

WESCO FINANCIAL CORP

Form 10-Q

November 07, 2005

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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 September 30, 2005**

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

(Exact name of Registrant as Specified in its Charter)

DELAWARE

95-2109453

(State or Other Jurisdiction of
incorporation or organization)

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

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

(Address of Principal Executives Offices)

(Zip Code)

626/585-6700

(Registrant's Telephone Number, Including Area Code)

(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 at least the past 90 days.

Yes No

Indicate by check mark whether registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Indicate by check mark whether registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

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

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 November 2, 2005

PART I. FINANCIAL INFORMATION

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Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Reference is made to Item 7A, Quantitative and Qualitative Disclosures About Market Risk appearing on pages 28 through 30 of the Form 10-K Annual Report for the year ended December 31, 2004, filed by Wesco Financial Corporation (Wesco), for information on equity price risk and interest rate risk at Wesco. There have been no material changes through September 30, 2005.

Item 4. Controls and Procedures.

An evaluation was performed under the supervision and with the participation of the management of Wesco, including Charles T. Munger (Chief Executive Officer) and Jeffrey L. Jacobson (Chief Financial Officer), of the effectiveness of the design and operation of Wesco’s disclosure controls and procedures as of September 30, 2005. Based on that evaluation, Mr. Munger and Mr. Jacobson concluded that Wesco’s disclosure controls and procedures are effective in ensuring that information required to be disclosed by Wesco in reports it files or submits under the Securities Exchange Act of 1934, as amended, is (1) recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, and (2) accumulated and communicated to Wesco’s management, including Mr. Munger and Mr. Jacobson, as appropriate, to allow timely decisions regarding required disclosure. There have been no changes in Wesco’s internal controls over financial reporting during the quarter ended September 30, 2005 that have materially affected or are reasonably likely to materially affect the internal controls over financial reporting.

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PART II. OTHER INFORMATION

Item 6. Exhibits

- 31 (a) Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Chief Executive Officer)
- 31 (b) Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Chief Financial Officer)
- 32 (a) Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Chief Executive Officer)
- 32 (b) Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Chief Financial Officer)

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WESCO FINANCIAL CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEET

(Dollar amounts in thousands)

(Unaudited)

	Sept. 30, 2005	Dec.31, 2004
ASSETS		
Cash and cash equivalents	\$ 1,223,534	\$ 1,161,163
Investments:		
Securities with fixed maturities	71,359	94,299
Marketable equity securities	855,137	759,658
Rental furniture	191,133	171,983
Goodwill of acquired businesses	266,607	266,607
Other assets	120,524	117,825
	\$ 2,728,294	\$ 2,571,535
LIABILITIES AND SHAREHOLDERS EQUITY		
Insurance losses and loss adjustment expenses payable		
Through affiliates	\$ 18,004	\$ 14,910
Unaffiliated	43,550	41,252
Unearned insurance premiums		
Transactions through affiliates	12,638	14,118
Unaffiliated	14,879	11,223
Deferred furniture rental income and security deposits	22,776	20,358
Notes payable	38,200	29,225
Income taxes payable, principally deferred	295,959	272,005
Other liabilities	57,480	51,501
	503,486	454,592
Shareholders' equity:		
Capital stock and additional paid-in capital	33,324	33,324
Unrealized appreciation of investments, net of taxes	487,665	427,690
Retained earnings	1,703,819	1,655,929
Total shareholders' equity	2,224,808	2,116,943
	\$ 2,728,294	\$ 2,571,535

See notes to condensed consolidated financial statements.

