

Tkr: NYSE: USG	P/E ('07) 12.7
Market Cap: \$4.6 Bn	Est. FY 2007 EPS: \$4.05
ROE ('07): 14%	Beta: N/A
EBIT ROIC : 28%	Revenue 2006: \$5.8 Billion

The bankruptcy and asbestos litigation are actually a positive for USG. Emerging from bankruptcy all asbestos liability is shifted from USG to a special asbestos trust, freeing USG from dealing with the burden of asbestos litigation. USG recently contributed \$3 billion to the trust, completing their obligation. The plan leaves USG with \$1.4 billion in total debt.

With the specter of a declining housing market and coming off recent bankruptcy and asbestos litigation settlements, USG offers the opportunity to buy a high quality company with leading market share and an extremely well respected management team at a very low price.

Margins

During 2006 USG earned an operating margin of 16.2% and ROE of 20%.¹ I expect the company to earn an operating margin of 13% and ROE of 14% during a difficult 2007.

Main Drivers

- USG has generated strong operating margins, earnings and cash flow, even through the recent bankruptcy, which was driven by asbestos liability, not poor business operation. USG has a dominant market share in gypsum wallboard, improving operations, and a top notch management team
- The key to understanding the value of USG is the fact that contributions to their \$3.9 billion asbestos trust qualify as operating cash flows and distort OCF and EPS for both 2005 and 2006.
- Using conservative estimates, USG trades at a substantial discount to its intrinsic value of \$61 per share, implying a margin of safety of 18% at \$51.40.

Since the fourth quarter of 2006 capacity utilization has declined as new home construction has fallen. In response USG has shut down 2 billion sq. ft. of less efficient capacity, including the permanent closure of 400 million sq. ft... USG management has stated that they believe that while demand will decline in 2007 their competitors remain rational and are implementing similar measures to limit over capacity.

Company Summary

USG is the largest producer of gypsum wallboard in the US, manufacturing 10.8 billion square feet of wallboard under the Sheetrock and Fiberock brand name. USG makes a range of products including mold resistant wallboard and low dust products. USG's gypsum wallboard division generated \$3.6 billion of revenue and \$792 million of operating income in 2006.

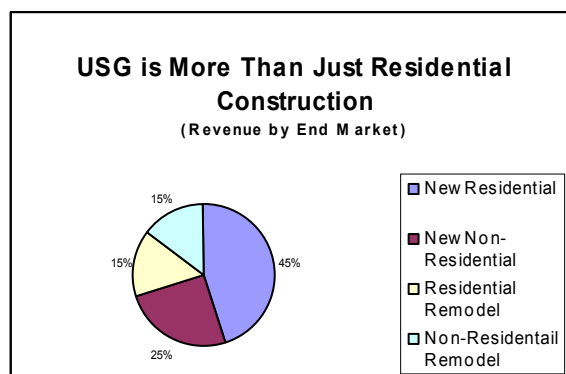
USG is currently investing to upgrade or replacing four of their older production lines with more energy efficient lines. Approximately half of USG's production lines are high speed lines with modern dryers. Natural gas comprises 20% of the cost of wallboard and modern dryers use half as much natural gas as older dryers. Once capex is complete 70% of USG's lines will use high speed, modern equipment. While margins will face pressure as volumes decline, efficiency improvements should create significant cost improvements, helping to stabilize USG's operating margins.

USG also manufactures ceiling materials, and distributes building materials through its L&W Supply subsidiary. During 2006 L&W generated \$203 million of operating profit and the Worldwide Ceilings division generated \$77 million.

Valuation

Investor fear of a sharp downturn in residential construction coupled with financial statements distorted by the recent asbestos settlement have made USG shares cheap, trading at a 2007 EV/EBITDA multiple of only 6.67 and a trough forward P/E ratio of 12.7.

Using conservative assumptions including the loss of 20% of wallboard revenue due to housing decline, operating margins below USG's historical margins, high ongoing capex and the assumption of tepid revenue growth following the housing decline, the DCF estimated intrinsic value of USG shares is \$61, 18% above the current price of \$51.40.



Peer companies trade at an average of approximately 8x 2007 EBITDA² vs. USG at 6.7x 2007 EBITDA. Similar companies have recently been acquired at prices ranging from 7.7 to 9.8 times EBITDA, the revaluation to a peer group multiple alone could generate a gain of 15%.

Management

Warren Buffett, who owns 19% of the company, called CEO William Foote's performance "the most successful management performance in bankruptcy I've ever seen." During bankruptcy, management preserved the rights of existing shareholders as well as paying all pre-bankruptcy debts.

Risks:

USG primarily sells undifferentiated products, if wallboard supply should grow faster than demand, USG's primary product would be open to price competition.

A more serious or prolonged decline in new housing starts could further negatively impact wallboard margins and volume.

¹ Adjusted to eliminate one time items.

² Jefferies and Company, December 27, 2006