

## Dear Fellow Shareholders

In a year that brought success, new challenges and continued uncertainty, we held a steady course.

We performed well. Our long-term strategies of introducing new products, investing in new low-cost manufacturing and expanding our distribution business provided the tools we needed to meet strong demand for our products. For the first time ever, our sales topped \$4 billion. And while our businesses faced high costs for many of the commodities used in their production, increased efficiency, tight spending controls, prudent energy hedging programs and selective price adjustments helped them meet the challenge.

Our results improved across the board. U.S. Gypsum shipped a record 11 billion square feet of wallboard, up 6 percent from 2003, at an average price of more than \$122 per thousand square feet. It also shipped record volumes of joint compound, cement board products and gypsum fiber products. L&W, our distribution company, achieved double-digit percentage gains in both sales and profit. USG Interiors, our ceilings company, also increased profits, even though the commercial market remained in a slump. USG's sales grew to a record \$4.5 billion, \$843 million more than we reported in 2003. Net earnings for the year were \$312 million, or \$7.26 per diluted share, more than double the \$122 million, or \$2.82 per diluted share reported in 2003.

USG achieved record sales of \$4.5 billion in 2004; sales and operating profit in all units exceeded 2003 results.

## Meeting the Challenge of Chapter 11

By virtually every key measure, our businesses are running well. Our growth strategies are succeeding. We're continuing to build the value of our enterprise. And we continue to face the uncertainties of our Chapter 11 restructuring.

When we entered Chapter 11 in mid-2001, it had nothing to do with our performance. We did it only to protect our assets, to stop paying the asbestos costs of other companies and to put the asbestos issue behind us, once and for all. Even though we never mined, made or sold raw asbestos, even though we never used it in our wallboard and even though we stopped using it

entirely more than a generation ago, asbestos claims spawned by a broken tort system threatened to destroy our shareholders' equity. Chapter 11 was the only way to protect their interests – and the interests of our suppliers, lenders and employees.

We're working to bring sanity to asbestos litigation in the bankruptcy court and in Congress. And as in everything we do, we've strived to find a better way. As our operations team has continued to serve our customers and build our enterprise, our restructuring team has worked to do what's right for our suppliers and other creditors, for shareholders and for those who truly have been harmed by our products.

### In the Courtroom

In the courtroom, we have advocated the same principles from the very beginning. We maintain that people who are not sick should not receive any payment, that people who were not harmed by our products should not receive compensation from USG and that the amount we pay for asbestos claims should take United States Gypsum Company's limited involvement with asbestos into account. While this approach is fair and rational, no large asbestos-related bankruptcy has been settled on such terms.

In 2004, we continued to seek an equitable resolution. We entered into mediation with the asbestos claimants, but failed to reach a settlement. We continue to disagree over how much we owe asbestos claimants. They continue to seek complete ownership of our entire enterprise. We continue to seek a solution that will fairly compensate the people who were harmed by our products, repay our creditors in full and allow shareholders to retain some portion of their ownership.

Asbestos litigation is not just our concern. It is a national crisis that hurts asbestos victims, costs workers their jobs and retirement funds, and weighs on the economy as a whole. The courts are clogged with tens of thousands of claims brought by individuals with no asbestos-related impairment, while those who are truly sick often wait years to receive a fraction of their claims.

More than 70 companies have now been forced into Chapter 11 at a cost of more than 60,000 jobs, \$200 million in lost wages and, often, devastated 401(k) and pension plans. And if asbestos lawsuits are left in the tort system, there is no end in sight.

## In Congress

Virtually everyone agrees that the current asbestos litigation system is hopelessly broken. For that reason, we have long supported efforts to find a legislative solution to the issue – a solution that has also been called for by both the Supreme Court and the President of the United States.

We actively supported legislation, known as the FAIR Act, which would establish a government-administered but privately funded victims' compensation fund that would end asbestos litigation in courts, pay fair settlements to people harmed by asbestos and reduce transaction costs and delays. Although approved by the Senate Judiciary Committee, the legislation was never put to a vote by the full Senate.

Now, in the new Congress, there is renewed hope. If the FAIR Act is approved, the most important issues in our bankruptcy would likely be resolved. We could pay our fair share to the fund and get on with our business.

But we still have a long way to go. There is no guarantee that asbestos legislation will be enacted, or what its final form might be. And while we'd welcome the opportunity to negotiate a just settlement – and avoid a lengthy battle in court – we will not simply surrender the company. In light of these circumstances, it is impossible to tell when or how we will emerge from Chapter 11, and the risks for our shareholders remain great. Once again, I must warn you that your investment in USG could be substantially diluted or even wiped out.

## Steering a Steady Course

Our future is uncertain, but not our actions or our strategies. We know what we must do and where we must go. The points of our compass – our values – haven't changed. Neither has the course we've set. We'll keep moving ahead.

On balance, we expect favorable conditions in our markets. Costs – and interest rates – are likely to continue to rise, which could slow home purchases. But the outlook for 2005 remains positive. Even with a slight moderation in demand, the new housing and residential remodeling markets are likely to remain strong. While office vacancy rates remain at high levels, the commercial construction market is beginning to show signs of improvement. And long-term

“Congress needs to pass meaningful class action and asbestos legal reform this year.” President George Bush, February 2005

The Brookings Institution estimates that the number of new residential housing units needed in the U.S. from 2000-2030 will exceed 59 million units. (*Toward a New Metropolis: The Opportunity to Rebuild America*, the Brookings Institution, December 2004.)

demographics are on our side, as the children of baby boomers enter their prime years for buying a home and the demand for new development continues to grow. In fact, the Brookings Institution predicts that more than 100 billion square feet of new residential space will be needed over the next 25 years – more than the development seen in any other generation.