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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		Nine Months Ended	
	Sept. 30, 2005	Sept. 30, 2004	Sept. 30, 2005	Sept 30, 2004
Revenues:				
Sales and service revenues	\$ 115,063	\$ 106,080	\$ 334,806	\$ 310,501
Insurance premiums earned				
Transactions through affiliates	7,171	(232)	21,600	7,992
Unaffiliated transactions	6,024	10,927	16,350	36,291
Dividend and interest income	14,547	8,912	40,103	25,823
Realized investment gains			774	
Other	895	797	2,643	2,420
	143,700	126,484	416,276	383,027
Costs and expenses:				
Cost of products and services sold	40,108	37,955	115,064	110,312
Insurance losses and loss adjustment expenses				
Transactions through affiliates	2,638	(20)	7,534	5,204
Unaffiliated transactions	4,942	7,342	8,401	15,568
Insurance underwriting expenses				
Transactions through affiliates	1,800	356	4,386	1,859
Unaffiliated transactions	3,117	4,247	5,759	9,601
Selling, general and administrative expenses	67,218	63,746	197,968	194,875
Interest expense	375	209	894	532
	120,198	113,835	340,006	337,951
Income before income taxes	23,502	12,649	76,270	45,076
Income taxes	5,636	3,605	20,797	13,273
Net income	17,866	9,044	55,473	31,803
Retained earnings beginning of period	1,688,481	1,636,172	1,655,929	1,618,324
Cash dividends declared and paid	(2,528)	(2,458)	(7,583)	(7,369)
Retained earnings end of period	\$ 1,703,819	\$ 1,642,758	\$ 1,703,819	\$ 1,642,758

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

Net income	\$	2.51	\$	1.27	\$	7.79	\$	4.47
Cash dividends	\$.355	\$.345	\$	1.065	\$	1.035

See notes to condensed consolidated financial statements.

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WESCO FINANCIAL CORPORATION
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

(Dollar amounts in thousands)

(Unaudited)

	Nine Months Ended	
	Sept. 30, 2005	Sept. 30, 2004
Cash flows from operating activities, net	\$ 125,507	\$ 121,360
Cash flows from investing activities:		
Proceeds from sales and maturities of investments	36,558	62,595
Purchases of investments	(16,178)	(2,907)
Acquisitions of businesses, net of cash and cash equivalents acquired		(12,704)
Purchases of rental furniture	(79,658)	(63,630)
Other, net	(5,250)	(1,242)
Net cash flows from investing activities	(64,528)	(17,888)
Cash flows from financing activities:		
Net increase in notes payable, principally line of credit	8,975	19,743
Payment of cash dividends	(7,583)	(7,369)
Net cash flows from financing activities	1,392	12,374
Increase in cash and cash equivalents	62,371	115,846
Cash and cash equivalents beginning of period	1,161,163	1,052,462
Cash and cash equivalents end of period	\$ 1,223,534	\$ 1,168,308
Supplementary information:		
Interest paid during period	\$ 1,216	\$ 153
Income taxes paid (recovered), net, during period	29,032	(2,633)

See notes to condensed consolidated financial statements.

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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

The unaudited condensed consolidated financial statements of which these notes are an integral part, include the accounts of Wesco Financial Corporation (Wesco) and its subsidiaries. In management s opinion, such statements reflect all adjustments (all of them of a normal recurring nature) necessary to a fair statement of interim results in accordance with accounting principles generally accepted in the United States. Certain amounts in the accompanying 2004 condensed consolidated financial statements have been reclassified to conform to the 2005 financial statement presentation.

Wesco s management does not believe that any accounting pronouncements issued by the Financial Accounting Standards Board or other applicable authorities that are required to be adopted after September 30, 2005 are likely to have a material effect on reported shareholders equity.

Reference is made to the notes to Wesco s consolidated financial statements appearing on pages 40 through 48 of its 2004 Form 10-K Annual Report for other information deemed generally applicable to the condensed consolidated financial statements. In particular, Wesco s significant accounting policies and practices are set forth in Note 1 on pages 40 through 42. In addition to such policies, the following practice is followed by the industrial segment: revenues from product sales and services are recognized upon passage of title to the customer, which coincides with product shipment.

Note 2

Following is a summary of securities with fixed maturities:

	September 30, 2005		December 31, 2004	
	Amortized	Fair	Amortized	Fair
	Cost	Value	Cost	Value
Mortgage-backed securities	\$ 50,319	\$ 52,310	\$ 76,212	\$ 80,531
U.S. government obligations	19,079	19,049	12,812	13,768
	\$ 69,398	\$ 71,359	\$ 89,024	\$ 94,299

At September 30, 2005, the estimated fair values of securities with fixed maturities contained \$1,991 of unrealized gains and \$30 of unrealized losses, compared with \$5,306 of unrealized gains and \$31 of unrealized losses at December 31, 2004.

