

WESCO FINANCIAL CORP

Form 10-Q

May 15, 2002

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**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

Quarterly report pursuant to section 13 or 15 (d) of the Securities Exchange Act of 1934

For the Quarterly period  
ended March 31, 2002 or  
Transition report pursuant to  
section 13 or 15 (d) of the  
Securities Exchange Act of  
1934 For the transition  
period  
from \_\_\_\_\_  
to \_\_\_\_\_

Commission file number 1-4720

WESCO FINANCIAL CORPORATION

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(Exact name of Registrant as Specified in its Charter)

DELAWARE

95-2109453

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(State or Other Jurisdiction of  
incorporation or organization)

(I.R.S. Employer Identification No.)

301 East Colorado Boulevard, Suite 300, Pasadena, California 91101-1901

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(Address of Principal Executives Offices) (Zip Code)

626/585-6700

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(Registrant's Telephone Number, Including Area Code)

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(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

**APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS  
DURING THE PRECEDING FIVE YEARS**

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13 or 15 (d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes No

**APPLICABLE ONLY TO CORPORATE ISSUERS**

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date, 7,119,807 as of May 8, 2002

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FOR QUARTER ENDED MARCH 31, 2002

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**PART I. FINANCIAL INFORMATION**

Item 1. Financial Statements

The condensed consolidated financial statements of Wesco Financial Corporation, listed in the accompanying index, are incorporated as an integral part of this report. Item 2.

Management's Discussion and Analysis of Financial Condition and Results of Operations. See pages 10 through 15. **PART II.**

**OTHER INFORMATION** Item 6.

Exhibits and Reports on Form 8-K (a) Exhibits None (b) Reports on Form 8-K None

**SIGNATURES**

Pursuant to the requirements of the securities exchange act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

WESCO FINANCIAL CORPORATION

Date: May 14, 2002  
By: /s/ Jeffrey L. Jacobson

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Jeffrey L. Jacobson  
Vice President and  
Chief Financial Officer  
(principal financial  
officer)

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FINANCIAL STATEMENTS FILED WITH FORM 10-Q  
FOR QUARTER ENDED MARCH 31, 2002**

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**WESCO FINANCIAL CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENT OF INCOME AND RETAINED EARNINGS**  
(Dollar amounts in thousands except for amounts per share)  
(Unaudited)

	Three Months Ended	
	March 31, 2002	March 31, 2001
<b>Revenues:</b>		
Sales and service revenues		
\$111,965	\$120,531	
Insurance premiums earned		
12,899	8,677	
Dividend and interest income		
17,634	19,855	
Other		
811	788	
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143,309	149,851	
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<b>Costs and expenses:</b>		
Cost of products and services sold		
37,062	39,452	
Insurance losses, loss adjustment and underwriting expenses		
11,928	7,179	
Selling, general and administrative expenses		
71,537	69,200	
Interest expense		
563	1,266	
Goodwill amortization		
1,831		
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121,090 118,928

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Income before income taxes

22,219 30,923

Provision for income taxes

(7,782) (11,106)

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Net income

14,437 19,817

Retained earnings beginning of period

1,509,691 1,466,126

Cash dividends declared and paid

(2,314) (2,242)

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Retained earnings end of period

\$1,521,814 \$1,483,701

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Amounts per capital share based on 7,119,807 shares outstanding throughout each period:

Net income

\$2.03 \$2.78

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Cash dividends

\$.325 \$.315



*See notes beginning on page 7.*

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**WESCO FINANCIAL CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEET**  
(Dollar amounts in thousands)  
(Unaudited)

	March 31, 2002	Dec. 31, 2001
<b>ASSETS</b>		
Cash and cash equivalents	\$165,472	\$120,784
Investments:		
Securities with fixed maturities	901,963	924,160
Marketable equity securities	724,285	667,262
Rental furniture	224,665	212,586
Goodwill of acquired businesses	264,839	264,465
Other assets	145,606	130,436
	\$2,426,830	\$2,319,693
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Insurance losses and loss adjustment expenses	\$65,177	\$61,879
Deferred furniture rental income and security deposits	25,004	23,796
Notes payable	53,506	33,649
Income taxes payable, principally deferred	252,590	225,665
Other liabilities	73,488	62,307

