

## Letter from the Chairman and President

### To Our Shareholders,

1994 was a difficult year. We successfully avoided the major potholes. We suffered no derivative disasters or mortgage backed security fiascos. Interest rates, however, rose sharply and that had a significant effect on our ability to realize security gains. With a bond portfolio accounting for 96% of our investments, we are a reluctant hostage to the bond market. Fortunately, good portfolio management by our investment advisors and staff enabled us to escape almost unscathed from rising rates. As you will see from the chart and discussion below, security gains accounted in great measure for the difference in earnings from 1993. After tax earnings were \$70,836,000, or \$2.41 a fully diluted share, which does not reflect the benefit of our net operating loss carryforwards. This is only an 8% after tax return on last year's ending equity. Not adequate by itself, but when taken in the context of the 1994 bond market and averaged with the 15 previous years, it is satisfactory. Net worth, adjusted for splits, was a negative \$.22 per share 16 years ago, and at December 1994 net worth was \$31.44 per share. The stock price adjusted for splits during the same period went from \$.16 to \$44.50 per share, a compound rate of return of 42% per annum over those 16 years.

Below is a list of earnings of our various business units. We remind everyone that we are highly decentralized. These numbers include all the costs up to and including those of the Presidents and Chairmen of the business units. There are no allocated costs for the undersigned or the other 43 people in the Corporate and Executive headquarters (see Corporate and Other below). Corporate expenses include interest, results of corporate security transactions, as well as overhead associated with accounting, portfolio management, taxes and the significant costs associated with pursuing new opportunities. We refer to this chart throughout this letter. Income (loss) by business segment is as follows (in thousands):

	<u>1994</u>	<u>1993</u>	<u>Prospects</u>
Property & Casualty Insurance:			
Operations .....	\$ 99,840	\$113,431	<i>Showing signs of growth</i>
Net securities gains (losses) .....	(3,448)	14,563	
Life Insurance:			
Operations .....	53,052	30,168	<i>Growing</i>
Net securities gains (losses) .....	(3,941)	31,867	
Banking and Lending:			
Operations .....	16,302	12,542	<i>Growing</i>
Net securities gains (losses) .....	(2)	46	
Incentive Services:			
Operations .....	10,335	13,121	<i>Hanging on</i>
Net securities gains (losses) .....	0	776	
Manufacturing .....	(11,758)	(2,239)	<i>Broken</i>
Corporate and Other:			
Operations .....	(55,449)	(42,078)	<i>Tomorrow's opportunities</i>
Net securities gains (losses) .....	(4,613)	4,671	
Subtotal income before tax:			
Operations .....	112,322	124,945	
Net securities gains (losses) .....	(12,004)	51,923	
Total pre-tax .....	100,318	176,868	
Tax provision <sup>1</sup> .....	(29,482)	(60,609)	
Total after tax .....	<u>\$ 70,836</u>	<u>\$116,259</u>	

<sup>1</sup>Does not reflect the benefit of net operating loss carryforwards. See Note 13 of Notes to Consolidated Financial Statements for an explanation of our net operating loss carryforwards.

Although we are not happy with last year's results, there is a time to reap and a time to sow. Rising interest rates made the harvest difficult last year, but we were able to invest in several opportunities for the future, about which more later.

In late 1993 we became convinced that interest rates would increase in 1994. Subsequently, the Federal Reserve increased the discount rate six times, from 3.0% to 5.5% and the long bond lost 15% of its value. To illustrate the magnitude of this movement, if you took our investment portfolio at January 1, 1994 and froze it, buying nothing and selling nothing, by December 31, 1994 the portfolio would have lost \$187 million in value. Since we lacked the courage to go into cash on January 1, 1994, during the year we shortened the average life of the \$2.4 billion portfolio from 4.7 to 3.6 years. By reinvesting the proceeds of sales, the yield to maturity increased from 6.2% at December 31, 1993 to 6.4% at December 31, 1994. The increase in yield will recoup the realized losses within two years. The total return on our portfolio was a negative .58% last year compared to the Salomon 5-year treasury index of a negative 4.05%. Furthermore, since we are not certain that rates will remain at present levels for the foreseeable future, the current portfolio is defensively postured against another increase in interest rates. The interest rate sword has two edges; in 1993 we benefited from one edge and in 1994 we suffered from the other. 1995 will be a challenge. It is a lot more fun taking gains as rates fall than preserving capital as rates rise.

