

Message From the Chairman of the Board and the President

Our Company completed its 131st year with common shareholders' equity at a record high of \$151,033,000 and book value per common share at a record high of \$19.88.

The year saw a number of notable transactions, including the significant expansion of our manufacturing operations and our entry into the field of equipment leasing.

In January, we received an additional payment of approximately \$39,800,000 related to our 1984 investment in Avco Corporation.

In March, Cardiff Equities Corporation, then our majority-owned subsidiary, completed the acquisition of Conwed Corporation for a total purchase price of approximately \$45,350,000. Conwed is engaged in manufacturing industrial products, including proprietary plastic netting, for various uses. Two of its other operations were sold during 1985 for a total of approximately \$42,500,000 and part of the proceeds of these sales were used to retire substantially all bank debt incurred for the acquisition. Because of the increased significance of the manufacturing operations following the acquisition of Conwed, the Company's financial statements were restated in 1985 to reflect Cardiff as a consolidated subsidiary. The Company recently acquired the balance of the equity interest in Cardiff by means of a tender offer and a merger.

In April, we sold our equity interest in one of the Associated Companies in which we have acquired interests by virtue of our partnership interest in The Jordan Company. We received aggregate consideration valued at approximately \$16,000,000 and reported a pre-tax gain of approximately \$12,000,000 from this sale. We also entered into another partnership agreement with the partners of The Jordan Company for leveraged buy-outs generally smaller than those currently being done by The Jordan Company.

In September, we entered into an agreement with National Intergroup, Inc. ("NII") pursuant to which, on January 2, 1986, NII purchased 75% of our

NII common stock for \$32,819,400 in cash plus warrants to purchase the same number of NII shares as were sold. As a result, the Company significantly reduced its cash investment in NII while retaining the opportunity to participate in appreciation in the market value of NII common stock. Because the cash consideration received and the value of the warrants approximated the cost of the NII shares sold, no pre-tax gain or loss will be recognized. However, the transaction will result in certain tax benefits that will be reflected in 1986 results of operations. The agreement with NII also contains certain standstill provisions. During 1985 the Company had conducted two proxy solicitations in opposition to NII's Board of Directors and had proposed a business combination with NII, subject to certain conditions, which the NII Board rejected.

In September, the Company also commenced equipment leasing operations when a subsidiary became a co-general partner of a partnership formed to lease aircraft and aircraft equipment. In November, we acquired O.P.M. Leasing Services, Inc. following its reorganization under Chapter 11 of the Bankruptcy Code. This subsidiary, which has been renamed AIC Leasing Services, Inc., is engaged in computer leasing and remarketing. We subsequently acquired 48% of the outstanding common stock of Brae Corporation, a public company principally engaged in the leasing and management of railcars. Executive officers of the Company now serve as directors of Brae.

During 1985, we made significant acquisitions of both equity interest in other companies and of our own equity securities. At present, we beneficially own more than 5% of the outstanding common stock of the following public companies: Minstar, Inc. (10.5%), GATX Corporation (8.9%), NII (7.8%), Brae (48%), British Airways of America (16.5%) and Prudential Financial Services Corporation (19.8%). Shareholders who have been following our involvement with GATX are referred to the discussion beginning on page 1 of the accompanying Form 10-K. During the year, we acquired, directly and indirectly, an aggregate of 1,098,108 of our own Common Shares at an average cost of approximately \$19.37 per share,

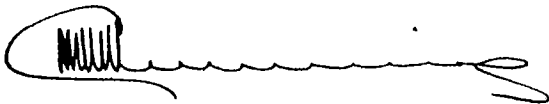
which is less than book value per share at year-end. In addition, we repurchased substantially all of our Series G Adjustable Rate Cumulative Preferred Stock and called for redemption all of our Series F \$2.00 Convertible Exchangeable Preferred Stock. Substantially all the Series F Preferred Shares were converted into a total of 1,426,131 Common Shares.

During 1985 and early 1986, we also completed a number of financings designed to increase our financial resources. These included public offerings of \$75,000,000 principal amount of 14% Senior Subordinated Notes, \$30,000,000 principal amount of 7¾% Convertible Subordinated Debentures and \$37,100,000 principal amount of Subordinated Swiss Franc Bonds that (after giving effect to a hedging transaction) bear interest at an effective annual rate of 10.8%. In addition, we added a third \$25,000,000 bank revolving credit agreement and entered into

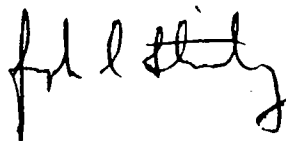
amendments that permit subordinated debt to be treated as capital for certain ratio purposes.

