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USG - Q3 2013 USG Earnings Conference Call

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OVERVIEW:

USG reported 3Q13 net sales of $925m, GAAP net income of $23m, adjusted net income of $24m and diluted EPS from continuing operations of $0.22.

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PRESENTATION

Operator

Welcome to the USG Corporation third-quarter 2013 earnings conference call. My name is Jeanine, and I will be your operator for today's call.

(Operator Instructions)

Please note that this conference is being recorded.

I will now turn the call over to Ken Banas. Ken, you may now begin.

Ken Banas - *USG Corp - Senior Director of IR*

Thank you. Good morning, and welcome to USG Corporation's third-quarter 2013 earnings conference call and live webcast. We will be using a slide presentation in conjunction with our call today. It is available by going to the investor information section of our website, www.USG.com, and clicking on the link to the webcast.

Before we proceed, let me remind you that certain statements in this conference call may be forward-looking statements under Securities laws. These statements are made on the basis of management's current views and assumptions of our business, market, and other conditions, and management undertakes no obligation to update these statements. The statements are also subject to a number of factors, including those listed at the end of the press release, and actual results may be different from our current expectations.

With me today to discuss our results and our outlook are Jim Metcalf, Chairman, President and Chief Executive Officer; and Matt Hilzinger, Executive Vice President and Chief Financial Officer. Jim will provide a general overview of the quarter, plus additional insight into some of our businesses. Matt will review the financial results for the quarter for the Corporation and the business segments. We'll then open the call for questions, and conclude with a few comments from Jim. As always, we'd like to ensure that everyone has an opportunity to ask questions, so when we get to the Q&A section, callers are asked to limit themselves to one question.

Jim?

Jim Metcalf - *USG Corp - Chairman, President and CEO*

Thank you, Ken. Good morning, and I appreciate everyone joining us this morning. This is a very exciting time at USG, and I'm looking forward to sharing our results from the quarter, our view on the market, and an update on our new international investment. During the third quarter, all of our businesses generated an operating profit, and the Corporation achieved net income for the third consecutive quarter. We believe we turned the corner, and our plan to win is beginning to drive our performance, improving both our year-on-year top and bottom lines during the past several quarters.

Despite macroeconomic headwinds and some uneven economic data, particularly in the commercial segment, we believe that the recovery is strengthening in all of our end-use markets. Looking at repair and remodel, residential and commercial, 2013 is stronger than last year, and we are optimistic about the 2014 market demand. It's important to know that we still have a long runway before we get to historic averages in each one of the segments, but we do see light at the end of the tunnel.

While we are cautiously optimistic, the positive trend in our results and the confidence in our recovery are enabling us to take a more proactive approach. You may have noticed that we have a new look. We recently launched a new brand, a tag line, and an Olympic sponsorship. The new brand is a reflection of our Company emerging stronger from what I like to say we have been through a small-d depression. And our new tag line -- it's your world, build it -- reflects our commitment to all of our customers. To activate our brand, the Olympic sponsorship gives us a platform for international brand visibility.

Also, as you may have heard last week, we had some very exciting news, as we announced an international joint venture with Boral Limited. This joint venture, with the leading plasterboard manufacturer that's based in Australia, positions USG very well in high-growth areas throughout Asia, Australasia, and the Middle East. I will discuss our partnership in a few minutes, but now I'd like to shift to our performance during the quarter.

In our North American gypsum business, we have generated our best third quarter of operating profit since 2006. To put this in perspective, in 2006 wallboard total demand was 36 billion feet, compared to around 20.5 billion feet this year. And I think that's an amazing comparison of all the hard work all of our employees have done over the last five years.

The primary driver of our improved results continues to be improvement in wallboard price, volume, and growth of our UltraLight portfolio. During the quarter, our Sheetrock brand UltraLight Panels represented 58% of our total shipments, the strongest quarter since we launched this very exciting technology. UltraLight continues to command a premium in the market, helping our customers improve their productivity, and, most importantly, our customers' profitability.

Worldwide Ceilings continues to perform well, and we are making some important strategic investments in ceilings to better position us for the commercial recovery. We're making upgrades that are currently underway at our Cloquet, Minnesota, plant, which produces most of our high-performance products. This investment is designed to increase our capacity, improve our efficiency, and, most importantly, improve our cost position.

During the quarter, our ceilings business delivered $22 million of operating profit. However, our operating profits were down 8% due to softer volume in both ceiling tile and grid. And this is evidence of the continued soft commercial segment, particularly in the education segment.

Now turning to our building products distribution business, L&W Supply. L&W generated a second consecutive quarter of positive operating results, earning $3 million in the quarter, with comp-store sales up 14%. We are seeing improved results at L&W across all of the core product areas, with the wallboard category being the primary driver of the improved results. L&W continues to make great strides in the results despite the exposure to this persistently choppy commercial market, which accounts for about 75% of L&W's sales.

Our strategy -- strengthening the core, diversifying our earnings, and differentiating through innovation -- continues to drive our improved performance. We have made progress throughout this downturn, and these three pillars have built the foundation for strong earnings potential as we see demand improving.