On the financing front, things were quiet in 1994. We purchased an option for \$2.6 million, exercisable in August 1996, to fix an interest rate of 8.39% on \$50 million of borrowings for an eight year term.

#### Property and Casualty Insurance Group

The Property and Casualty Insurance Group has two operating groups, Colonial Penn and Empire. Colonial Penn, headquartered in Valley Forge, Pennsylvania, is licensed in all 50 states and provides private passenger automobile and homeowners insurance to the mature adult population. Colonial Penn, as a direct marketer, deals directly with the public and endeavors to be the lowest cost provider to this market segment.

Empire, headquartered in New York City, operates in the New York metropolitan area. Through a network of independent agents and brokers, Empire provides both personal and commercial insurance products and continues to be successful in identifying and developing niche programs. Empire's expertise in its market has allowed it to secure a considerable amount of service work, which complements its voluntary insurance operations.

In property and casualty operations we strive for profitability not market share or volume. To that end, we emphasize high quality underwriting, expense containment and careful claims control. The ratios below illustrate the results of our property and casualty operations as compared to the industry as a whole:

	<u>1994</u>	<u>Combined Ratio</u>	
		<u>1993</u>	<u>1992</u>
GAAP (Generally accepted accounting principles) . . . . .	99.1%	96.9%	101.7%
SAP (Statutory accounting principles) . . . . .	98.8%	93.7%	102.8%
Industry (SAP Basis) . . . . .	N/A	106.9%	115.7%

Our goal, which we have stated before, is to have a combined ratio of no more than 100%. A combined ratio of 100% means that premiums equal the sum of claims, administrative expenses and underwriting expenses. Thus, if the combined ratio is 100% or less, the shareholders keep the after tax earnings on the invested reserves and the equity, which can be quite substantial on \$1.6 billion of investments. We exceeded that goal in 1994 and 1993 with a combined ratio of under 100%.

From the segment data you will note that the Property and Casualty operations' profitability was \$113.4 million in 1993 and \$99.8 million in 1994. This needs further explanation. From experience we estimate the claims and expenses so that the aggregate reserves will be sufficient to pay over time for all the crumpled fenders and bumped heads. Keep in mind that insurance only works if you have a large number of policies over which individual claims can be averaged. In 1993, as in 1991 and 1992, we

concluded that too much had been previously reserved as a result of our advantageous purchase of Colonial Penn in 1991. Excess claim reserves were released and operating earnings were higher. As all good things end, the "bargain" associated with the purchase of Colonial Penn is over.

In 1994, the casualty companies' total net losses and expenses, after reinsurance, from earthquakes and storms were \$18.3 million. In 1993, similar events cost us \$10.9 million. The most spectacular loss in 1994 was from the Northridge, California earthquake which cost the industry \$11 billion. Several major companies found their surplus impaired. Colonial Penn fared better than most with a net loss of \$11.7 million. Our losses have not significantly increased from earlier estimates because we reserve conservatively. California is a remarkable place. In spite of the fact that it burns, slides, shakes and floods, it is the seventh<sup>2</sup> largest economy in the world.

Starting with the devastation of Hurricane Andrew in 1992, the cost and availability of catastrophe reinsurance has gone up or is no longer available<sup>3</sup>. Nevertheless, we have been able to complete our reinsurance treaties over the last three years but at a higher cost. As our surplus has grown, we have increased retentions and used the savings to increase reinsurance at upper levels.

Colonial Penn and Empire are also in the business of servicing other insurance companies' policies. Empire was one of the first companies in New York State to do so. Servicing companies assume assigned risk business from other insurance companies and receive a fee in addition to policyholder premiums. At present we service approximately \$200 million of annualized premium of this type business, all with insurance risk. Empire also performs administrative services for the New York Public Automobile Pool without insurance risk. This activity is profitable in its own right and absorbs fixed costs.

