

We go the distance
to provide **The Better Way.**
Delivering building solutions
for customers worldwide
is our goal. Relationships are
our foundation. Integrity,
dependability and innovation
are the standards by which
we live.



William C. Foote CHAIRMAN AND CHIEF EXECUTIVE OFFICER, USG CORPORATION, CHICAGO, ILLINOIS

USG Corporation has come a long way in the past five years—from financial crisis to record performance and growth. We have pursued a focused strategy designed to increase sales and earnings in USG's core gypsum, ceilings and distribution businesses and to position the corporation solidly for the future. These are businesses at which we excel and where we can continue to create wealth.

Because the organization and its goals have changed over the past several years, we spent a good deal of time in 1998 creating a new mission statement to guide us. This was a process in which every employee had an opportunity to participate. The result, I believe, precisely describes who we are and where we are going. For that reason, we are presenting our new mission statement to you as the theme of this report.

What is The Better Way? The statement says that USG goes the distance to provide the better way. But what is the better way? It is the concept that underlies all our dealings with our customers, their customers—the people who use our products, our shareholders, our co-workers and the communities in which we do business. It means that the people of USG innovate daily. We continuously seek to improve the corporation and its products, processes, systems and services, to solve customers' problems and increase shareholder value. In that search, we go the distance, the extra mile, to build long-term relationships with customers, employees, communities and investors. We have gone the distance to return USG to financial health and will go the distance to further build shareholder wealth.

What is USG's strategy for growth? Our plan is to invest in the core businesses in ways that will create value over the long term. In implementing our growth strategy, we are:

- introducing new products and product platforms
- improving service
- strengthening our brands
- adding capacity to serve growing customers and markets
- renovating manufacturing capacity to make USG the undisputed low-cost producer
- and expanding distribution

To these ends, USG has invested more than \$800 million in its core businesses since May 1993, when the corporation completed its financial restructuring.

To increase sales and meet customers' changing needs, we have introduced innovative gypsum and ceilings products with excellent growth potential. In 1998, we brought to market an entirely new product platform for USG: FIBEROCK brand gypsum fiber panels. To improve service, we have invested in information technology for the USG Customer Service Center and our sales force. To strengthen our name recognition in the marketplace, we are conducting extensive advertising and promotion for USG's SHEETROCK brand.

We have made significant progress in our program to add and renovate manufacturing capacity. In 1998, USG completed the modernization and expansion of its U.S. ceiling tile production facilities and announced the final pieces of its wallboard manufacturing plan: a new plant in Oregon and a new line in southern California. When fully operational in late 2000, these and the three other wallboard facilities under construction, together with other cost-reduction initiatives, will ensure that USG is the undisputed low-cost deliverer of wallboard in the United States and that we are able to supply our rapidly growing customers. We also have expanded manufacturing capabilities in other product lines such as joint compound and ceiling grid.

To profitably grow the distribution business, we have added a net 54 locations in the past five years and significantly increased our presence in the acoustical ceilings market.

What have been the results of implementing this strategy? Investment in the core businesses has supported dramatically improved operating performance. Aided by solid market fundamentals, this performance has produced increases in net sales and earnings in each of the past six years and enabled USG to achieve record profitability in 1998.

For 1998, net sales totaled \$3.1 billion, up 9 percent from 1997. Net earnings were \$332 million, an increase of 124 percent over 1997's earnings of \$148 million. Diluted earnings per share for 1998 were \$6.61, an increase of 118 percent from 1997's \$3.03. (1997 earnings and diluted earnings per share were reduced by \$127 million and \$2.60, respectively, because of charges resulting from an amortization related to USG's 1993 financial restructuring. These charges concluded in the third quarter of 1997.)

Within the core businesses, United States Gypsum Company set a record for shipments of SHEETROCK brand gypsum wallboard of 8.8 billion square feet. U.S. Gypsum also reported record shipments of SHEETROCK brand joint compound and DUROCK brand cement board. The company's average realized price for gypsum wallboard was \$129.50 per thousand square feet vs. \$122.65 in 1997. In addition, its average manufacturing costs were the lowest since the early 1990s as a result of greater efficiency and lower raw materials costs.

USG's worldwide ceilings business shipped record quantities of ceiling tile and DONN brand suspension grid. L&W Supply Corporation, our distribution business, set records for shipments of gypsum wallboard and sales of complementary building products such as drywall steel and acoustical ceilings.

In addition, USG has reduced its debt nearly \$1 billion since May 1993 and has achieved its goal of an investment-grade rating from both Standard & Poor's (December 1997) and Moody's (March 1998).

How are conditions in domestic and international construction markets affecting USG's business?