Our commitment to strengthening the core is evident in the L&W results I just mentioned. Despite fluctuations in the commercial segment, L&W has generated consecutive quarters of operating results for the first time since 2008. L&W's commitment to product portfolio growth beyond wallboard has helped drive revenue and margin improvement across all the categories, as well as the 14% more revenue that we ran through the branch network during the quarter. We're also continuing at L&W to reduce cost with a focus on lowering our breakeven.

The second pillar of our strategy is to diversify our earnings. As I mentioned a few minutes ago, we made a significant step forward by entering into a 50/50 long-term joint venture with Boral Limited. The joint venture, which is called USG Boral Building Products, will give us critical mass that would have taken years and significant capital if we attained it independently. It's immediately accretive. It is NPV positive, and it is balance-sheet neutral.

Leveraging Boral's extensive manufacturing footprint and their sales organization, coupled with USG's superior technology, and our assets both in the Middle East and Asia, will enable us to grow our wallboard and adjacent products through several of the world's highest growth construction markets. We have talked the last several years about the importance at USG of diversifying our earnings. We have taken some important steps to date, but this investment is a major leap forward as we build critical mass in our international business.

The joint venture, which is expected to be self funding, gives us immediate significant presence, and, most importantly, a competitive advantage throughout this fast-growing region. We expect USG Boral Building Products will deliver synergies, help smooth out some of the cyclicality that's inherent in our business, and, most importantly, generate positive earnings for the long term.

The last part of our strategy is differentiating through innovation. I would like to spend a moment on another new product we have introduced this year, Sheetrock UltraLight Mold Tough panels. This product extension was introduced earlier this year, and is the industry's first and only lightweight mold-resistant product.

Sheetrock UltraLight Mold Tough products are easier to lift, carry and install. They perform extremely well in high-humidity areas. And some of the international markets I just mentioned, this product will be excellent for. Most importantly, it is the lightest weight half-inch mold-resistant panel that is available today.

There is a clear contractor preference for this product, and we are extremely excited to make it available nationwide by the end of this year. This product adds to our industry-only lightweight platform of panels and joint finishing. We are committed on delivering all the key elements of our strategy, and we will continue to strengthen, diversify and differentiate our Business to grow USG.

Now, with that, I would like to turn it over to Matt, who is now going to provide greater details on the results from the quarter.

Matt Hilzinger - *USG Corp - EVP, CFO*

Thanks, Jim, and good morning to everyone who has joined us today. I will take you through our third-quarter results and provide some additional details into each of our business segments. During the third quarter, net sales were $925 million, up 12% from the third quarter of last year. Our third-quarter GAAP net income was $23 million, which compares to a net loss of $29 million in the third quarter of 2012. Adjusted net income for the quarter was $24 million versus an adjusted net loss of $27 million in the third quarter of 2012. The third-quarter GAAP net income measure is about $1 million lower than our adjusted net income due to taxes associated with the sale of our European business in the third quarter of last year.

The year-on-year improvement in net income was driven by improved results in all of our businesses. We generated our third consecutive quarter of net income and positive net earnings, reporting diluted earnings per share of $0.22 from continuing operations. For those of you looking at our

EPS calculation, we have included about 2.5 million shares of potential common in our diluted EPS, but we will not include the 35 million shares related to our 2018 convertible debt in our dilutive calculation, and won't until we have more net income.

Overall, we had a solid -- a very solid third quarter. Sales in each of our segments outperformed last year, and we are very pleased with the results. But before I get into the specifics of each segment, I will make a few comments on our SG&A expenses. As I mentioned on several of our past earning calls, we have expected our SG&A for 2013 to be slightly higher than last year, with most of the increase coming in the second half of this year. So, the increase in our third quarter SG&A expenses, which increased to $80 million from $74 million a year ago, was planned. The increase in this quarter is largely due to additional marketing and IT investments as we continue to enhance our ability to serve our customers.

In addition, during the third quarter we made incremental investments in our Sheetrock UltraLight platform, as well as an investment in our new corporate branding strategy. As we look to the fourth quarter, we expect SG&A to be higher than last year as we make incremental investments to drive growth in our Business. We will continue to work to offset the effects of inflation and our additional customer-focused investments, but we still expect SG&A to be up slightly in 2013 versus 2012.

Now I'd like to walk through our third-quarter segment results. In our North American gypsum segment, we reported net sales of $577 million for the quarter, an operating profit of $76 million, compared to net sales of $496 million and an operating profit of $35 million in last year's third quarter. The primary contributor to our improved results is our wallboard business, which contributed $32 million in margin improvement and $7 million in volume improvement.

Our US wallboard business shipped approximately 1.37 billion square feet in the quarter, an increase of 6% compared to the second quarter of this year, and an increase of 14% compared to the third quarter of last year. Our quarter-over-quarter increase was better than the industry pace of 9% due in part to our shipments to both the big-box channel and the specialty dealer channel, but also due to the growth in our UltraLight volumes, which we believe resulted in modest share gains.

