1985

Message from the Chairman of the Board and the President

Your Company completed its 130th year with its common shareholders' equity at an all time high. The net income achieved for 1984 was also a record. Though the April 30, 1979 restructuring seems ancient history today fewer than six years have actually passed. At the time of the restructuring we had a common shareholders' deficit of approximately $7,680,000 compared to our positive common shareholders' equity of $126,097,000 at December 31, 1984. The book value per common share at April 30, 1979 was a negative of approximately $.85 compared to a positive book value per common share of $17.70 at December 31, 1984, or an increase of $18.55 per common share.

Clearly the most significant event that occurred during the year was our $77,475,000 investment in the undervalued equity securities of Avco Corporation. Prior to our entering into commitments for financing sufficient to seek control of Avco, Avco offered to buy our position at the existing market price, which was substantially above our cost, plus reimbursement of expenses. We accepted the offer subject to a provision in the repurchase agreement that if Avco were acquired within a specified period we would receive an additional payment measured by the difference between the price at which our Avco shares were repurchased and the acquisition price. As you are aware, Avco was subsequently acquired by Textron Inc. and we received the additional payments called for by the repurchase agreement. As a result of our Avco investment we realized pre-tax income in 1984 of about $61,000,000, exclusive of interest and other related costs.

The success of the Avco transaction should not hide the many other important events of 1984 and early 1985, most of which were positive:

Our consumer finance operations had the finest year in their history. Almost all measures of operating performance were at record levels. This was particularly true of the "NIBIT" discussed in Robert Brock's report, which was at a record high 17.74% of average investment in consumer finance receivables. We also increased our average investment in consumer finance receivables by 24%. We believe there is no company of comparable size in the consumer finance industry which can match our performance. Your attention is directed to the report of Robert Brock for more details.

Since the beginning of 1984 we have added bank credit facilities of over $150,000,000, including $75,000,000 at the parent company level. Consistent with our policy of properly matching interest rates and maturities, during the year we had in place interest rate "swap" and interest rate "cap" agreements covering over $110,000,000.

During 1984 we sold our headquarters building at 315 Park Avenue South in New York City, and realized a pre-tax gain of approximately $16,000,000.

During 1984 and continuing into 1985 we made investments in equity securities of a number of companies we believed represented undervalued situations. We currently hold equity positions of more than 5% in the following companies: Bench Craft, Inc. (OTC), British Land of America (NYSE), Minstar, Inc. (OTC), National Intergroup, Inc. (NYSE) and Prudential Financial Services, Inc. (OTC). The investment in Bench Craft, Inc., results from our partnership interest in The Jordan Company and the investment in British Land of America results from the sale of our headquarters building.

During 1984 we looked at many potential acquisitions. While none were completed during 1984, our unconsolidated subsidiary, Cardiff Equities Corporation, recently completed the acquisition of Conwed Corporation. Conwed, which has headquarters in St. Paul, Minnesota, manufactures coordinated ceiling and furniture products for commercial interiors as well as various industrial products.

As of February 14, 1985, our common shares were split three-for-two. This was effected by means of a 50% stock dividend distributed to holders of our common shares.

Among the investments we made during 1984 were investments in our own common stock. During the year we acquired directly or indirectly 964,958 common shares at an average price of $12.00.

During 1984 we redeemed all our outstanding Series E $1.85 Cumulative Preferred Shares and acquired an aggregate of 272,400 Series F Convertible Exchangeable Preferred Shares for $6,262,000. In March 1985 we called for redemption all remaining Series F Preferred Shares; we expect substantially all such shares to be converted into common shares prior to redemption. In early 1985 we also began to acquire Series G Adjustable Rate Cumulative Preferred Shares. The acquisitions and redemptions of preferred shares were done in large part because of our changed tax situation due to the succession of profitable years. When our tax loss carryforwards were available we were not concerned about the non-deductibility of the dividends. On an after-tax basis, however, the preferred dividends became too costly.

During 1984 our sales of investment oriented insurance products declined from the 1983 levels. We believe the decline is explained in part by the well publicized financial difficulties of two single premium insurance issuers. We also believe the favorable stock market conditions and lower interest rates of 1984 had a negative effect on sales of these products.

At the end of 1984 we determined to reduce the carrying value of Charter to reflect the unfavorable experience of certain traditional life insurance products sold by Charter principally prior to our acquisition of the Company at the end of 1980. These write-downs, which approximated $16,000,000, should have a favorable effect on future results since Charter will not bear the expense that arises when insurance policies are terminated earlier than expected.