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

	September 30, 2005		December 31, 2004	
	Cost	Fair Value	Cost	Fair Value
The Coca-Cola Company	\$ 40,761	\$ 311,210	\$ 40,761	\$ 300,041
The Gillette Company	40,000	372,480	40,000	286,592
American Express Company	18,108	97,699	20,687	109,533
Ameriprise Financial Inc*	2,579	13,913		
Wells Fargo & Company	6,333	59,835	6,333	63,492
	\$ 107,781	\$ 855,137	\$ 107,781	\$ 759,658

* Spun off by American Express Company to its shareholders on September 30, 2005

Reference is made to information as to the pending purchase of The Gillette Company by The Procter and Gamble Company (PG) discussed in Note 2 to the consolidated financial statements appearing on page 42 of Wesco's 2004 Form 10-K Annual Report. PG completed the acquisition on October 1, 2005. Wesco earnings will include a non-cash pre-tax realized investment gain from the disposition of Gillette of approximately \$331,000 (\$215,000, after taxes) in the fourth quarter of 2005. However, since Wesco's investments are carried at fair value, with unrealized gain reflected in shareholders' equity, net of taxes, at the balance sheet date, consolidated shareholders' equity will not change significantly as a result of this transaction.

Note 3

The following table sets forth Wesco's consolidated comprehensive income for the three- and nine-month periods ended September 30, 2005 and 2004:

	Three Months Ended		Nine Months Ended	
	Sept. 30, 2005	Sept. 30, 2004	Sept. 30, 2005	Sept. 30, 2004
Net income	\$ 17,866	\$ 9,044	\$ 55,473	\$ 31,803
Change in unrealized appreciation of investments, net of income tax effect of (\$22,045), \$27,007, (\$32,189) and \$14,178	41,106	(50,280)	59,975	(26,370)
Comprehensive income (loss)	\$ 58,972	\$ (41,236)	\$ 115,448	\$ 5,433

Dollar amounts in thousands, except for amounts per share

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Note 4

Federal and state environmental agencies have made claims relating to alleged contamination of soil and groundwater against Precision Brand Products (PBP), whose results, like those of its parent, Precision Steel, are included in Wesco s industrial segment, and various other businesses situated in a business park in Downers Grove, Illinois. PBP, along with the other businesses, has been negotiating remedial actions with various governmental entities. In addition, PBP, Precision Steel, and other parties have been named in several civil lawsuits, including lawsuits by and on behalf of area residents, relating to this matter.

In 2003, PBP recorded a provision of \$1,044 (\$628 after income tax benefit), representing a preliminary estimate of its share of costs of remediation agreed to with governmental entities and other parties to date and related expenses. PBP increased that estimate by \$139 (\$84 after income tax benefit) in the third quarter of 2004, and by an additional \$110 early in 2005. Several of PBP s and Precision Steel s insurers have agreed to undertake their defenses and to indemnify them to the policy limits in connection with certain of the matters. To date in 2005, PBP recovered \$237 (\$142 after taxes) from its insurers. Additional recoveries are expected, but in amounts that management is unable to estimate. Accordingly, future recoveries, if any, are not reflected in the accompanying condensed consolidated financial statements. The accompanying financial statements for the first nine months of 2005 reflect the net reduction in provision for costs and expenses associated with the environmental matters, aggregating \$127 (\$76 after income taxes), recorded in the first half of the year.

Management anticipates that additional provisions with respect to such remediation and other legal matters may be required in the future. However, as of September 30, 2005, it was not possible to reasonably estimate the amount, if any, of additional loss or a range of losses that may be required in connection with the matter. Although management does not anticipate that the ultimate impact of such provisions, net of future insurance recoveries, if any, will be material in relation to Wesco s shareholders equity, it believes that the effect on industrial segment and consolidated net income in any given period could be material.