We had an average realized wallboard sales price of about $154 for the third quarter of 2013, basically flat sequentially to the second quarter, but an improvement of 17% compared to an average realized wallboard sale price of about $132 in the third quarter of 2012. As we have previously stated, this price may vary throughout the year due to changes in freight, mix, regional demand fluctuations, excluding exports.

We remain very pleased with the price improvement versus the prior year, and believe that we continue to realize pricing improvement due to our high-quality products, strong customer relationships and service, and our commitment to help our customers improve their product offerings and profitability as we build on the recovery. The improvement in our wallboard business is an important component of our Business generating an appropriate return on invested capital.

Our offshore shipping business, GTL, produced $4 million less in operating profit in the third quarter of 2013 versus last year, primarily due to timing, which is associated with how we account for these shipments. For the full-year 2013, we expect our GTL business to generate a slightly greater level of profit than it did in 2012, and the cadence of how we realize it will fluctuate as well. So, for the fourth quarter this year, we expect our GTL profit to be around $8 million to $10 million.

Shifting to our worldwide ceiling business, we delivered another solid quarter, with operating profit of $22 million compared with $24 million in the third quarter of 2012. Similar to the second quarter of this year, our results were adversely impacted by another $3-million environmental charge related to a property we sold decades ago. If not for this charge, we would have improved our 2012 results.

Our USG Interiors business performed well from a gross margin standpoint, but sales were flat, and operating profits were down due to softer volumes in both our ceiling tile and our grid business related to the ongoing choppiness in the commercial markets. Additionally, revenues in our USG international business improved by 13%, while margins fell $2 million, primarily attributable to an increase in overhead and miscellaneous costs associated with the start up of our joint ventures in Oman.

In our building products distribution segment, L&W generated an operating profit of $3 million on $331 million in sales, compared with an operating loss of $10 million on $300 million in sales during the third quarter of 2012. Same-store sales increased by 14% versus the third quarter of 2012.

L&W's wallboard volume and price were up during the quarter, contributing $7 million in incremental operating profit. Additionally, L&W continues to lower its breakeven and diversify its product offering beyond wallboard, as operating expenses and restructuring decreased by $2 million and $3 million, respectively, and non-wallboard sales contributed an additional $1 million in operating profit.

For all of USG, our third-quarter incremental operating profit was 44%. As we have previously stated and discussed, it is important to look at incremental operating profit over a multi-quarter time frame due to fluctuations on a seasonal basis. And since the start of 2012, our incremental operating margins have averaged about 60% above our historical incremental margins of 30% to 50% for the first few years following a recession. As we have been doing, we will continue to take the steps needed to lower our breakeven, while investing in growth opportunities, and anticipate fluctuations in our future operating margins, especially as we get further into the recovery.

Our cash and liquidity positions have improved since a year ago. Capital expenditures remain on plan as of September 30 of this year, and we had liquidity of around $873 million, including $590 million of cash and cash equivalents. As we discussed in our USG Boral joint venture announcement last week, we expect to use about $150 million of our on-hand cash, as well as long-term debt of about $350 million, to fund the purchase of our 50% share of the new joint venture. Considering this use of cash, I believe that we have adequate liquidity, and our position remains strong for this point in the cycle.

I would like to conclude by saying that this is a really exciting time for USG. We are strategically investing in the Business to drive growth, but I want to assure you that we remain committed to controlling our costs, delevering the balance sheet, and delivering an appropriate return on invested capital to our shareholders.

Jim, I will turn it back to you.

Jim Metcalf - *USG Corp - Chairman, President and CEO*

Thank you, Matt. Now what I'd like to do is review some of the things that we are seeing in the market, and the segments for this year and beyond. In the residential market, we have seen some softening on housing starts, which appears to be largely associated with rising interest rates and the US government fiscal issues. Builder confidence, as measured by NAHB, slipped 2 points in October, but still remains above 50, indicating there is still optimism in the residential market.

Although the recovery over the next few years may be modest, we believe there is still a pent-up demand for housing. As you look at household formation, both birth rates and immigration remain positive, and the economy is coming off historically low levels of starts. For 2013, we are projecting approximately 900,000 starts, but we feel next year in 2014 will improve slightly. We expect that, over the long term, housing starts will begin to approach the historical averages of 1.4 to 1.5 million starts.

The residential repair and remodel is showing signs of strengthening. Both the pace and value of existing home sales continues to increase, resulting in homeowners adding almost $2.7 trillion of paper net worth since the fourth quarter of 2011. And the trend in consumer confidence continues to be positive. These are important factors that are giving the home buyers and homeowners the confidence to invest in household repairs, which we typically see an investment in repair and remodel in the first 24 months after purchasing. At USG, we are well positioned to benefit from this growth in the segment, because our strong partnership we have with our customers with large national and big-box retailers.

In the commercial R&R segment, we are also seeing more strengthening. The average age of a commercial building in the United States is in excess of 40 years old, and typically requires repair and upgrades in order to remain functional within building codes, and attractive to tenants. The demand for commercial R&R benefits all of our businesses, particularly our ceilings business and L&W supply. We believe that this segment will continue to perform well as confidence in the economy improves and employment recovers. If you look at total repair and remodel, it represents approximately 50% of our Business. And we expect growth in the mid- to upper-single digits in 2013, with improvement in 2014 as well.