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469,765 407,296

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Shareholders' equity:

Capital stock and capital in excess  
of par value

30,439 30,439

Unrealized appreciation of  
investments, net of taxes

404,812 372,267

Retained earnings

1,521,814 1,509,691

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Total shareholders' equity

1,957,065 1,912,397

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\$2,426,830 \$2,319,693

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*See notes beginning on page 7.*

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**WESCO FINANCIAL CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS**  
(Dollar amounts in thousands)  
(Unaudited)

	Three Months Ended	
	March 31, 2002	March 31, 2001
Cash flows from operating activities, net	\$54,521	\$35,907
Cash flows from investing activities:		
Maturities of investments	135,274	208,838
Purchases of investments	(120,932)	(2,044)
Acquisition of business, net of cash and cash equivalents acquired	(30,185)	(16,470)
Purchases of rental furniture	(10,270)	(24,852)
Other, net	(1,263)	(1,054)
Net cash flows from investing activities		
(27,376)	164,418	
Cash flows from financing activities:		
Net increase in notes payable	19,857	39,500
Payment of cash dividends	(2,314)	(2,242)

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Net cash flows from financing activities

17,543 37,258

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Increase in cash and cash equivalents

44,688 237,583

Cash and cash equivalents beginning of period

120,784 153,810

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Cash and cash equivalents end of period

\$165,472 \$391,393

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Supplementary information:

Interest paid during period

\$530 \$1,161

Income taxes paid (recovered), net, during period

(1,441) 21,394

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*See notes beginning on page 7.*

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**WESCO FINANCIAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
(Dollar amounts in thousands except for amounts per share)  
(Unaudited)

Note 1

In management's opinion, the condensed consolidated financial statements of Wesco Financial Corporation ( Wesco ) reflect all adjustments (all of them of a normal recurring nature) necessary to a fair statement of interim results in accordance with generally accepted accounting principles.

In June 2001, the Financial Accounting Standards Board issued SFAS No. 142, Goodwill and Other Intangible Assets, changing from an accounting model that required amortization of goodwill, supplemented by impairment tests, to an accounting model based solely on impairment tests. SFAS No. 142 also provided guidance on accounting for identifiable intangible assets that may or may not require amortization. The provisions of SFAS No. 142 became effective for Wesco at the beginning of 2002; as a result, the accompanying condensed consolidated financial statements do not reflect any goodwill amortization in 2002, compared to \$1,831, before taxes, of goodwill amortization for the first quarter of 2001. Had Wesco adopted the provisions of SFAS No. 142 and ceased goodwill amortization as of the beginning of 2001, its after-tax income would have been \$21,494 (\$3.02 per share), an increase of \$1,677 (\$.24 per share) over earnings previously reported.

Reference is made to the notes to Wesco's consolidated financial statements appearing on pages 36 through 44 of its 2001 Form 10-K Annual Report for other information deemed generally applicable to the condensed consolidated financial statements.

Note 2

Following is a summary of securities with fixed maturities:

	March 31, 2002		December 31, 2001	
	Amortized Cost	Estimated Fair (Carrying) Value	Amortized Cost	Estimated Fair (Carrying) Value
Mortgage-backed securities	\$ 751,475	\$ 760,949	\$ 886,186	\$ 899,066
Other	145,410	141,014	26,119	25,094
	\$896,885	\$901,963	\$912,305	\$924,160





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Following is a summary of marketable equity securities (all common stocks):

	March 31, 2002		December 31, 2001	
	Cost	Quoted Market (Carrying) Value	Cost	Quoted Market (Carrying) Value
The Coca-Cola Company	\$40,761	\$376,565	\$40,761	\$339,744
The Gillette Company				
40,000 217,664 40,000 213,760				
Other				
27,020 130,056 27,020 113,758				
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\$107,781	\$724,285	\$107,781	\$667,262	
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Note 3