The many transactions mentioned above tend to obscure the achievements of our basic operations — consumer finance, life insurance and manufacturing. Each had a very successful year and we are including separate reports from the executives with primary responsibility for them. We believe these businesses are properly financed and conservatively managed and we are proud of their achievements.

Once again we wish to express our appreciation to our employees, lenders, investment bankers and professional advisors who, in a challenging yet fruitful year, assisted us in creating further value for our shareholders.



Ian M. Cumming
Chairman



Joseph S. Steinberg
President

Report on Consumer Finance Operations

The year 1985 was one of continued progress for our Company. We accomplished record earnings, expansion of our branch network, and an increase in finance receivables.

During 1985, we continued to follow our policy of orderly expansion, adding 12 locations and ending the year with 173 operating branches located in thirteen states, primarily in the Southeastern part of the country. The development costs for these new locations whose earnings level has not yet attained that of our established offices is included in results of operations.

Principally due to the increases in the number of offices, the Company's gross receivables continued to grow. During 1985, consumer finance receivables increased \$34,200,000 to \$363,600,000 compared to \$222,800,000 at the 1982 year end for a 63% increase in this three year period.

Income before income taxes for the consumer finance operations (including related credit insurance) increased in 1985 by approximately 17% from the 1984 level. Income from consumer operations before interest and taxes also reached record levels. We believe the most important measure and the principal measure used in the management of the business is net income before interest and taxes stated as a percentage of average outstanding consumer finance receivables ("NIBIT"). The NIBIT was 17.2% in 1985 and continued to place us at the top of our industry among those companies with outstanding net receivables of our size or larger. A primary reason for our continued success has been our ability to maintain our gross income percentage while reducing our operating expenses as a percentage of funds employed.

City Finance is exclusively in the consumer finance business. Ninety-one percent of our receivables are in loans made direct to the consumer and the remaining nine percent are in dealer acquired sales finance contracts (primarily of a non-automobile variety). At December 31,

1985, forty-five percent of the direct loan receivables were secured by either a first or second mortgage on real estate, with the remainder primarily secured by automobiles and/or miscellaneous consumer goods.

A very important part of the finance business is the sale of credit related insurance, including credit life, credit disability, and various types of property insurance designed to protect the collateral used as security for the loan. Approximately 12% of our total gross income originated from commissions and premiums earned from the sale of this insurance.

Our operating strategy in 1985 was affected by a tremendous increase beginning in the last quarter of 1984 in the amount of lendable funds being offered to the consumer, primarily through unsolicited credit cards. This has led to a concern that the consumer may be overloaded with debt. Also, some of our competition began offering unrealistically low rates of interest.

As a result, during 1985 we directed our personnel to use caution in our loan granting, paying particular attention to those individuals with excessive obligations. In addition, we continued to price our interest charge on extended term real estate loans to realistically match our long-term cost of funds. We were determined not to price our interest charge on loans, which are essentially long-term in nature, by reference to short-term rates.

Market conditions and competition created a difficult operating environment which had a negative impact on the volume of new real estate loans that we were able to generate during the year and increased bankruptcy filings throughout the country had a negative impact on delinquency and bad debt charge-off ratios. In addition, the reduced rates offered by some of our competitors resulted in retirement of an unusual number of our existing loans. In spite of this, we were successful in maintaining a high percentage of real estate secured loans and, in fact, had a gain of \$6,200,000 in this category of receivable during the year. Sixty day contractual delinquency increased from 3.01% at December 31, 1984 to 3.25% at December 31, 1985 and the

loss ratio (write-offs less recoveries) was 1.44% in 1985 up from .94% in 1984. Both of these ratios are still well in line with industry average and are better than our Company's historical averages.

As we look forward to 1986, we have mixed emotions. On the one hand, we continue to believe that excessive funds in the consumer marketplace will result in a greater number of individuals becoming over-obligated, bringing about higher delinquency and a subsequent rise in personal bankruptcies. Also, rate competition may possibly become even more aggressive and make it more difficult to maintain an increased level of realistically priced consumer finance loans. On the other hand, the over-obligation by consumers will also offer opportunities to work with individuals in restructuring their debts by more properly matching their debt to their incomes. This should be an excellent source of new business if properly qualified and adequately secured.

