building, at a later date, on a vacant parcel of land in the next block. For more information, if you want a very-high-end condominium, simply phone Bob Sahn (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 (Loss)

Other operating earnings (loss), net of interest paid and general corporate expenses, amounted to (\$0.1 million) in 2007, versus \$0.2 million in 2006. The components of the \$0.1 million of other operating loss in 2007 were (1) rents (\$3.9 million gross in 2007) 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.

Consolidated Balance Sheet and Related Discussion

Wesco carries its investments at fair value, with unrealized appreciation, after income tax effect, included as a separate component of shareholders' equity, and related deferred taxes included in income taxes payable, on its consolidated balance sheet. As indicated in the accompanying financial statements, Wesco's net worth, as accountants compute it under their conventions, increased to \$2.53 billion (\$356 per Wesco share) at yearend 2007 from \$2.40 billion (\$337 per Wesco share) at yearend 2006. The main causes of the increase were net operating income after deduction of dividends paid to shareholders, and appreciation in fair value of investments.

The foregoing \$356-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 of \$322 million, 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 \$45 per Wesco share at yearend 2007.

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 \$45 per Wesco share. Instead, the present value of Wesco’s shareholders’ advantage must logically be much lower than \$45 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.

Last year we reported that Wesco had held more than \$1 billion of cash equivalents and fixed-maturity investments since early in 2003. In the latter part of 2007 Wesco invested \$802 million, net, in marketable equity securities. Of its \$3.1 billion of assets at December 31, 2007, \$565 million is invested in cash equivalents and fixed-maturity investments. Unless significant additional amounts 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.

The Board of Directors recently increased Wesco’s regular dividend from 37½ cents per share to 38½ cents per share, payable March 6, 2008, to shareholders of record as of the close of business on February 7, 2008.

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, 2008