It should be noted that the experience on our investment oriented insurance products such as TAPLAN, CHART-A-PLAN, Competitor and Competitor II, has been satisfactory and we expect to begin to recognize profits on these policies in 1985. It should also be noted that the amount of reserves and investments should compound every year if the business is retained, and therefore provide an increasing amount of future income. The report of David Cumming on the insurance operations is included as a separate section of this report.

We are pleased to note that during 1984 The Jordan Company partnership agreement was extended through 1986. The amended agreement provides for increased cash contributions and lower profit participations by the Company. In addition to the earnings from the ten companies in which we have equity interests as a result of our interest in The Jordan Company, we also receive investment banking and management fees. During 1984 our share of the profits of these companies was $4,807,000 and our share of the fees earned in 1984 was approximately $415,000. As reported last year one of these companies went public in 1983. Discussions are in progress for our sale at a substantial profit of our interest in another of the companies.

We are again appreciative of our lenders, investment bankers, employees and professional advisors who have continued to perform in an extraordinary way to help us achieve more for our loyal shareholders.

We do not promise that 1985 will be better—or even as profitable—as 1984, but we do believe our consumer finance and life insurance operations are properly and conservatively managed. The Company also has the financial resources and management ability to take advantage of opportunities as they arise.

Ian M. Cumming
Chairman

Joseph S. Steinberg
President

Report on Consumer Finance Operations

I am pleased to report continued progress in our operation during the 1984 year. Record high yields were obtained on our invested funds. This, coupled with greater control of our operating expenses and record-low bad debt losses, resulted in record earnings, both in dollars and as a percentage of average net receivables before interest expenses and income taxes.

Progress was made both in increasing our total receivables and in opening new branch locations. Gross receivables were up 21% over the previous year, to $329,400,000 at year end. Delinquency on direct loans, 60 days and over, as reported on original contractual terms, showed continued improvement, reducing to 3.01% at year end. Net bad debts charged off for the year were at a record low .94% of average net receivables during the year.

Our receivables at the end of 1981 were $339,800,000, reduced to $222,800,000 at December 31, 1982 principally as a result of the sale of certain selected receivables to reduce dependence on short-term variable rate debt. Having achieved that reduction, we then had an increase in 1983 to $271,900,000, which continued during 1984. As a result, our total gross receivables which were $222,800,000 at December 31, 1982 had increased 48% to $329,400,000 at the end of 1984. Our receivable base at the end of 1981 listed 34% of our receivables in loans secured by real estate. This has increased to 48% at the 1984 year end. Also, our dealer retail sales contracts, which were 5% of total receivables in 1981 are now 9%.

Contractual delinquency on direct loans has shown continued improvement, starting at 5.56% at the 1981 year end and steadily dropping to 3.01% at the 1984 year end.

Also showing great improvement was the bad debt loss ratio, going from 3.4% in 1981 to a record low .94% in 1984. The provision for bad debts, of course, is in part controlled by the receivable base and is generally higher when receivables are growing and lower when receivables are declining.

The final and most important measure, and the principal measure used in the management of the business, is net income before interest and taxes ("NIBIT") stated as a percentage of average net receivables. The NIBIT was 10.91% in 1981, our first year with the AIC receivables, and has improved steadily to its present 17.74%, a record high for our Company, and the best percentage return on invested funds that I have seen in any consumer finance company of comparable size!!!

Forecasts for 1985 continue to project a moderate expansion in our economy. Our charge is to make certain that we obtain our fair share of this business and increase the size of our receivable base for continued increase in our earnings. Even under this optimistic projection, we will still be tested in using our expertise. I am convinced that credit grantors will be tested in our loan approval guidelines during the year, which will require keeping a watchful eye on overloading of debt by consumers. It is no secret that the present availability and reduced cost of funds have made vast amounts of funds available to the consumer.

Plastic cards, with very generous credit lines attached, are being received, unsolicited, by a very large number of average consumers. If these consumers become liberal users of these sources of credit, we will be faced with notable increases in our delinquency and quite possibly, an increase in bankruptcy and bad debt losses. This would also reduce the presence of these individuals in the consumer retail market, with its adverse effect on sales. We will be aware of this in our loan approval guidelines and will seek to further strengthen our loans with added security to protect us from those debtors who over-obligate themselves after we have closed our loan with them.

Another area of concern for 1985 is the March 1 effective date of the FTC Trade Regulation Rule on Credit Practices, which among other things, limits our ability to take certain non-purchase liens on household goods furnishings. We have surveyed a cross section of our customers regarding their reaction to a substitution of household goods items that are not in the restricted area and the response from our customers has been most encouraging. Substitution of collateral could enable us to continue uninterrupted our present method of making small size consumer loans that have historically been secured by household goods furnishings that are exempt under the new rule.