In the commercial segment, as we mentioned earlier, we continue to see volatility. The ABI, or the architecture billings index, which typically precedes commercial starts by about 9 to 12 months, has been above 50 in 12 of the last 13 months. However, our products typically lag a commercial start anywhere from 12 to 18 months. In contrast to the positive trend by ABI, current projections show that commercial and industrial sectors are up, but institutional and government is lagging. While we are seeing some green shoots in commercial construction, we still believe that there is going to be continued choppiness, and this will persist probably until mid next year. Through all of 2013 we are anticipating commercial growth to be in the very low-single digits.

We recognize that there are some headwinds, but we believe that the US economic recovery is real, and the overall demand in 2014 will be stronger than this year in all of our end-use markets.

So with that, I would like to open it up -- the call for your questions.

QUESTIONS AND ANSWERS

Operator

Thank you.

(Operator Instructions)

Bob Wetenhall.

Bob Wetenhall - *RBC Capital Markets - Analyst*

I just wanted to see in the ceilings business modest topline growth. I was looking for a little bit more profitability. You had mentioned choppy volumes. I was wondering if there is any transitory or one time charges that are impacting profitability in ceilings.

Jim Metcalf - *USG Corp - Chairman, President and CEO*

Yes, Bob, on the ceilings business, we are continuing to feel really good about it, but, if you look on a year-on-year basis, we have a couple things. You have an environmental charge in the quarter, and, as Matt indicated, we had some start up costs that show up in the ceiling segment. So, you put those numbers in there, actually we performed better year-on-year.

So you look at sequentially from the quarter, basically it was a volume impact on our high-end ceilings, and I think that is indicative of what is happening in the overall commercial business. Our commodities ceiling tile volume quarter-on-quarter was up slightly, and I think that is our big-box retailers that have done a nice job, but I think the high-end quarter on quarter slipped because of the commercial demand. So we still feel very confident with the business, and, as you know, this business has really been a tried and true part of the segment through this downturn.

Bob Wetenhall - *RBC Capital Markets - Analyst*

Got it, and if I could sneak a follow-up there, congratulations on the JV with Boral. It's a very exciting development. Could you give us a context does talking about from an implementation standpoint how you see it unfolding and what the glide path is to capture some of the synergies you mentioned after your conference call where you announced the acquisition?

Jim Metcalf - *USG Corp - Chairman, President and CEO*

Thanks Bob, as I said, we are very excited about the JV with USG Boral. It gives us, as I said, immediate access to the worlds fastest growing markets. They have a manufacturing footprint of 24 wallboard lines. We will be contributing our Oman lines, 25 wallboard lines, footprints. Along with that, they have a market share in excess of 40%. We are moving into a business that is a profitable business, and we think with our technology we can really take it to the next level. We're looking at the glidepath, Bob, on your specific question, we are going to be going in as a technical partner right off the bat. We feel once we start getting these synergies there's about $50 million there. And really, it is broken into three areas.

If you look at the $50 million, most of it is product adjacencies. We have some cost reductions. About 35% of that is cost reductions which is both manufacturing cost, and we think we have some opportunity on freight as well. And we also think there is also some cost areas that we can focus on.

So you are not going to see right out of the gate. We have a very short window. We have put together a plan in the next 12 to 48 months. As I said earlier it is immediately accretive. You will see the net impact to our earnings next year of anywhere from $7 million to $12 million, and we are going to really focus on implementing our technology. We are going to be putting basic technology in first, and then we will be following up with technology that will be implementing our lightweight portfolio in very specific markets.

This JV operates in 12 countries across Asia, Australasia and the Middle East, and it is putting 6.8 billion feet of plasterboard capacity that we will be accountable for. So we are extremely excited. We are going to have our ceilings business that will be part of this. Our joint treatment business, we think we can grow a market share on joint treatment there with our technology. So I think the adjacencies are going to be a nice part of the synergies as well.

So very excited, our time frame is going to be very fast. We are very focused on getting this implemented once the deal closes, and we are projecting that the deal will be closing the last part of January. So I think this will be a wonderful part of diversifying the earnings, and we're really excited to continue to share the results with you in future calls.

Bob Wetenhall - *RBC Capital Markets - Analyst*

Congratulations and good luck.

Operator

Stephen Kim from Barclays.

Stephen Kim - *Barclays Capital - Analyst*

Thanks very much guys. You had some pretty nice incremental margins even I guess in the ceilings business if you adjust for the environmental. My question first would be on those environmental charges, could we expect those to continue for a period of time? If you could give us any color on that, and then in your distribution business, now that you are starting to get that really back on track, what kind of incrementals do you think we should be looking for for that business on a going forward basis?