For 1993 (the latest data available) Colonial Penn, GEICO, Liberty Mutual and USAA had the lowest expense ratios among national automobile insurers. In 15 states, our new business rates are 30% below our largest competitors. There is, however, a conundrum here: Why are we not growing faster? If we have built a better mouse trap, where are the mice? The answer is that we have faith in financial gravity. If we are 30% cheaper, as we are in 15 states, we believe the customers will eventually find their way to us past the downfield blocking of commission salesmen and higher advertising budgets. Our competition is not other direct response companies but rather insurance agents whom we can profitably underprice. The results are beginning to show. As of this writing we are adding more auto policies than are lapsing. We remain enthusiastic about the auto insurance business. The success of no load mutual funds and discount brokers is comforting. Keep the faith.

New York City and its Boroughs, where Empire lives and works, is an interesting and appealing place. So many people in so little space is a siren song to aggressive insurers. Inevitably bruised by the tough urban milieu, poorer and wiser, some of them leave. Empire knows this pattern well. We do not chase price. We pleasantly say good-bye when prices go down and expect to see the clients again when the market tightens. In 1994, several competitors decided they had had enough and withdrew. Empire profitability grew by 19%.

We have settled our obligations to the New Jersey Joint Underwriting Association within the amount we reserved. We expect a similar result in regard to Proposition 103 in California. We are encouraged that state regulators are seeming to realize that when a car runs into a tree it costs money to adjust the claim, fix the car and settle third-party claims. By and large, the marketplace is pretty good at allocating these costs and prices. Neither irresponsible political rhetoric nor propositional dicta can change these facts.

When we acquired Colonial Penn, we inherited a batch of difficult commercial lines and reinsurance receivables which we continue to satisfactorily resolve. There may be a recovery some day.

<sup>2</sup>World Bank Atlas 1994.

<sup>3</sup>For example, Barbados Light and Power Company has been unable to get any catastrophe insurance on its distribution assets. 37.4% of Barbados Light and Power's common stock is owned by Canadian International Power Liquidating Trust. Leucadia National Corporation owns 57.3% of the Trust which is recorded at \$2 million at December 31, 1994.

## **Life Insurance Group**

We conduct our life insurance business through Colonial Penn Life headquartered in Philadelphia, Pennsylvania; Charter National Life in St. Louis, Missouri; and Intramerica Life Insurance in Pearl River, New York. Our principal life insurance product is a guaranteed issue policy sold directly to persons age 50 to 80 in face amounts of \$350 to \$10,000. We have over 900,000 policies in force. This is a predictable and profitable block of business where the laws of large numbers operate in our favor. Ed McMahon is our spokesperson on television and through direct mail.

In 1992, we sold \$12.7 million of new annualized premium (NAP), \$17 million in 1993 and \$20.5 million in 1994. At approximately \$15 million in NAP, the business grows. Critical to success is the cost of acquiring new business. Since 1991, we have managed to reduce acquisition costs by almost 50%. This growth was achieved by adhering, with religious fervor, to a pre-defined acquisition cost structure. We are pleased with the 1994 result.

Charter sells a no-load variable annuity product. Premiums are invested at the direction of the policyholder in a series of unaffiliated mutual funds (managed by Scudder, Stevens and Clark) where the policyholder bears the entire investment risk. Total assets are \$295 million.

## **Banking and Lending**

The Company's banking and lending activities are conducted through its national bank subsidiary, American Investment Bank, N.A., (AIB); a Utah State chartered industrial loan corporation, American Investment Financial (AIF); and a New York based SSBIC, Transportation Capital Corp. (TCC).

During 1994, these companies produced \$16 million in pre-tax earnings with outstanding loans receivable of \$264 million. Pre-tax return on assets was 6.2%, pre-tax return on equity was 31%. AIB paid a \$5.8 million dividend to Leucadia.

AIB and AIF offer executive and professional loans primarily by mail. AIB also offers auto loans to people with less than sterling credit. We operate the auto loan program in ten states and continue to cautiously expand. There is significant competition coming into this market. We intend to maintain our concentration on careful underwriting to avoid losses. TCC makes loans secured by taxicab medallions in New York, Boston and Chicago. AIB and AIF deposits are insured by the FDIC, with whom, for the time being, we are at peace.