The following table sets forth Wesco's consolidated comprehensive income (loss) for the three-month periods ended March 31, 2002 and 2001:

	Three Months Ended	
	March 31, 2002	March 31, 2001
Net income	\$14,437	\$19,817
Increase (decrease) in unrealized appreciation of investments, net of income tax effect of (\$17,701) and \$61,286		
32,545 (113,396)		

Comprehensive income (loss)  
 \$46,982 \$(93,579)

Note 4

Following is condensed consolidated financial information for Wesco, broken down by business segment:

	Three Months Ended	
	March 31, 2002	March 31, 2001
Insurance segment:		
Revenues		
\$30,395	\$28,280	
Net income		
12,558	14,279	
Assets at end of period		
1,802,541	1,672,162	

Furniture rental segment:

Revenues  
 \$100,192\$ 105,958  
 Net income  
 1,754 6,775  
 Assets at end of period  
 315,193 347,564



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Industrial segment:

Revenues  
 \$11,780 \$14,578  
 Net income (loss)  
 (4) 283  
 Assets at end of period  
 18,893 22,828

Goodwill of acquired businesses:

Amortization, net of income taxes  
 \$ \$(1,677)  
 Assets at end of period  
 264,839 268,264

Other items unrelated to business segments:

Revenues  
 \$942 \$1,035  
 Net income  
 129 157  
 Assets at end of period  
 25,364 28,725

Consolidated totals:

Revenues  
 \$143,309 \$149,851  
 Net income  
 14,437 19,817  
 Assets at end of period  
 2,426,830 2,339,543

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WESCO FINANCIAL CORPORATION  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Reference is made to management's discussion and analysis of Wesco's consolidated financial condition and results of operations appearing on pages 18 through 27 of its 2002 Form 10-K Annual Report for information deemed generally appropriate to an understanding of the accompanying condensed consolidated financial statements. The information set forth in the following paragraphs updates such discussion. Further, in reviewing the following paragraphs, attention is directed to the accompanying condensed consolidated financial statements.

FINANCIAL CONDITION

Wesco's shareholders' equity at March 31, 2002 was approximately \$1.96 billion (\$275 per share), compared to \$1.91 billion (\$269 per share) at December 31, 2001. The increase was due mainly to an increase in appreciation in market value of investments, which under accounting convention, is credited directly to shareholders' equity, net of taxes, without being reflected in earnings. Because unrealized appreciation is recorded based upon current market quotations, gains or losses ultimately realized upon sale of investments could differ substantially from recorded unrealized appreciation, which constituted 21% of shareholders' equity at March 31, 2002.

At March 31, 2002, Wesco's consolidated cash and cash equivalents totaled \$165.5 million, up from \$120.8 million at December 31, 2001. The \$44.7 million increase resulted from a number of factors as shown in the condensed consolidated statement of cash flows in the accompanying statements.

Wesco's consolidated borrowings totaled \$53.5 million at March 31, 2002 versus \$33.6 million at December 31, 2001. The increased borrowings related to an acquisition by CORT early in 2002, which it financed using its revolving line of credit.

Wesco's management continues to believe that the Wesco group has adequate liquidity and financial resources to cover existing liquidity requirements and provide for contingent needs.

RESULTS OF OPERATIONS

The following summary sets forth the contribution to Wesco's consolidated net income of each business segment—insurance, furniture rental and industrial—as well as activities not considered related to such segments. Goodwill amortization was discontinued in connection with the adoption of new accounting standards required by Statement of Financial Standards No. 142, Goodwill/Other Intangible Assets, effective in 2002. (Amounts are in thousands, *all after income tax effect.*)

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	Three Months Ended	
	March 31, 2002	March 31, 2001
Insurance segment	\$ 12,558	\$ 14,279
Furniture rental segment		
1,754 6,775		
Industrial segment		
(4) 283		
Unrelated to business segment operations		
Goodwill amortization		
(1,677)		
Other nonsegment items		
129 157		
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Consolidated net income		
\$14,437 \$19,817		
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*Insurance Segment*

The insurance segment comprises Wesco-Financial Insurance Company ( Wes-FIC ) and The Kansas Bankers Surety Company ( KBS ). Following is a summary of the results of segment operations, which represent essentially the combination of underwriting results with dividend and interest income. (Amounts are in thousands.)