Matt Hilzinger - *USG Corp - EVP, CFO*

It's Matt Hilzinger. Why don't I address the environmental. We had a charge in the second quarter. We had another charge on a different property this quarter. These go back to properties that we no longer own and operate. They go back for decades. And these are things that we thought we had fully remediated, and in fact we had even gotten some certifications that they had been remediated, but environmental laws change, and sometimes you have to go through and get them back to the proper state. These are things that go back decades. Obviously we are disappointed, but we need to do the right thing for the environment.

As to whether there is any more out there, we have been in the business for 111 years. There are obviously properties out there that we will continue to watch and monitor. We go through and take a look at our environmental reserves every quarter and feel that they are appropriate and adequate, but it doesn't mean that there is not stuff out there that will pop up again whether it is next year or the year after. It could very well happen, but there is not anything that we know of right now. Jim, do you want to take the one on L&W?

Jim Metcalf - *USG Corp - Chairman, President and CEO*

Yes, thank you, Matt. The question on incremental L&W -- just a couple comments on L&W. As we talked in previous calls we have really reinvented L&W with a focus on the seven core product areas. L&W is just -- they are not just a wallboard specialty dealer. Our seven core categories are very important.

And just a fact on that, if you look at the second quarter to the third quarter, the improvement that you saw in L&W almost two thirds of that improvement were non-wallboard products. So it's a focus on insulation, construction field, ceiling tile and grid, on exterior systems. So that is a really important component as we come out of this depression that we are in on the commercial side of the business. We are also continuing, as Matt said, is to focus on reducing overhead, both branch and corporate overhead at L&W and being extremely efficient there.

On the incrementals let me give you a little historical. The mid-cycle margins of L&W were around 5% with the peak around 9.5%. Without giving any real projections, we would expect once the commercial market starts getting some traction, and we are still probably 24 to 36 months away from any real traction on commercial, those are the historic margins we're looking at.

We have taken a lot of costs out of the system, L&W does not play up that much in the residential side, they don't play in the big-box retailing side. So really with 75% focused on commercial and commercial R&R, we still need some wind at our back from a demand standpoint. Just in your model you are thinking mid-cycle historic have been around 5%, peak has been about 9.5% and we have taken out more costs here as we go forward.

Stephen Kim - *Barclays Capital - Analyst*

That's really encouraging. Last question I had relates to your corporate expense. We saw the corporate expense move up this quarter. Was that due to the rebranding effort that happened this quarter? Again, is that a run rate -- should we be expecting a run rate lower than that going forward? If you could just give us a little bit of help there.

Matt Hilzinger - *USG Corp - EVP, CFO*

Stephen, its Matt Hilzinger again. It was a combination of a couple of things. It was a marketing expense and also some additional IT expense. We have been making a number of investments that are really focused on building customer connections. So we put in the new brand; that is part of it. We also updated and redid our website. If you take a look at our website and USG Answers for our customers. We have done some things IT wise that have added to SG&A, and then we have spent a little bit of additional marketing dollars. Jim referenced Mold Tough and broadening the UltraLight platform.

We also had some additional marketing expense on Securock for our roof board and our floor prep. There are things that we are growing the business, and we are making some incremental investments. Part of it is run rate, and part of it is one-time. Total expenses were up quarter-on-quarter about $5 million. I think it's too hard to go through and tell you what is exactly what is run rate and what is not. I think it really depends upon the growth opportunities that we have next year. But that is really what is driving it, things that are connected to really growing our customers' business.

Jim Metcalf - *USG Corp - Chairman, President and CEO*

Just to add on the IT, we have not invested in some of the IT and particularly the back office IT in six or seven years because of the recession we were in. Some of the IT expenses that Matt is talking about not only were important for our customers but we also had to do it from a back office standpoint. So we can continue to focus on lowering our break even. So on some IT expenses there will be an upfront IT expense but we feel there will be some lower cost going forward because of the efficiencies and not having as many hands touch paper.

If I could also just remind callers I really appreciate the interest, but we have quite a few folks in queue. So if we can keep it to one question. I know we have done great on a couple of the follow-ups, gentlemen, but I'm just looking at the board here and we are trying to get everyone we can. So if you could do that I would really appreciate it.

Operator

Michael Rehaut, JPMorgan.

Michael Rehaut - *JPMorgan Chase & Co. - Analyst*

Just wanted to get a little more clarity on the ceilings business if possible and the 2% decline in the USG Interiors. If that's -- if you have any sense in terms of which end markets were softer than others, and if you were to -- and some of that choppiness, if you would expect to continue. And before I get -- I just need a technical clarification if possible. The environmental charge in ceilings, if you could tell us if that was in the USG Interiors segment and similarly the ARO adjustment in North American Gypsum which line item that was in. Thanks.

Jim Metcalf - *USG Corp - Chairman, President and CEO*

Michael, I think that counts as two, but we will work that into one. Let me talk about the ceilings business, and then I will turn it over to Matt to talk about the environmental. Really, the ceilings business, it is demand. If you look at year-on-year, you have the environmental and some of the start up and you put that in year-on-year, we comped nicely.