An expansion of our office network, increasing the receivables within the existing branches and maintaining gross yields will be our main objectives in 1985. This will require a concerted effort toward training the necessary employees to staff the management positions of these new locations. We realize that increasing receivables in the branches is the answer to controlling operating expenses in the branch as a percentage of funds employed, and we are determined to see that this is done. This, coupled with the added earnings from growth of our receivables, should give us the added earnings that we hope to generate in 1985.

We are very proud of our accomplishments in 1984. Our employees are hard-working and dedicated to the best interests of the Company. We feel they are exceptionally well trained and capable of competing successfully with any credit grantor in the consumer finance market. With their fine efforts and the continued support that we have enjoyed from our corporate headquarters, I am very optimistic about our ability to continue to show progress in 1985.

Robert P. Brock

Robert P. Brock
Chairman and Chief Executive Officer
City Finance Company
Memphis, Tennessee

Report on Insurance Operations

In 1984, the non-captive insurance business of Leucadia was 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 National's core business is in single premium life insurance which has been principally sold through securities brokers. Over the last few years there have been a series of changes in the tax treatment of life insurance. In addition, the public's awareness of the financial troubles of several deferred annuity companies have focused attention on the fact that the GAAP basis financial statements are sometimes not useful in determining whether a life insurance company is solvent. Since most securities brokers have a limited ability to do due diligence based on statutory financial statements, many of them have adopted a very cautious attitude toward the insurance industry. This change in attitude has been bad for sales for life insurance through broker dealers for Charter National and virtually all other companies. Only at the very end of 1984 was there any sign of a return of the stock brokers to life insurance sales.

During 1984, Charter developed a strategy to respond to the changes in the market-place. We had only moderate success. Charter's new single and flexible premium production was $23,641,000 in 1984 compared to $57,697,000 for 1983. Indeed, the change is more dramatic than initially appears since the 1984 production from securities dealers was down nearly 90% from the 1983 level.

We see early signs that Charter's production in the securities dealer market will increase again in 1985. The amount of that production will depend on two factors. The first is the amount of adverse publicity the insurance industry receives as a result of insolvencies. The second is the strength of the stock and bond markets, since securities dealers generally turn more to insurance products when their primary markets are slack.

Charter National continues to have excellent experience with the single premium block of business it has written. A comprehensive review of our persistency and mortality experience has been made, and we expect to begin recognizing GAAP income on this block of business during 1985. When Charter instituted its policy of deferring income on single premium business, it was virtually alone in an industry which preferred to recognize future income in the greatest amount possible in the year in which a policy was issued. Since that time, the instability of companies which followed this accounting procedure has caused a major shift in accounting policy so that many companies now defer earnings to one degree or another.

After a significant drop in overhead in 1983, expenses remained constant in 1984. With a reorganization of our staff and continued automation, we hope for renewed reduction of our expense levels in 1985.

As in the last few years, competition in life insurance is very intense. Many companies, in search of dramatic increases in sales volume, are selling life insurance products with inadequate profit margins. Charter has consciously decided not to pursue sales unless the profits appear to be adequate. Because of this decision, we frequently do not match our competition when they make what we view as ill-advised pricing decisions. In turn, this fact will tend to make Charter's growth slower than it would otherwise be and somewhat irregular. One beneficial effect of this slower pattern of growth is that Charter's statutory capital and surplus will be less strained by the volume of new business. In addition, our profitability should improve steadily as we accumulate a larger and larger block of business.

During 1984, Charter and Leucadia reviewed many possible acquisitions in the life insurance industry. In particular we were looking for companies which could be consolidated with Charter to create a significant benefit by decreasing aggregate overhead expense. Although there were no acquisitions in 1984, we will continue to review potential companies while keeping in mind that it is more important to avoid mistakes than to complete a transaction.

In addition to single premium whole life, Charter continues to market immediate annuities, structured settlement annuities, and 10-year level term insurance and intends to market pure endowments in 1985. We have achieved only moderate success in these lines to date, and they will require greater effort in 1985.

The experience on certain traditional life insurance policies principally written prior to the acquisition of Charter by Leucadia has not been satisfactory. Accordingly, during 1984, based on actuarial studies which reflect the adverse experience of recent years, we decided to write-off value of life insurance in force related to this line of business amounting to $16,000,000. We expect that earnings in the next few years will benefit, since the excess lapses and unfavorable mortality related to this line of business should no longer adversely affect our earnings.

We confidently expect to return to higher levels of new premium production and to contribute to the Company's profitability.

David Cumming
President
Charter National Life Insurance Company
St. Louis, Missouri