## **Incentive Services**

Leucadia's incentive services are carried on by The Sperry and Hutchinson Company, Inc. (S&H). Since 1969, when annual sales peaked, the stamp business has been declining. S&H has managed to shrink profitably. By adding a new, much less expensive computer system and by utilizing a third-party fulfillment operator (they mail the toasters to the customers), we will generate further expense savings in 1995. As long as our customers continue to buy stamps, S&H will continue to redeem them through the catalog.

At December 31, 1994, the liability for unredeemed stamps was \$42 million. Latest statistical studies indicate that approximately \$5.4 million of this liability will not be required; it will be amortized into income next year.

## **Manufacturing**

In 1994, manufacturing was a disaster. More precisely, one company, our bathroom vanity division, was a self-inflicted, unmitigated disaster. The other manufacturing companies did reasonably well. Here is the story.

This division makes bathroom vanities and cultured marble (i.e., plastic) sinks for the top of the vanities. In 1991, we decided to consolidate several facilities into one and install new semi-automated

production equipment in the hopes of increasing efficiency. Two bad things happened; one strategic, one tactical. The market is moving away from solid wood, fully assembled cabinets to paper and wood veneer, home-assembled cabinets. The new plant presently makes the former, not the latter. The implementation of this flawed strategy was also atrocious. As a result, we have a new President of the Manufacturing Group and have, we hope, written off all of our past mistakes. We are paying close attention. Our apologies to the shareholders. Hopefully, better news next year.

### Real Estate

Until recently our real estate interests came about as a result of other acquisitions whereby we ended up with surplus property. Recently, however, this has changed. "We tend to be buyers of assets that are troubled or out of favor, and as a result, are selling at substantially below the values which we believe are there."<sup>4</sup> Our theory is that a well located property bought in a bad market will, in a good market, appreciate to at least replacement cost. Here is what we have done.

We purchased for \$50.8 million in cash a 615,000 square foot building at 685 Third Avenue in New York City, which formerly was the corporate headquarters of American Home Products. 405,000 square feet are available for rent, of which 355,000 square feet are contiguous. Empire Insurance will very shortly be in need of 200,000 square feet. With Empire as a tenant, the building has sufficient cash flow, after expenses, to justify a long-term mortgage in excess of the purchase price. Other potential tenants will probably pay more rent for space near Grand Central where the availability of large blocks of contiguous space is shrinking. This will have an even better financial outcome. If another tenant appears, Empire can move to the Wall Street area where there are also many interesting opportunities.

We purchased, out of bankruptcy, two 41-story luxury San Diego condominium towers known as The Harbor Club, located across the street from the Convention Center, with expansive views of the harbor! The buildings have 350,000 square feet, of which 42,000 is commercial, and 202 residential units. We purchased the buildings for \$120 a square foot and are marketing the 180 remaining residential units at an average price of \$345 per square foot, before the cost of models, management and sales. If the reader is interested in a beautiful San Diego condominium, please call!<sup>5</sup>

We are conditionally committed to purchase (again, out of bankruptcy) a 3,400 lot subdivision in Southern California in an area where home builders are in need of lots. We are working with the City of San Marcos to finalize details of the entitlement process before moving forward. We may end up with a national home builder as a partner.

In another complicated bankruptcy transaction, we invested \$21 million in HomeFed Corporation bonds (the parent of HomeFed Bank, which was seized by the RTC). Under the bankruptcy reorganization plan, we expect to receive approximately 40% of HomeFed as well as a convertible note that would allow us to increase our ownership to approximately 89% in three years. HomeFed owns several single family developments which will be completed.

We also purchased a 46% interest in 30 North LaSalle Street in Chicago. The building cost \$63.8 million, \$16 million in cash and the balance with excellent non-recourse financing. The building has 926,000 square feet and shortly will be fully leased.

During 1994, Colonial Penn Life took advantage of the soft real estate market in Philadelphia and acquired a 127,000 square foot office building in the Philadelphia historic section for \$4.2 million or \$33 per square foot. On March 20, 1995, the company occupied 60% of the space with expansion room for the future as the current tenants' leases expire. Colonial Penn Property and Casualty also purchased a 104,000 square foot building in Valley Forge, Pennsylvania for \$6 million for its own use.

<sup>4</sup>Report to the shareholders 1988, 1990 and 1991.

<sup>5</sup>Our goofy lawyers insist we state that this sentence does not constitute an offer, which can only be made through a written prospectus.