	Three Months Ended	
	March 31, 2002	March 31, 2001
Premiums written	\$ 13,492	\$ 10,632
Premiums earned	\$ 12,899	\$ 8,677
Underwriting gain	\$ 971	\$ 1,498
Dividend and interest income		
17,496 19,603		
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Income before income taxes	
18,467	21,101
Income tax provision	
(5,909)	(6,822)

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Segment net income	
\$12,558	\$14,279

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Premiums written for the first quarters of 2002 and 2001 included \$8.0 million and \$5.7 million related to Wes-FIC. The remainder in each quarter was attributable to KBS. The Wes-FIC increase was attributable principally to its ongoing participation in a three-year arrangement for reinsurance of certain property and casualty exposure ceded by a large, unaffiliated insurer.

Earned premiums for the first quarters of 2002 and 2001 included \$8.4 million and \$4.5 million attributable to Wes-FIC. The balance for each period was attributable to KBS. The increase in Wes-FIC's premiums earned was due mainly to the reinsurance participation described in the preceding paragraph.

The underwriting gains reported for the quarters ended March 31, 2002 and 2001 were attributable to the profitable underwriting results of KBS. The decrease in underwriting gain for the first quarter of 2002 from the comparable prior year figure resulted mainly from an increase in losses incurred by KBS.



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Dividend and interest income declined for the quarter ended March 31, 2002 from the comparable prior year figure due principally to a change in mix of fixed-maturity investments.

The income tax provision of the insurance segment generally fluctuates somewhat as a percentage of its pre-tax income mainly due to fluctuations in the relationship of substantially tax-exempt components of income to total pre-tax income.

*Furniture Rental Segment*

The furniture rental segment consists of CORT Business Services Corporation ( CORT ) and its Relocation Central Corporation subsidiary ( Relocation Central ). Following is a summary of segment operating results for the quarters ended March 31, 2002 and March 31, 2001. (Amounts are in thousands.)

	Three Months Ended	
	March 31, 2002	March 31, 2001
<b>Revenues:</b>		
Furniture rentals	\$81,939	\$88,895
Furniture sales	18,253	17,063
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Total revenues	\$100,192	\$105,958
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<hr/>		
Income before income taxes	\$3,594	\$10,976
Income tax provision	(1,840)	(4,201)
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Segment net income	\$1,754	\$6,775
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Furniture rental segment revenues for the first quarter of 2002 decreased \$5.8 million, or 5.4%, from those reported for the comparable 2001 period. Rental revenues for the quarter declined \$7.0 million, or 7%. Excluding rental revenues from locations acquired since the 2001 period, trade show operations and \$1.3 million generated by Relocation Central from the start-up of its apartment locator operation, rental revenues for the first quarter of 2002 decreased approximately 20.8% from those reported for the comparable 2001 period. The number of furniture leases outstanding continued the downward trend begun in late 2000, reflecting continued weakness of the economy. Furniture sales revenues increased approximately 7% for the current quarter. Excluding sales revenues resulting from an acquisition in January 2002, furniture sales decreased by approximately 3.5%, also reflecting weakness in the economy.

Income or loss before income taxes and net income of the furniture rental segment are dependent not only on revenues, but also on operating expenses and cost of rentals and sales. The drop in first quarter income before income taxes from 2001 to 2002 (10.4% to 3.6% of revenues) was caused principally by a decline in gross profit due to the decline in revenues coupled with a slight increase in cost of rentals and sales (from 26.1% to 27.2% of revenues). In addition, selling, general and administrative expenses increased: The 2002 quarter included expenses related to the January 2002 acquisition as well as increased expenses of Relocation Central, which began operations in January 2001; these more than offset significant expense reductions realized by CORT on its older operations.