We intend to lead this growth. Leadership is our tradition and our objective. We'll remain the leader by focusing on customer service and operational excellence.

### Serving Customers

We've always taken good care of customers, and it's helped us earn a place in the Fortune magazine Hall of Fame, which honors companies that remain in the Fortune 500 for 50 consecutive years. Today, our commitment is as strong as ever. Market research shows that our businesses are leaders in service, and their customers agree. We're pleased to report that in 2004 we received vendor of the year awards from two of our largest customers, with one of them giving us the award for the sixth time in seven years.

United States Gypsum Company received prestigious vendor awards from two major customers in 2004.

Such strong relationships begin with products that meet our customers' needs, and Chapter 11 hasn't slowed the pace of our innovations. In the past several years, our businesses have introduced a number of award-winning products, including GEOMETRIX metal ceiling panels and the TOPO 3-Dimensional ceiling system. FIBEROCK brand underlayment provides a new, environmentally friendly replacement for wood-based underlayment. New SHEETROCK brand HUMITEK gypsum panels and FIBEROCK brand AQUA-TOUGH interior panels respond to concerns about moisture and mold. TUFF-HIDE, a new primer-surfacer, helps contractors complete projects more quickly with superior results.

In 2004, we earned more than 60 U.S. and foreign patents – a significant achievement for a company in an industry like ours. More are on the way. In 2005, we plan to launch a number of other new products that will help expand our share of the house and round out our product lines.

Along with offering more to customers, we'll be even easier to do business with. We're now halfway through the implementation of a new enterprise-wide software system, called LINX, that will connect every aspect of our operations, reduce costs for USG and our customers and provide us with better information. At our customer service center, which fields as many as 70,000 calls per month, new training and quality programs are helping provide "one and done" service – allowing customers to get answers to their questions, track deliveries and place orders with a single call, every time. The improvements will continue – our business plans include measurable customer satisfaction goals.

### Investing for Leadership

Our commitment to outstanding customer service is matched by our commitment to operational excellence.

In 2004, our gypsum business once again combined the highest utilization rates in the industry with the lowest production costs. Its position as the high-volume, low-cost producer is a key strength that enables U.S. Gypsum to outperform competitors in good times and bad. We have achieved a leadership position by continually investing in our operations. Since we entered into Chapter 11 in 2001, we have invested more than \$300 million to maintain the most productive and profitable operations in the industry. Improvements have included a DUROCK cement board line in Baltimore, which is already meeting strong demand and a new joint compound plant in Phoenix. Our distribution business has continued to build its distribution channels. The acquisitions L&W made expanded our presence in several markets.

We continue to invest in the businesses today. The expansions begun in 2004 at United States Gypsum Company's Aliquippa, Pennsylvania, and Jacksonville, Florida, facilities will add more than 100 million square feet of new, low-cost wallboard production capacity. We also began a project that will almost triple production capacity at Norfolk, Virginia, investing more than \$130 million to modernize a facility that began operations in 1948. Other projects include

L&W Supply had record sales of \$1.7 billion and operating profit of \$103 million, the second highest level in its history.

Wallboard manufacturing speeds in 2004 were the fastest in U.S. Gypsum Company's history, and are now more than 40 percent faster than five years ago.

expansion of joint treatment plants, and in Monterrey, Mexico, construction of the first DUROCK production line outside the United States. Upgrades to the Bridgeport, Alabama, facility will create the fastest wallboard line in the world, capable of producing more than a mile of drywall in less than 10 minutes.

Building low-cost production is part of a broader, enterprise-wide commitment to reducing costs in all of our businesses. In the past several years, we made good progress. We successfully united our wallboard and ceilings sales and marketing operations and rationalized our international business. We launched new strategic sourcing programs that made our supply chain more efficient. We developed new programs to help keep a lid on energy and benefit costs.

Today, we're doing even more. We are intensifying our efforts to reduce downtime and waste, and as additional low-cost production comes on line in the gypsum business, we will close higher-cost lines. We're continuing to push for structural cost reductions that will not just lower, but eliminate, costs. Our research and development staff is exploring breakthrough technologies that have the potential to revolutionize wallboard production.

The actions we have taken to build our businesses and our entire enterprise will help us succeed at every point of the economic cycle and put us in the strongest possible position when we emerge from Chapter 11. We will keep pushing for a fair resolution to asbestos litigation and are hopeful that our bankruptcy case will move forward at a faster pace. We'll also continue to play an active role in developing and passing asbestos legislation. It is the right thing for our company and right for the country, too.

### Working Together

We're doing more for our customers than ever before. We're keeping faith with our stakeholders. We've remained a great place to work – with an outstanding safety record. We're preparing for the future.

USG's businesses achieved higher gross margins in every product category in 2004.

Overall safety performance for the manufacturing groups was the second best in the company's 103-year history.

No company that has performed as well as we have, that has kept its promises, should ever be forced into bankruptcy court. Yet as I've said before, you can learn something from Chapter 11. One of the lessons we have learned is the true value of loyalty. Over the past three years, many of our shareholders and virtually all of our customers, suppliers and lenders have stayed in our corner and helped to keep us in the fight. We prize their confidence and continued support, and we will work to maintain their trust.

Most of all, I am reminded, once again, that USG's greatest strength is its people. From the board line to the board room, the challenges and uncertainties of the past few years have tested the people of USG as few other things could. They have responded with hard work, perseverance and genuine teamwork. Their commitment to our company, their ability to turn change into growth, has kept this an exciting, vibrant place to work, and has made us stronger. More than ever – Chapter 11 or not – I am proud of the enterprise that I am privileged to lead. Together, we'll continue to move forward.

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, CEO and President

February 24, 2005

All of USG's international businesses achieved increases in net sales and operating profit in 2004, compared to 2003.