We have initiated a training program which will educate our loan personnel to look for and recognize these opportunities. They will be

trained to give professional counseling to the consumer, urging awareness of their indebtedness and, where advisable, recommend a restructure of their payment schedule to obtain current payment performance.

With our expanding branch network and increased portfolio of receivables, we are in an extremely good position for a continued increase in our gross income and a reduction in our operating expense as percentage of funds employed. This should enable us to once again show improvement in our profit contribution.

We are proud of our consistent earnings performance and of the high quality of our assets. Our employees are dedicated and hard-working and are determined to be tops in their industry. We will continue to train them for new opportunities that arise in today's competitive and complex consumer finance market. Again, we are most appreciative of the unfailing encouragement that we receive from our parent company and, with their ongoing support, we are committed toward enhancing the quality of our assets while continuing to make a significant profit contribution.



Robert P. Brock
Chairman of the Board
City Finance Company

Report on Insurance Operations

The insurance business of Leucadia is principally conducted through Charter National Life Insurance Company, which is licensed in all states (except New York), the District of Columbia, Puerto Rico and seven provinces of Canada.

Charter's major line of business since 1982 has been investment oriented life insurance ("IOL") products. These policies have varying characteristics but are similar in that they have significant cash values and are sold principally on the basis of the tax deferral of the increases in their cash values.

After a lackluster year in 1984 (\$23.6 million of new IOL premium) Charter determined in the spring of 1985 to change its marketing approach. Marketing of IOL products had been through independent wholesaling organizations. Representation by these organizations was not exclusive which created chronic problems for the Company. In May 1985, Charter hired a national sales manager for the IOL products. The effect of this change in strategy was quickly evident as our 1985 new premium production from these products was \$69.0 million, the highest annual production to date.

A significant ongoing problem for the Company with the IOL products has been changes in the tax laws which have required changes in the products. In 1985, further changes in the tax code affecting these products were proposed but were ultimately not adopted in the tax reform bill which was passed by the House of Representatives. The Company does not expect that provisions which materially affect IOL products will be introduced into the bill in the Senate.

Charter has recognized no income on its IOL products although experience to date has been satisfactory. It seemed clear to us when we first started to sell IOL products that the then prevailing accounting treatment (recognition of the present value of all anticipated future profits at the time the premium is received) was not prudent and did not properly reflect the economic realities of the product. In the last four

years the financial troubles of companies which have reported substantial income on similar products have done much to change acceptable accounting procedures. As of early 1986, the Financial Accounting Standards Board was considering new accounting methods which would require recognition of income as it is realized through interest margins, mortality and expense margins and surrender charges. This is in accord with our view of a sensible method of accounting for this product. We will begin to recognize income on certain of our IOL products starting in 1986 utilizing a method which will reflect the earnings over time.

Overhead, which decreased significantly at Charter in 1982 and 1983, remained essentially level in 1984 and increased slightly in 1985. The 1985 increase was a result of substituting in-house expenses for the outside commission expense of the third party wholesalers. We expect that overhead will be level or increase very slightly in 1986 despite what we hope will be another year of substantial new business.

Competition has increased markedly over the last year. The number of companies selling products essentially similar to Charter's has increased roughly four-fold in 1985 and there are now approximately fifty companies selling similar products. Many of these companies have attempted (some with success) to capture market share by selling policies with artificially high rates. Our success in 1985 indicates that we can be successful in this market with sensible rates as long as we provide good marketing and service.

In February 1986, Charter introduced new IOL products which permit additional premium payments after the first year, add an option to index interest credits to Treasury paper, and add a policy with an optional additional death benefit.

During 1986, Charter expects to begin marketing variable life insurance through its existing distribution channels. Premiums from variable life insurance policies will be invested through a "separate account" of Charter in unaffiliated mutual funds. Gains and losses from mutual fund investments will be for the account of the policyholders.

At the end of 1984, Leucadia wrote off \$16 million of value of life insurance in force because of unsatisfactory experience with the block of traditional life insurance policies which Charter had at the time it was acquired by Leucadia. Actuarial studies at the end of 1985 indicate that this block has stabilized.