**Table of Contents***Industrial Segment*

Following is a summary of the results of operations of the industrial segment, consisting of the businesses of Precision Steel Warehouse, Inc. and its subsidiaries. (Amounts are in thousands.)

	Three Months Ended	
	March 31, 2002	March 31, 2001
Revenues, principally sales and services	\$ 11,780	\$ 14,578
Income (loss) before income taxes	\$ (7)	\$ 468
Income tax (provision) benefit 3 (185)		
<hr/>		
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Segment net income (loss)		
\$(4) \$283		
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Industrial segment revenues for the first quarter of 2002 decreased \$2.8 million, or 19.2 % percent, from those reported for the first quarter of 2001. Pounds of steel products sold decreased 16.2%. These declines resulted principally from weakness in the manufacturing sector of the economy coupled with further increases in competitive pressures above those already existing at the end of 2001.

Income or loss before income taxes and net income or loss of the industrial segment are dependent not only on revenues, but also on operating expenses and the cost of products sold. The latter, as a percentage of revenues, amounted to 83.2% for the first quarter of 2002 versus 81.1% for the comparable period last year. The cost percentage typically fluctuates slightly from period to period as a result of changes in product mix and price competition at all levels.

*Unrelated to Business Segment Operations*

Set forth below is a summary of items increasing (decreasing) Wesco's consolidated net income that are viewed by management as unrelated to the operations of the insurance, furniture rental and industrial segments. (Amounts are in thousands.)

	Three Months Ended	
	March 31, 2002	March 31, 2001
Goodwill amortization, before income tax effect	\$	\$(1,831)
Income tax benefit 154		

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\$ \$(1,677)

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Other nonsegment items, net, before income tax effect  
\$165 \$211  
Income tax provision  
(36) (54)

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\$129 \$157

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As explained in Note 1 to the accompanying condensed consolidated financial statements, Wesco discontinued amortization of goodwill effective as of the beginning of 2002, as required by the Financial Accounting Standards Board. Goodwill amortization for 2001 related principally to CORT.

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Realized gains and losses on investments, when they occur, are classified by Wesco as nonsegment items. These realizations tend to fluctuate in amount from period to period, sometimes impacting net income significantly, and their amounts and timing have no predictive or practical analytical value. No securities gains or losses were realized during the first quarter of 2002 or the entire calendar year ended December 31, 2001.

Other nonsegment items comprise mainly rental income from owned commercial real estate and dividend and interest income from investments owned outside the insurance segment, reduced by real estate and other expenses.

\* \* \* \* \*

Wesco's effective consolidated income tax rate typically fluctuates from period to period for various reasons, such as the inclusion in consolidated revenues of significant, varying amounts of dividend income, which is substantially exempt from income taxes. The respective income tax provisions, expressed as percentages of income before income taxes, amounted to 35.0% and 35.9% for the quarters ended March 31, 2002 and March 31, 2001.

**CRITICAL ACCOUNTING POLICIES**

In applying certain accounting policies, Wesco is required to make estimates and judgments regarding transactions that have occurred and ultimately will be settled in the future. Amounts recognized in the financial statements from such estimates are necessarily based on assumptions about numerous factors involving varying, and possibly significant, degrees of uncertainty. Accordingly, the amounts currently recorded in the financial statements may prove, with the benefit of hindsight, to be inaccurate.

Wesco accrues liabilities for unpaid property and casualty insurance and reinsurance losses based upon estimates of the ultimate amounts payable under the contracts related to losses occurring on or before the balance sheet date. As of any balance sheet date, all claims have not yet been reported and some claims may not be reported for many years. As a result, the liability for unpaid losses includes significant estimates for incurred-but-not-reported claims. Additionally, reported claims are in various stages of the settlement process. Each claim is settled individually based upon its merits and certain liability or workers' compensation claims may take years to settle, especially if legal action is involved.