If you look at quarter-on-quarter which I look at more the sequential, it is still very weak demand. Particularly if you look at our commodity tile which is more of our bread-and-butter tile might the units were up sequentially, but our higher-end higher-margin tile quarter-on-quarter was down. And that is primarily on opportunity, particularly office opportunity, but we are seeing education and governmental down. So those are really the key drivers.

If you look at the commercial business under the commercial segment, you go through -- retail is up, which is a fairly large footage segment. So as retail is up, you have education is down so basically counterbalances what retail is up. Office is only up single digits, and you go down and look at healthcare, healthcare is down probably low single digits, and government is down double digits.

So what we see is there is nothing inherent that we are concerned about. We're still just in a choppy commercial market. And if you look at just the building starts commercially with the lag, we are coming off of 2010 and 2011 with some pretty pathetic opportunity numbers. I don't think it is anything to be concerned about.

We are investing as I said in my prepared comments in Cloquet, and the reason we are investing in Cloquet is our high-end products we have been sold out. We have been running at capacity at the high end high-margin and we are investing in Cloquet to add some capacity and lower costs. So that investment we have looked at really carefully, and that gives us some confidence that we think the next couple of years is going to be very good for the ceilings business.

Matt Hilzinger - *USG Corp - EVP, CFO*

Jim, I'll provide a little clarity on the ARO and environmental. They are both in cost of goods sold. The ARO, I just remind everybody, our adjustment we made in the third quarter of this year was a credit. Last year we had a charge in the fourth quarter. If you go back and take a look and doing your models in the fourth quarter we had a charge last year. Hope that is helpful.

Operator

Mike Wood from Macquarie.

Mike Wood - *Macquarie Research Equities - Analyst*

In terms of L&W Supply how much of the profit improvement that you are seeing to date? And the ramp back up to the normalized profit levels will be dependent on fixed cost leverage versus the products spread that you get from changing that markup in different demand cycles?

Jim Metcalf - *USG Corp - Chairman, President and CEO*

That's a great question. It's going to take both. It's not only margin expansion as Matt said, L&W has been proactively getting margin improvement not only in wall board but their other products because of their value. They have a very specific customer segmentation program where they look at customers they can grow with and share a wallet. Along with that is lowering the fixed cost. Delivery costs are variable, so delivery costs is going to increase as your volume increases. But we are very focused, back to my previous comment, on IT. Is investing in some IT that we're doing here that a lot of the things we are doing at L&W will reduce their fixed cost. It is both of those, but along with that, it is really important that we start seeing some consistent demand on the commercial side.

It is a velocity business. And getting throughput from a standpoint of the commercial side is really important. Lowering your fixed, improving your spreads, and not just selling wallboard. The margins on those non- wallboard products are very consistent over the cycle, and are at nice levels. So it's really selling more than just wallboard, and then along with that is continuing to lower your break even. So each one of those components that are very important for that glidepath at L&W.

Matt Hilzinger - *USG Corp - EVP, CFO*

Jim, I would add to that, just a reference back to some of the leverage points we talked about. You may recall last quarter we talked about L&W sales. Back in 2008, they made about $1 million on $500 million of sales. There making about the same amount of money on $300 million of sales. That shows you the power of the leverage that that team has done in terms taking out costs and lowering their break even.

Mike Wood - *Macquarie Research Equities - Analyst*

Thank you.

Operator

[Philip Ming], Jefferies.

Phillip Ming - *Jefferies & Co. - Analyst*

How should we handicap the outlook for 2014 from a demand standpoint? It sounds like you're seeing a pickup in R&R, but you are a little cautious on new construction next year, not expecting much growth. Can you help us get a sense what top line will look like in '14?

Jim Metcalf - *USG Corp - Chairman, President and CEO*

If you look at overall demand, the R&R you are right is the most robust segment, and that positions us well because of our footprint in that with our customers there. Commercial, we are still low single digits. Still choppiness -- we are not optimistic, as I said, we really don't see anything commercially taking any type of traction until may be mid- next year if not later. However one handicaps that and we are around [900] for this year, slightly higher for next year. You're aren't looking -- I want to clarify historical has been 1.4 million, 1.5 million. We aren't anywhere near those numbers, so slightly better than 900,000.

And then repair and remodel we're looking at mid to high single digits. So there will be lift, there will be lift in demand which is good. This will be the third year and lift and demand. But just to put in perspective, the industry is going to ship approximately 20 billion to 21 billion feet this year. Even with an increase of next year which is good, capacity utilization is still in some areas still very low. And we have a lot of work to do from a demand standpoint. So we are still at historical low levels, but there is some wind at our backs. It is better than where we have been three years ago, so nothing real robust. It's going to be a slow glidepath. And quite frankly, that isn't bad because we don't have the big sharp peaks and troughs, and we think a U recovery is positive for us.

Phillip Ming - *Jefferies & Co. - Analyst*

Does that R&R pickup have a positive impact on margins or mix?

Jim Metcalf - *USG Corp - Chairman, President and CEO*

Depends what segment. Commercial R&R helps L&W and ceilings more where residential R&R will help US gypsum business. Got it, thanks guys.

Operator

Dan Oppenheim from Credit Suisse.