We hope that our reorganized marketing and sales effort will make 1986 another successful year for Charter.

A handwritten signature in black ink, appearing to read 'David Cumming', with a stylized flourish at the end.

David Cumming
President
Charter National Life Insurance Company

Report on Manufacturing Division

The manufacturing operations of Leucadia are conducted through Cardiff Equities Corporation, which was acquired in March of 1982. Since that time we have continuously evaluated the operations applying our long established criteria in regards to market share, margins, and return on investment.

In 1984, after several poor earnings years, Cardiff determined it should concentrate its resources in the manufacturing portion of its business which had historically been profitable. Accordingly, in mid-1984, Cardiff sold the last non-manufacturing subsidiary that it owned. In late 1984, Cardiff began an acquisition of Conwed Corporation which was completed in March 1985 for a purchase price of \$45.4 million. The acquisition of Conwed added four manufacturing businesses to the two that Cardiff already owned. It also was the main factor in Cardiff's achieving record operating results in 1985 as pre-tax income from continuing operations before income taxes and minority interest rose to \$6.7 million.

The six manufacturing operations consist of the following product lines: Plastic Netting, Bonded Fiber Products, Hydraulic Mulch, Office Partitions and Workstations, Power Cord Sets, and Bathroom Vanities and Cultured Marble Tops.

After completing the acquisition, Cardiff applied the same criteria to each of the Conwed businesses as it had in the past. As a result, two businesses whose margins and returns were inadequate were sold, allowing Cardiff to reduce bank debt by \$19.1 million.

Our plastics business, part of Conwed, manufactures proprietary plastic netting for various industrial and agricultural uses. 1985 was an excellent year with operating profit up 33% on a sales increase of 13% compared to pre-acquisition 1984. We are a significant force in the markets in which we compete, and we expend substantial research dollars to both improve market positions and to develop new markets. While we do anticipate greater competition in 1986, we are looking at certain alternative

production techniques which will allow us to supplement our existing product lines.

Two of our other Conwed businesses, Bonded Fibers Products and Hydraulic Mulch, consolidated production from two manufacturing facilities into one during 1985. Bonded Fibers manufactures insulated pads for sale to, among others, the bedding and automotive industries. The Mulch division produces hydraulic mulch for use in turf establishment markets. This production consolidation was necessitated by the sale of a facility in northern Minnesota which had contained production for several different businesses including these two. The consolidation of production caused us to curtail sales efforts in certain geographic regions, as these products are freight sensitive and would no longer be competitive. Sales in these two divisions fell 8% from pre-acquisition 1984 levels with operating profits down 14%. The disruption caused by the move of certain Bonded Fibers production equipment had a detrimental effect on margins. In both divisions we are industry leaders and have a commanding market position, particularly in the bedding and turf establishment markets. In 1986, we are committing substantial effort to the development of new products for the Bonded Fibers automotive market.

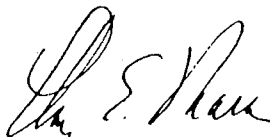
Our office partition business, acquired with Conwed, manufactures and markets freestanding office partitions and workstations to office furniture wholesalers and dealers. Workstation systems and panels for open-office design is the largest and fastest growing segment of the office furniture business. New products designed to target the commodity segment of the market are expected to improve 1986 operating results.

Our cord set business produces electric power cord sets sold to manufacturers of a wide range of products from small tools to personal computers. This business services a highly competitive market and experienced a decline in sales and margins during 1985. Foreign competition had a particularly adverse effect on this business, which we expect to continue until the dollar reaches a more competitive level.

Cardiff's vanity business manufactures bathroom vanities (hardwood cabinets and cultured marble tops) for sale to home improvement centers and other retailers specializing in the do-it-yourself market. We hold a strong position in the bathroom vanity market which is a market served by several national and many regional suppliers. During 1985, this business added a second production facility which will help to counteract strong regional competition in future years. In 1985, operating income declined from the prior year despite sales remaining unchanged.

Competition from both domestic and foreign suppliers had a negative impact on margins as did certain start-up costs associated with the new facility. The substantial increase in production capabilities will improve operating results in the near future.

We believe that each of our businesses has excellent growth and earnings potential. We hope that, during 1986, emphasis on new product development and return on investment will produce another fine year for Cardiff.



Thomas E. Mara
Chief Operating Officer
Manufacturing Division