What is the outlook for the future? Conditions in all segments of the U.S. construction industry have been quite good over the past several years and are likely to remain solid in 1999.

The repair and remodel market is the fastest growing segment for USG and accounts for the second-largest portion of our sales. Opportunity from residential repair and remodel activity increased approximately 7 percent in 1998. Sales of existing homes hit a record 4.8 million units, driven in large part by strong sales of new houses. Because many buyers remodel an existing home within 18 months of purchase, the residential repair and remodel market should be healthy over the next several years. Additionally, the building stock in the United States—both homes and nonresidential structures—is growing and aging. Approximately 25 percent of current homes in the United States were built before World War II, and another 25 percent were built during the 1950s and 1960s. More older buildings mean more remodeling.

U.S. housing starts for 1998 were an estimated 1.616 million, an increase of 10 percent over 1997 and the highest level in more than a decade. Although it is believed that new residential construction may not maintain this level in 1999, housing starts are expected to approximate the healthy pace of the past several years.

Sales of USG products to the nonresidential market increased significantly in 1998 and are expected to remain strong in 1999. Future demand for our products from new nonresidential construction is gauged by floor space for which contracts are signed. Installation of gypsum and ceilings products follows signing of the construction contract by about a year. Floor space for which contracts were signed rose 10 percent in 1997 and increased 5 percent in 1998, although segments that are most relevant to our business, such as offices, stores, hotels and motels, grew at a much higher rate.

The international picture is clouded by economic problems in Asia and Russia. However, USG's exposure to these markets is small. Most of our sales outside the U.S. come from Canada, Western Europe and Latin America. Conditions in Canadian construction are expected to be positive in 1999, as is the outlook for Western Europe and Latin America, despite some economic uncertainties.

In summary, we expect USG's construction markets to be healthy in 1999. We remain sensitive to changes in the economic outlook and are well-positioned to respond, given our strategy and renewed financial strength.

Why is USG adding wallboard capacity at this time? First, USG's wallboard capacity has been sold out for the past two years. Our branding initiatives and strong customer relationships, supported by vigorous construction markets, have succeeded in increasing demand for our products. This has led to capacity constraints, which are putting pressure on our ability to meet customers' requirements. Also, many of our customers, particularly retailers and specialty dealers selling to the repair and remodel market, are growing rapidly. We must grow with them.

Second, USG is investing in manufacturing renovation to ensure that its capacity is the most efficient in its industry. This will help us maintain solid profitability in all kinds of market conditions and meet our goal of doubling our past trough EBITDA of \$159 million in the next downturn. (EBITDA is earnings before interest, taxes, depreciation, depletion, amortization and other items.)

Finally, we do not foresee a construction recession in the near term. As long as the U.S. economy is healthy, demand for our products should be healthy, too. While new construction, both residential and nonresidential, will soften sometime in the future from the current high levels, we do not think it will drop precipitously because our markets are underpinned by solid fundamentals. Population trends favor long-term increases in construction, and there has not been the overbuilding that marked the last cycle. Also, growth in the repair and remodel market should mitigate any fluctuation in demand from other construction segments. In any case, USG is prepared to adapt as conditions vary.

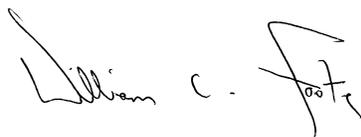
How is USG's strategy providing value to shareholders? The first part of the strategy is to invest to create future earnings growth. As USG proves its ability to produce solid earnings through all types of economic conditions, we believe the stock price will come to more accurately reflect USG's underlying value.

The second part is to offer more-immediate returns to shareholders through dividends and share repurchases. In December 1998, USG paid its first quarterly dividend in 10 years. We have also initiated a share repurchase plan that calls for buying back about 10 percent of current shares outstanding over the next several years. By the end of 1998, the corporation had repurchased 225,000 shares under this program. We believe the total plan offers a beneficial mix of short-term and long-term returns.

In conclusion, USG is on track for sustained, profitable growth and wealth creation. We are pursuing our mission by going the distance to provide solutions, build relationships and deliver value. We are looking for the better way at every turn—the better way to serve customers, build buildings, position our products and companies, and increase value for our shareholders.

I would like to thank our many constituents for their support: our customers for their business; our employees for their efforts and ideas; our directors for their counsel; and you, our shareholders, for your continuing faith in USG's ability to achieve its goals. I look forward with enthusiasm and confidence to this organization's future.

Sincerely,

A handwritten signature in black ink that reads "William C. Foote". The signature is written in a cursive style with a large, stylized "F" at the end.

William C. Foote
Chairman and Chief Executive Officer

February 10, 1999