Dan Oppenheim - *Credit Suisse - Analyst*

Wondering if you can talk a little more in terms of the thoughts in JV knowing you won't be closing until the end of January. But as you think going forward, that certainly is a great way of using technology and then not putting too much capital and in terms of having the expansion there. Just thinking about further activity, do think this would be a way to expand into other geographies as well, or would that be done on the USG side or through the JV?

Jim Metcalf - *USG Corp - Chairman, President and CEO*

Thank you. What we're looking on the JV, as I said, we are very optimistic, but we have some work to do over the next 24 months. From a capital standpoint, we think the JV will be probably using about $50 million in capital to do this. It's not -- when you are looking at 24, 25 plants that is not a lot of capital. The markets that the JV will be operating in are the high-growth markets, you're looking at Thailand, Korea, Indonesia, Malaysia, Singapore, India, as I indicated earlier. And these are the strategic markets that the JV is going to be operating in. We aren't looking to move the JV into other areas. There's enough growth here.

And the adoption rates, we have 6.8 billion feet of capacity which the capacity in that area is running about 60% capacity utilization. We feel with our technology, we can put in some pretty minor adjustments and get some nice speed up if the line, which those incrementals really will follow to the bottom line.

But I think really, the interesting part of this JV is they have gone to market with basically just a plasterboard portfolio. We are now going to market with -- and plasterboard is what they referred to it in that part of the world. Now we are going to market with plaster board wallboard, ceiling tile and grid, joint compounds, Securock, Durock, the entire portfolio and we are bringing to the JV the way we go to market in North America.

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If you look at just our joint treatment market share is in North America compared to our wallboard market shares, in most markets our joint compound market share is in excess of where our wallboard share is. That is not the case in that part of the world. The joint compound opportunity is very, very exciting for us as well.

The next 36 months is going to be get our technology in, do the basic technology, put UltraLight in some key strategic markets, go to market as a full product provider. They have a very vast sales and marketing network right now. We are integrating that with our Asia-Pacific network. We have a great quarry in Oman. That is going to help lower costs, and that investment we made in Oman last year is a really key strategic part of this joint venture.

So we are very excited. We have a lot of work to do, but if you look in the next five years, the adoption rate of plasterboard is growing. Outside of India and China, there are 500 million people in that region, and high-rise construction is very important. And Western construction practices are very prevalent. So with the USG brand and our background in technology really help the footprint of Boral, and they are a fine Company. They are a name brand in Australia, and they -- this is a wonderful partnership that we are extremely excited about, and I believe it is going to reap benefits for our shareholders as we get into the future.

Dan Oppenheim - *Credit Suisse - Analyst*

Thank you.

Matt Hilzinger - *USG Corp - EVP, CFO*

If I could add a couple of things. On the $50 million of capital we do expect the JV to be self funding, and we expect it to be cash flow positive over the planning horizon as well. So net-net we feel very good about what that is going to do for us both from a cash flow standpoint and a P&L standpoint.

The other thing Jim touched on which I think is important for everybody to note is dampening our cyclicality. We've done some analysis, we did a ton of analysis before we did the deal around that and if you look back historically over the last ten years and you take BGA which is their Asian operation, and match it with ours over the last ten years, it dampens the volatility of our earnings by up to 15%. I would say 10% to 15%. That's pretty powerful when you think about what it's really doing for us. So I think there is more opportunities as Jim said when you grow the business, have even a greater impact so we're really happy on those two fronts as well.

Operator

Kathryn Thompson from Thompson research.

Unidentified Participant - *Thompson Research Group - Analyst*

Good morning this is [Wenjun] sitting in for Kathryn. One question on the nonresident market. Our nonres industry context have reported tangible improvement in volumes this late summer. Knowing that L&W greater non-res focus, could you give more granularity on end market trends that you see through your distribution business? You mentioned that government and education sector remains weak. But if you could give more information on other nonresidential segment you have seen as working and not working today versus 9 to 12 months ago. Thank you.

Jim Metcalf - *USG Corp - Chairman, President and CEO*

Sure. If you break the nonres down, the numbers that we are looking at, retail, the retail segment which is a fairly substantial segment of nonres, is projected to be up double digits, 10% to 15%. Office is 6%, so positive there. Hotel, which is a smaller segment, it's about half the size of the office segment, it's projected to be 10% to 15%. Education, which is about the size of retail, is down mid-single digits. So that's dampening the retail improvement. Healthcare is about half the size of education from an opportunity standpoint. That is down mid-single digits, and then government is the biggest downdraft which is down pretty solid double digits, anywhere from 15% to 25%.

But what we are also seeing just from a overall macro standpoint, construction payrolls increased in September by 4%, which was the strongest month of total construction payroll since February of this year. But if you break that down into nonresidential, of the construction payrolls, commercial construction payrolls were up almost 10%, which was the best increase of construction payrolls in commercial since December of 2007. So as we step back from this segment, there is some good news here, and there is some downdrafts here.

