1978

## TO OUR SHAREHOLDERS AND EMPLOYEES:

Since the beginning of 1978 management has been engaged in continuous efforts to restructure the debt and capital of Talcott National Corporation and its operating finance subsidiary, James Talcott, Inc. We are pleased to report that the Restructuring Plan announced in November, 1978 for the comprehensive refinancing of certain outstanding debt and preferred shares was successfully completed on April 30, 1979.

The Restructuring Plan, as consummated, resulted in the payment by James Talcott of $99,694,000 to debtholders and preferred shareholders in satisfaction of $127,126,000 of debt and preferred stock, at redemption value. James Talcott also has called for the redemption, at par, on June 5, 1979, of its 5½% Senior Notes due December 1, 1979 and its 5½% Senior Notes due June 1, 1980 totaling $3,700,000. The cash required for these payments was generated, in substantial part, from sales, basically at book value, of the assets of James Talcott's Business Finance Division.

These payments, coupled with other transactions resulting from the Restructuring Plan, increased James Talcott's net worth, which was $56,600,000 at December 31, 1978, by approximately $6,700,000 and increased National's net worth, which was $1,000,000 at December 31, 1978, by approximately $26,700,000.

James Talcott's bank revolving credit arrangement which under the previous agreement permitted maximum borrowings of $240,000,000, with interest at 120% of prime, now provides for borrowings of up to $188,400,000 through May 31, 1982, with interest at 125% of prime, and with no compensating balances required under either credit agreement. The agreement provides that the revolving credit arrangement on that date will be extended annually or be converted to a five-year revolving term loan with 5% quarterly reductions of the original commitment.

James Talcott also now has outstanding $963,000 of senior notes due 1979-85; $1,229,000 subordinated and capital notes due 1983-89; and $757,000 of preferred stock, at redemption value, subject to mandatory redemption in 1985-90. The amounts outstanding on these notes and preferred shares prior to the restructuring aggregated approximately $100,000,000. James Talcott's Series A Junior Preferred Shares scheduled for redemption in 1980-82, an aggregate of $1,200,000, are not affected by the Restructuring Plan.

National's senior debt of $6,300,000 has been reduced to $2,900,000 and the maturity extended to the years 1985 to 1991. National's 6% Convertible Subordinated Debentures due 1994, amounting to $25 million, were not changed by the Restructuring Plan but, as announced on April 12, 1979, National intends to make an exchange offer to these holders. Under the proposed exchange offer, which will only be made by means of a prospectus or offering circular as required by applicable securities laws, holders of outstanding 6% Debentures would be offered an opportunity to exchange such debentures for a new issue of National debt which would be non-convertible, senior to the outstanding 6% Debentures and subordinated to the senior debt of National. Although the terms of the exchange offer have not been completed, it is presently intended to offer approximately $600 of principal amount of new debt in exchange for each $1,000 face amount of outstanding 6% Debentures with a coupon rate consistent with current market yield on comparable securities and with maturity dates yet to be determined. Management estimates this offer will probably be made later in 1979. The closing price of the 6% Debentures on the New York Stock Exchange on April 11, 1979 was $490 per $1,000 principal amount.

In addition, National intends to offer its Series C preferred shareholders the opportunity to exchange their shares, which had an aggregate redemption value of $7,090,000 and accrued dividends of $1,385,000 at December 31, 1978, for 7½% Junior Subordinated Notes payable over 3 years in the aggregate amount of $3,360,000.

The remaining continuing businesses of Talcott National Corporation are consumer finance and factoring. James Talcott's Factoring Division has been separately incorporated as an independent subsidiary to be known as James Talcott Factors, Inc. Its shares, along with those of City Finance Company, James Talcott's consumer finance subsidiary, are being pledged as security for the revolving credit arrangement and for the other senior debt. The assets of James Talcott Factors, Inc. and City Finance Company have not been pledged. An additional $20,000,000 line of credit has been arranged for James Talcott Factors to provide for its periodic needs.

A report on City Finance Company's 1978 performance by Robert P. Brock, chairman, appears on page 5.

A report on The Factoring Division's 1978 performance by William R. Gruttemeyer, chairman and president of James Talcott Factors, Inc., is on page 4.

For the year 1978 Talcott National Corporation reported income from continuing operations, exclusive of an extraordinary tax credit of $639,000, or $.09 per common share. This compares to a 1977 loss from continuing operations of $198,000, or $.19 per common share.

After giving effect to discontinued operations and the extraordinary tax credit, Talcott National Corporation in 1978 had a net loss of $1,846,000, or $.74 per common share, compared to a net loss of $7,995,000, or $2.79 per common share in 1977.

For the fourth quarter ended December 31, 1978, Talcott National Corporation showed a loss of $584,000, or $.23 per common share as against a net loss of $2,326,000, or $.81 per common share for the same period of 1977.

The fourth quarter 1978 results included a loss from continuing operations of $186,000 or $.09 per common share, exclusive of an extraordinary tax credit of $165,000, or $.05 per common share, compared to a gain of $507,000 or $.13 per common share for the same period in 1977.