## Latin America

In the first quarter of 1994, we completed the sale of the bonds we received from the expropriation of the Compañía de Alumbrado Eléctrico de San Salvador in 1986. We reported an \$8.5 million gain.

In the fourth quarter of 1994, we completed the sale of our remaining interest in the Bolivian Power Company and reported a \$14.5 million gain. The Government of Bolivia is pursuing policies in the electric sector with which we disagree. This was clearly a time to reap. Since 1986, we have realized value of \$63.7 million from our Latin American investments.

During 1994 we were, along with local partners, the successful bidder in the privatization of Caja de Ahorro y Seguro, S.A. ("Caja"), a company with insurance and banking operations formerly owned by the Argentine government. We purchased 30% for \$46 million, our local partner purchased 30% for the same amount, and the government retained the remaining 40%. Caja is Argentina's largest insurance company with 55 branches located throughout the country. The restructuring is proceeding nicely. Hopefully, 1995 will report profits.

Argentina is being buffeted by the back wash from the Mexican financial crisis. They call it the "tequila effect" in Buenos Aires. There is likely to be tough sailing. Bank liquidity is tight and Argentina owes a lot of money abroad.

Since we are already in the Argentine boat, we look on the bright side. There is not a lot of money moving South and we are already committed. It is unlikely that much foreign competition will appear this year. This is good for Caja, as we will be able to complete the planned restructuring, move to new headquarters, and solidify our market share. Caja has revenues of \$535 million, insures approximately 311,000 automobiles and has group life insurance policies covering 4 million lives. Not a small company.

## Russia

In June of 1994 we went to the world's largest garage sale. Russia put 15,000 companies up for privatization. We invested \$25 million and are accounting for this on a cost recovery basis. We have taken \$5.4 million out and our year-end book value is \$19.6 million invested in 32 companies.

As previously reported, we are drilling for oil in Siberia and supplying raw materials to an aluminum smelter in Tajikistan.

As a result of this activity, we have opened an office in Moscow to look after these investments and to look for other opportunities. Larry Hershfield, Executive Vice President, has moved to Moscow with his family to head up this operation.

Time and space preclude us from telling you much about our attitude toward the future of Russia or the former Soviet Union. It is, however, the sixth largest population on the globe. The technical and engineering education is first-rate. Many factories have up-to-date western equipment. What is missing is the legal, financial and marketing infrastructure necessary for a functioning free market. It is reminiscent of the Wild West. Companies are extremely inexpensive compared to similar companies in the West. There is little working capital available. If there is political stability, the market will flourish and we will do very well. High risk, high reward. If not, the losses will be tolerable.

A vignette: each Russian citizen was given a voucher, which looks like a small stock certificate. Vouchers were the only currency allowed in the privatization auctions. A voucher market developed whereby people like us purchased vouchers for between \$15 and \$25 U.S. each. We visited the voucher auction market in downtown Moscow one day and on the way out noticed an older lady wearing a babushka trying to sell one voucher. We negotiated the purchase of her voucher. When the transaction was complete, she said to us with great conviction: "There are two things Russia will never be without, bad roads and fools."<sup>6</sup> We have been warned!

<sup>6</sup>Attributed to Nikolai Gogol, a Russian author born on April 1, 1809.

### Other Things

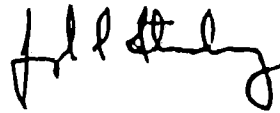
1994 was both a difficult and a successful year. Interest rate increases are the nemesis of bond portfolios and we have a big one. The bathroom vanity division is a problem and an embarrassment. Our other operating companies are doing well and most are showing signs of growth. We made several investments which should bear fruit in the future.

In Genesis, Chapter 41, Joseph interpreted Pharaoh's dream of the lean cows eating the fat cows to mean that seven lean years would follow seven fat years. There has been an almost continuous bull market since 1980, 15 fat years! We worry that the bears are out there somewhere and they must be very hungry! We hope we are prepared for their arrival. There are opportunities in bear markets, too.

Thanks to our loyal employees, advisors, and banks for their hard work and good cheer in a difficult year.



IAN M. CUMMING  
*Chairman*



JOSEPH S. STEINBERG  
*President*