So that's why we continue the comment, maybe you're tired of the comment, we keep saying it is choppy. But we feel it is going to be choppy with some good news in the segment, but there are some forward-looking green shoots as I said earlier. What you have to think about in our business, whatever positive you see in the commercial business, it is still a 12 to 18 month lag. I think it's really important that any numbers that you look on nonresident for USG, you have to lag those numbers 12 to 18 months. I hope that helps.

Unidentified Participant - *Thompson Research Group - Analyst*

Have you seen

Jim Metcalf - *USG Corp - Chairman, President and CEO*

I don't mean to interrupt, but we still have quite a few in queue, there's a lot of interest today which is wonderful so I'm going to ask if we are going to have a follow-up with Ken Banas from Investor Relations, and he would be more than happy to follow-up with him afterwards.

Unidentified Participant - *Thompson Research Group - Analyst*

Sure, thank you.

Operator

Garik Shmois from Longbow Research.

Garik Shmois - *Longbow Research - Analyst*

Thanks and congrats on the progress this quarter. Just wondering Jim, previously indicated your attention to raise wallboard prices in 2014, but now that you are starting to see a little bit of slowing in the growth in new residential construction, how does that impact your ability to go to market with price increases? Has it changed your confidence at all in being able to raise price next year?

Jim Metcalf - *USG Corp - Chairman, President and CEO*

When we look at the total opportunity for next year, we still think the overall wallboard opportunity is going to be increased over 2013. It's not going to be big increases, so there is going to continue to be opportunity increases. Also we are projecting our capacity utilization is going to improve. If you look at our capacity utilization, we are running just below 60%. And that compares to the third quarter of 2012, we were running at 50% and you go back to 2011, we were at 43%.

We are very optimistic. We feel that our pricing strategy for our customers has worked. We intend, and we're having conversations with their customers on 2014 now. And we're going to have one price for 2014. We're not going to have job quotes. And we are having specific conversations with our customers probably in the next month. And we are still optimistic on the 2014 price improvement.

To answer your question in the short, no, we have not changed our strategy. In fact, the strategy is working, and the reason I say that is you can see it in the results, but more importantly, our customers like our strategy. It is easier for them, it takes a lot of paperwork cost out for them, and they can log their number in at the beginning of the year, and they know that's what it is for the year. We are optimistic about 2014.

Ken Banas - *USG Corp - Senior Director of IR*

We have time for one additional question.

Operator

Dennis McGill from Zelman and Associates.

Dennis McGill - *Zelman & Associates - Analyst*

Matt, can you -- not really on the joint venture, but once the joint venture closes, can you talk about how you will operate the capital structure at the corporate level on a go forward basis? What the priorities will be, how cash flow will be allocated, what you think other opportunities would be from a strategic standpoint, et cetera?

Matt Hilzinger - *USG Corp - EVP, CFO*

Yes, happy to. First it will be accounted for as an equity investment. It will not be consolidated on our balance sheet. When we look at the joint venture, we're targeting 50% distribution in terms of dividends. We have the ability to bring back that capital to the US if we want, but I think what we are really thinking about is we want to grow that business. And I think a lot of that capital will end up staying in the joint venture, at least initially as we continue to grow the business.

From an overall corporate capital strategy standpoint, the long-term debt will be held at the parent company. And for the most part it will be serviced through cash flows of worldwide ceilings, L&W and principally North American Gypsum.

When we have talked in the past about the importance of delevering the balance sheet, that is a huge goal of ours. And as we look out in the future, we don't see any issues in terms of our ability to delever the balance sheet as we have discussed before. That is going to continue to be a main objective of ours, and we are just so excited about having this joint venture. These doings don't come along very often and it was something we felt was very important and so we found a way to make it work. We are really happy.

Dennis McGill - *Zelman & Associates - Analyst*

I've a follow-up but I will do it offline. Thanks.

Jim Metcalf - *USG Corp - Chairman, President and CEO*

Thank you, Dennis. Thank you for all your interest and questions and I apologize we did not get through the entire Q. There is a tremendous amount of interest today. Obviously, this is an extremely exciting time for USG. We have been through quite a few of these calls, and we always said we wanted to get to the other side of the small d depression, and we wanted to get here stronger. And we are continuing to take steps towards delivering on our plan and generating net income which we are delivering now and positive EPS for the third consecutive quarter. I couldn't be more pleased to deliver that news to you.

We believe we have been a more resilient and agile company, as Matt said this opportunity came along a year or so ago. We worked really hard and really balanced our strategy with our balance sheet and looking ahead and I always said, what is the Company going to look like in the next trough? We now feel we are very well-positioned to grow our business. Where going to invest by keeping an eye on lowering our breakeven, but we are going to grow our business not only in North America, but now we can do it internationally as we work to maximize all of our shareholders' value.

I would like to thank you for joining us today and your interest in USG. And we look forward to giving you an update on the business next quarter.

Ken Banas - *USG Corp - Senior Director of IR*

Thanks Jim. A taped replay of this call will be available until Friday, November 8. Information is available on www.USG.com. This concludes our conference call. Thank you and have a great day.

Operator

Thank you, ladies and gentlemen. This concludes today's USG Corporation third quarter 2013 earnings conference call. Thank you for participating.