Dollar amounts in thousands, except for amounts per share

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

	Three Months Ended		Nine Months Ended	
	Sept. 30, 2005	Sept. 30, 2004	Sept. 30, 2005	Sept. 30, 2004
Insurance segment:				
Revenues	\$ 27,505	\$ 19,402	\$ 77,390	\$ 69,526
Net income	10,458	5,660	37,460	26,419
Assets at end of period	2,146,293	1,979,392	2,146,293	1,979,392
Furniture rental segment:				
Revenues	\$ 99,624	\$ 90,463	\$ 288,415	\$ 264,298
Net income	6,986	3,232	16,317	3,836
Assets at end of period	257,215	251,871	257,215	251,871
Industrial segment:				
Revenues	\$ 15,439	\$ 15,607	\$ 46,391	\$ 46,203
Net income	185	33	823	1,245
Assets at end of period	18,520	20,306	18,520	20,306
Goodwill of acquired businesses, included in assets at end of period	\$ 266,607	\$ 266,607	\$ 266,607	\$ 266,607
Realized investment gains:				
Before taxes (included in revenues)	\$	\$	\$ 774	\$
After taxes (included in net income)			503	
Other items unrelated to business segments:				
Revenues	\$ 1,132	\$ 1,012	\$ 3,316	\$ 3,000
Net income	237	119	370	303
Assets at end of period	39,659	35,765	39,659	35,765
Consolidated totals:				
Revenues	\$ 143,700	\$ 126,484	\$ 416,276	\$ 383,027
Net income	17,866	9,044	55,473	31,803
Assets at end of period	2,728,294	2,553,941	2,728,294	2,553,941

Dollar amounts in thousands, except for amounts per share

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

Reference is made to Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations appearing on pages 19 through 30 of the Form 10-K Annual Report filed by Wesco Financial Corporation (Wesco) for the year 2004 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 unaudited condensed consolidated financial statements.

OVERVIEW

Financial Condition

Wesco continues to have a strong balance sheet at September 30, 2005, with relatively low debt and no hedging. Liquidity, which has traditionally been high, has been even higher than usual for the past two years due principally to sales, maturities and early redemptions of fixed-maturity investments, and reinvestment of the proceeds in cash equivalents pending redeployment.

Results of Operations

After-tax earnings improved in the third quarter and the first nine months of 2005 from the corresponding 2004 amounts mainly due to improved results of the furniture rental segment and increased investment income earned by the insurance segment principally as a result of increased interest rates on short-term investments.

FINANCIAL CONDITION

Wesco's shareholders' equity at September 30, 2005 was approximately \$2.22 billion (\$312 per share), up from \$2.12 billion (\$297 per share) at December 31, 2004. Shareholders' equity included \$487.7 million at September 30, 2005, and \$427.7 million at December 31, 2004, representing appreciation in market value of investments, which is credited directly to shareholders' equity, net of taxes, without being reflected in earnings. Because unrealized appreciation is recorded using market quotations, gains or losses ultimately realized upon sale of investments could differ substantially from recorded unrealized appreciation.

Wesco's consolidated cash and cash equivalents, held principally by its insurance businesses, increased slightly from \$1.16 billion at December 31, 2004, to \$1.22 billion at September 30, 2005.

Wesco's consolidated borrowings totaled \$38.2 million at September 30, 2005 versus \$29.2 million at December 31, 2004. The increase in borrowings related to a revolving line of credit used in the furniture rental business.

Wesco's management continues to believe that the Wesco group has adequate liquidity and capital resources to provide for any contingent needs that may arise.

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Wesco's operating businesses are managed on a decentralized basis. There are essentially no centralized or integrated business functions (such as sales, marketing, purchasing, legal or human resources) and there is minimal involvement by Wesco's corporate headquarters in the day-to-day business activities of the operating businesses. Wesco's Board of Directors has delegated to Berkshire Hathaway Inc. (Berkshire Hathaway), Wesco's ultimate parent, of which Wesco's Board Chairman is Vice Chairman, the responsibility for significant capital allocation decisions, investment activities and the selection of the Chief Executive to head each of the operating businesses, subject to the approval by Wesco's Board of Directors.

Wesco's reportable business segments are organized in a manner that reflects how Wesco's top management views those business activities. Wesco's management views insurance businesses as possessing two distinct operations underwriting and investing, and believes that underwriting gain or loss is an important measure of their financial performance. Underwriting gain or loss represents the simple arithmetic difference between the following line items appearing on the consolidated statement of income: (1) insurance premiums earned, less (2) insurance losses and loss adjustment expenses, and insurance underwriting expenses. Management's goal is to maximize underwriting gains over the long term, without regard to investment income.

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. (Amounts are in thousands, *all after income tax effect.*)

Three Months Ended		Nine Months Ended	
Sept.	Sept. 30,	Sept.	Sept. 30,
30,	2005	30,	2005