Wesco uses a variety of techniques to establish the liabilities for unpaid claims recorded at the balance sheet date. While techniques may vary, all employ significant judgments and assumptions. Techniques may involve detailed statistical analysis of past claim reporting, settlement activity, claim frequency and severity data when sufficient information exists to lend statistical credibility to the analysis. The analysis may be based upon internal loss experience, the experience of clients or industry experience. Techniques may vary depending on the type of claim being estimated. More judgmental techniques are used in lines when statistical data is insufficient or unavailable. Liabilities may also reflect implicit or explicit assumptions regarding the potential effects of future economic and social inflation, judicial decisions, law changes, and recent trends in such factors.

Wesco's condensed consolidated balance sheet includes estimated liabilities for unpaid losses from property and casualty insurance and reinsurance contracts of \$65.2 million at March 31, 2002. Due to the inherent uncertainties in the process of establishing these amounts, the actual ultimate claims amounts will likely differ from the currently recorded amounts. Future effects from changes in these estimates will be recorded as a

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component of losses incurred in the period of the change. Such changes are not expected to materially affect Wesco's shareholders' equity.

Wesco's financial position reflects large amounts of invested assets. A substantial portion of these assets are carried at fair values based upon current market quotations and, when not available, based upon fair value pricing models.

Wesco's Consolidated Balance Sheet as of March 31, 2002 includes goodwill of acquired businesses of approximately \$265 million. These amounts have been recorded as a result of Wesco's prior business acquisitions accounted for under the purchase method. Prior to 2002, goodwill from each acquisition was generally amortized as a charge to earnings over periods not exceeding 40 years. Under SFAS No. 142, which was adopted by Wesco as of January 1, 2002, periodic amortization ceased.

A significant amount of judgment is required in performing goodwill impairment tests. Such tests include periodically determining or reviewing the estimated fair value of Wesco's reporting units. Under SFAS No. 142, fair value refers to the amount for which the entire reporting unit may be bought or sold. There are several methods of estimating reporting unit values, including market quotations, asset and liability fair values and other valuation techniques, such as discounted cash flows and multiples of earnings or revenues. If the carrying amount of a reporting unit, including goodwill, exceeds the estimated fair value, then individual assets, including identifiable intangible assets and liabilities of the reporting unit are estimated at fair value. The excess of the estimated fair value of the reporting unit over the estimated fair value of net assets would establish the implied value of goodwill. The excess of the recorded amount of goodwill over the implied value is charged off as an impairment loss.

**FORWARD-LOOKING STATEMENTS**

Certain written or oral representations of management stated herein or elsewhere constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, as contrasted with statements of historical fact. Forward-looking statements include statements which are predictive in nature, or which depend upon or refer to future events or conditions, or which include words such as *expects*, *anticipates*, *intends*, *plans*, *believes*, *estimates*, *may*, or *could*, or which involve hypothetical events. Forward-looking statements are based on information currently available and are subject to various risks and uncertainties that could cause actual events or results to differ materially from those characterized as being likely or possible to occur. Such statements should be considered judgments only, not guarantees, and Wesco's management assumes no duty, nor has it any specific intention, to update them.

Actual events and results may differ materially from those expressed or forecasted in forward-looking statements due to a number of factors. The principal important risk factors that could cause Wesco's actual performance and future events and actions to differ materially from those expressed in or implied by such forward-looking statements include, but are not limited to, changes in market prices of Wesco's significant equity investees, the occurrence of one or more catastrophic events such as hurricanes or other events that cause losses insured by Wesco's insurance subsidiaries, changes in insurance laws or regulations, changes in income tax laws or regulations, and changes in general economic and market factors that affect the prices of securities or the industries in which Wesco and its affiliates do business, especially those affecting the property and casualty insurance industry.