The company's wholly-owned subsidiary, James Talcott, Inc., for the year 1978 had income from continuing operations, exclusive of the extraordinary credit, of $3,846,000, as against $2,830,000 for 1977. Net income in 1978 amounted to $1,361,000, including the extraordinary tax credit of $734,000, compared to a 1977 net loss of $4,968,000.

James Talcott's income from continuing operations exclusive of extraordinary item for the fourth quarter of 1978 was $649,000 versus $1,255,000 for the comparable period of 1977. Fourth quarter 1978 net income was $251,000, including an extraordinary tax credit of $165,000. For the fourth quarter of 1977, James Talcott, Inc., had a net loss of $1,578,000. The loss on discontinued operations for the fourth quarter of 1978 was $563,000, as against $2,833,000 for the same period of 1977.

In the accompanying financial statements, the Company has treated its real estate portfolio and Business Finance Division as discontinued operations.

Substantial progress was made during 1978 in the management of the Company's real estate assets. During the past year, the positive net cash flow from real estate assets was $9,000,000 as against $6,700,000 in the preceding year. During the year $7,000,000 was provided in additional allowances for losses and estimated future holding costs for the non-earning real estate finance receivables and owned properties held for sale. This compares with $10,500,000 provided in 1977 for this purpose.

The net investment in real estate in 1978 declined by $12,600,000. While significant reductions in real estate investment have been accomplished during the past two years, it must be noted that satisfactory resolution of the real estate problems will require an extended period of time and is dependent, to a great extent, upon market conditions and the outcome of pending litigation.

During 1978 several management changes took place. Ian M. Cumming was elected chairman of the Board of Directors and president of Talcott National Corporation in June, 1978, and chairman of the Board of Directors and president of James Talcott, Inc. in August, 1978. In December, 1978, Joseph S. Steinberg was elected to the Board of Directors of Talcott National Corporation and James Talcott, Inc., and in January, 1979 was named president of both Talcott National Corporation and James Talcott, Inc.

Effective May 16, 1979, John W. Jordan, II, vice president, Carl Marks & Co., Inc. and Lawrence D. Glaubinger, chairman, Stern & Stern Textiles, Inc. were elected directors of Talcott National Corporation and James Talcott, Inc. Messrs. Jordan and Glaubinger are associated with Marks Investing Corporation, which together with Messrs. Cumming and Steinberg, indirectly acquired 1,600,000 shares of Talcott National Corporation on April 30, 1979.

We wish to thank our clients, creditors, employees and shareholders for their loyalty and support.

Joseph S. Steinberg

Ian M. Cumming
Chairman of the Board

Joseph S. Steinberg
President

The recent successful closing of the Restructuring Plan has had an important effect on our factoring operations and offers new opportunity and increased potential for improving performance in the years ahead.

Under terms of the Plan, the factoring business, which has been operating as a division of James Talcott, Inc., has been incorporated as a separate company to be known as James Talcott Factors, Inc. One immediate direct benefit of this move is the establishment of one of the strongest balance sheets in the factoring industry.

This, along with other advantages derived from the restructuring, considerably strengthens our position and gives tacit assurance to present and prospective clients of our ability to provide more and better services.

James Talcott Factors, Inc., is a unique new company that is actually 125 years old in terms of its history, tradition and experience. 1979 marks the Silvertennial anniversary of the founding of our factoring business which was begun in 1854.

In 1978 The Factoring Division enjoyed one of the best years in our long, proud history, and achieved an increase, over 1977, of $1.8 million in pretax income, exclusive of a $1.4 million non-recurring insurance recovery related to a Swiss factoring office which was discontinued in 1976.

Our stated pretax profit objective for 1978 was to exceed 4% of average funds employed. Actual 1978 pretax earnings, excluding the insurance recovery, amounted to 5.7% of average investment.

The high profit yield was attained as the result of several contributing elements but was due principally to substantially reduced purchased receivable losses and an increase in average investment of approximately $9 million.

Net purchased receivable write-offs in 1978 were .05% of factored volume, compared to .18% of factored volume in 1977, a reduction of 72%. This substantial improvement was directly attributable to three major causes.

First, most customers improved inventory control and reduced purchase commitments which enabled them to maintain better financial positions. Second, we continued to improve the performance of our customer credit administration. And lastly, recoveries from amounts written off in prior years increased as a percentage of gross write-offs.

The provision for client losses increased 50% in 1978 to .3% of average funds employed from .2% in 1977. This increase, while anticipated, is still well under the accepted industry standard of approximately .5% of average funds employed. This lower than normal incidence of client losses reflects the effective client administration and sound marketing standards and practices of our account executives.

Direct expenses rose approximately 9% in 1978 as against a pretax earnings increase of 49%. The increase in direct costs was attributable, in part, to inflationary pressures and had been anticipated. A considerable amount of these higher costs related to the development of new data processing systems. This expenditure is regarded as an investment which will help to increase our operating efficiencies in the years ahead by providing improved on-line application systems which are, and will continue to be, among the most advanced in the industry.

Over the past several years we have been able to substantially and consistently improve our earnings. Our average factored investment has grown steadily each year since 1975 and in 1978 rose 10.1% over the previous year. James Talcott Factors, Inc.'s return on funds employed is believed to be among the highest in the industry. We have been able to achieve these results while also furnishing responsive, timely, innovative and liberal financial and credit related services to our clients and their customers.

Our goals for 1979 are for moderate increases in volume and average investment and for pretax earnings to again exceed 4% of average funds employed. In the coming year we expect an increase in purchased receivable losses to a mo[illegible] traditional level of about .15% of factored sales volume. Fra[illegible]tional increases are also anticipated in client losses and direct expenses.

The added benefits to our factoring business resulting from the restructuring give us encouragement for attaining both our short-term and long-term objectives.

Further, the substantial increase in the net worth of Talcott National Corporation and James Talcott, Inc., should enable James Talcott Factors, Inc. to obtain funding in amounts adequate to service its existing portfolio and to provide for planned growth.

Additionally, as a result of the successful completion of the restructuring, the executives and operating personnel of James Talcott Factors, Inc., are now free to devote their full attention to the expansion and refinement of our factoring services.

Throughout the recent period of uncertainty, we managed to retain our reputation for integrity, quality of performance and profitability. We are now better geared to move forward. With the continued support of our factored clients and traditional referral sources such as accountants, attorneys and bankers, we are confident that we will regain our position of eminent leadership in the field.

Our Financial Statements begin on page 34.

W. R. Gruttemeyer

William R. Gruttemeyer
Chairman and President
James Talcott Factors, Inc.

For 1978 receivables, representing cash instalment loans made directly to customers and retail instalment contracts purchased from dealers, were at a record high $102,615,000. This represents an increase of $17,158,000, or 20% over the 1977 receivables. The volume of receivables for 1978 also rose to $120,618,000 which is an increase of 25% over the previous year.

As a result of only limited funds being available for expansion, City Finance Company continued to conduct its consumer finance operation from 102 branch offices located in eight states, primarily in the Southeastern part of the country.

In 1978, pretax income was $3,583,483, a decrease of 26% from the record $4,853,200 of 1977. 1978 net income represented a 4.9% return on average net receivables, compared to 7% for 1977. The decline in net income was attributable principally to three factors. First, interest expense increased due to a higher prime rate by $1,422,000, or 34%, on an increase in average net receivables of 5%. Second, provision for losses increased $842,000 over 1977, though actual net credit losses were reduced. Third, a reduction in gross income of approximately $1,000,000 was caused by an adverse Tennessee Supreme Court decision limiting the interest charged on Tennessee originated loans to 10% per year. City operating expenses as a percentage of gross income were reduced. Despite the negative factors, income before taxes and interest expense stated as a percentage of average net receivables was 12.6% in 1978, the second highest return in recent years.

The high quality of City's receivables was again very evident. The ratio of net credit losses to average outstanding loan receivables was 1.11% and net credit losses to liquidations on dealer contracts was .78% compared to 1.23% and .86%, respectively, in 1977. Delinquencies continue favorable. Loans delinquent 60 days or more on a contractual basis were 1.66% in 1978 compared to 1.85% in 1977 and on a recency of payments basis, 1.70% in 1978 compared to 1.74% in 1977. At December 31, unearned interest on precomputed loans receivable as a percentage of gross outstandings at year-end 1978, increased by 15% to 21.4%. The unearned premium on credit related insurance increased by more than $1,000,000. These two deferred items represent revenues which will be reflected in future earnings.

As noted above, financial and operating results for 1978 were affected by our Tennessee operations. Because of a Tennessee Supreme Court decision in August, 1977 declaring parts of the State Loan Act to be unconstitutional, City suspended its lending activities in that state from August, 1977 to April, 1978. However, an amendment to the State Constitution was passed in March, 1978, allowing all provisions of existing statutes regulating rates of interest and other charges to remain in full force and effect until July 1, 1980. Following that amendment, City once again became active in making consumer loans in Tennessee. At the time of the August, 1977 Supreme Court decision, City had $27,257,000 in Tennessee loan receivables. Suspending lending activities for the seven-month period resulted in a reduction to $16,585,000 by April, 1978 when we reactivated operations in Tennessee. An active solicitation program to regain the lost loan receivables was successful and, at the 1978 year end, Tennessee loan receivables had increased to $28,397,000.

New legislation was recently enacted in Tennessee to be effective July 1, 1979, which permits the same interest and loan charge rates as contained in the loan act under which we are now operating and with a permitted increase in maximum maturities. This law removes one of the uncertainties affecting our future operations.

Continued high interest cost will adversely affect 1979 profits. However, with the increase in deferred revenues, enactment of the aforementioned Tennessee legislation, a portfolio of high quality receivables and a commitment to cost control, we are optimistic that 1979 will be a good year.

Our Financial Statements begin on page 40.

Robert P. Brock

Robert P. Brock
Chairman
City Finance Company