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ODP.OQ - Q1 2002 Office Depot Earnings Conference Call

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OVERVIEW:

1Q02 operating income up 69% to $163.9m. EPS up 68% to $0.32. BSG operating profit 9.9% -- best in company's history. Expect to grow FY02 earnings in 30% range, depending on growth in North America. Fifth consecutive quarter of improving North America retail. Q&A focus: earnings growth potential, business segments comps, global economy softening and its impacts.

CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

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PRESENTATION

Operator

Good morning. We would like to welcome you to Office Depot's first quarter 2002 earnings conference call.

All lines have been a listen-only mode until after today's presentation, at which point instructions will be given in order to ask a question. At the request of Office Depot, today's conference is being recorded. I would like to introduce Miss Eileen Dunn, Vice President of Investor Relations and Public Relations, who will make a few opening comments. Miss Dunn, you may begin.

Eileen Dunn - *Office Depot, Inc. - Vice President of Investor Relations and Public Relations*

Good morning everyone, and thanks for joining us for today's first quarter2002 earnings call.

Before we begin today's presentation, I'd like to remind you that except for historical data, comments on this call should be considered forward-looking within the meaning of the Private Securities Litigation Reform Act. Forward-looking statements, including projections as to revenues or earnings, and other statements related to expected future performance by Office Depot may involve risks and uncertainties which may cause actual results to differ materially from those discussed on this conference call. Please refer to our filings with the SEC for further information.

Now I'd like to turn today's call over to Office Depot's Chairman, and CEO, Bruce Nelson.

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

Thanks Eileen, and good morning to all of you who have joined us.

For our international colleagues who are listening, good afternoon to you as well. Some highlights as you've seen in our release this morning, our first quarter operating income rose 69 percent, to 163.9 million. EPS increased 68 percent to 32 cents, compared to 19 cents in the first quarter of 2001. Cash reached $845 million, on track now to generate $350 million of free cash flow this year. Our inventory turns overall improved to seven for the trailing 12 months.

Our DSO and our contract business hit record lows in the first quarter. Worldwide e-commerce sales reached 488 million, on track to achieve $2 billion in 2002. We had strong operating results across all of our business segments. We added two new executives to our key management leadership team, a new CIO Patty Morrison, and a new CMO, Jocelyn Carter-Miller. We remain comfortable with our 2002 EPS growth target of 30 plus percent.

On a consolidated sales basis, total first quarter revenue increased one percent, comparable worldwide sales declined one percent in the quarter. Our company-wide customer complaints dropped by 35 percent in the first quarter, our customer service indexes across all of our business segments increased. We did experience some softness in our European catalog operations, which I'll comment on when I get to international, and we continue to face strong U.S. dollar currency translation, which has the impact of impacting negatively our reported international sales and operating profits.

On the comparable sales basis, retail comp sales were negative 1.7 percent for the first quarter, representing the fifth consecutive quarter of improving North America retail comp sales trends. The decline was still driven by a decline in hardware sales, with desktop and laptop computers comps dropping 18 percent, and overall technology sales were down 13 percent. Comp sales decreased 2.26 percent in our business services group during the first quarter of 2001, an improvement of negative 4 percent, in a similar period in the fourth quarter last year. Comp sales were somewhat soft across all customer size segments in BSG, excluding our e-commerce sales. These soft sales largely reflect the economic slowdown in medium and large contract accounts in the West in particular, and portions of the Central region. We continue to experience solid growth in the North and Southeast regions of the U.S. in our BSG business.

International comparative sales were, grew four percent in local currencies in the first quarter. The strongest performance were in the Netherlands, Germany, Austria and Italy, with particular softness in the U.K., France and Japan. As we mentioned in our release this morning, we now anticipate some slowing of our historical high comp growth rates in our European catalog operations for the next few quarters, as a result of softer European economies, but somewhat offset by strong sales growth in France retail, and in the four countries where we have launched our new Office Depot Business Services Group.

Our consolidated operating profit basis, as I said earlier, operating profit rose 69 percent to 164 million, from 97 million in 2001. Our North America retail operating profit achieved 7.6 percent, versus 4.3 percent in quarter one last year, and 6.2 percent -- 6.02 percent in quarter four. Our BSG group had its best ever quarter with Office Depot, with operating profit achieved at 9.9 percent of sales, in spite of negative comps.

International division operating profit was almost 14 percent, versus 14.83 percent a year ago, despite softer catalog sales performance. Gross margin improvement more than offset our comparable sales softness. The biggest impact was in our North American retail business, where last year in the first quarter we had SKU rationalization. I'll comment more on that in the retail section.

Lower levels of technology sales in North America retail also translate to a higher margin mix. We have for some time now, had more rational promotional activity, and we continue our intense focus on large contract account profitability. The key drivers of the operating profit expansion the first quarter, in addition to the gross margin increases, were that our BSG selling and operating costs improved by 224 basis points in the first quarter. As I said earlier, our customer service metrics substantially improved across all of our business segments.

We did experience somewhat higher G&A costs, associated with international expansion to new countries, higher security and insurance costs as a result of the aftermath of September 11th, the inclusion of our new business forsure.com, their G&A costs in this quarter were not in the same quarter year ago, and some higher professional fees related to supply chain and merchandising initiatives that we're undertaking to even get better at supply chain, and higher bonus accruals to reflect our continued improvement in our performance metrics across all of our businesses.

On a diluted gap reporting basis, EPS is 32 cents versus a first quarter year ago of 19 cents. Now let's talk about each of the business segments.

North America retail sales -- as I said earlier, our fifth consecutive quarter of comparable sales improvement. Supplies continued to show improvement with positive comps overall on our supply business. Our first quarter product mix had furniture down four percent in the first quarter, versus 11 percent in the fourth quarter, some sign of improvement in that business.

Overall technology hardware sales was down 13 percent in the quarter versus 25 percent in quarter four. It would appear to us that we may have bottomed out our decline in technology. Our software sales continue to be flattish. Average ticket in our North American retail business grew slightly in the quarter, an encouraging sign, and our average transactions were basically flattish.

Our customer service index was up in our retail stores across our chain, as the benefits of our focus on making this a compelling place to shop continue to make shopping at Office Depot a better experience, evidenced by store complaints down again this quarter. This is the fifth or sixth consecutive quarter of improvement as we intentionally focus on making shopping at Office Depot a better place, and our average outs per store in spite of our inventory turn increases, and our supply chain efficiencies, actually went down in the first quarter this year, versus the first quarter of last year.

Our North American operating profit in retail stores was up 289 basis points over the first quarter last year. Gross margins improved 312 basis points. Almost two-thirds of this gross margin improvement is directly attributable to the 2001 SKU rationalization we did in the first quarter of last year. The other third is changes in our promotional activity, becoming smarter about pricing and demand, and the continuing reflection of our improving margins in this business over the past four quarters.

The balance of improvement is related to the continued mix shift, with softer technology sales, which have dropped from about 25 percent of our retail sales in 2000 to about 15 percent so far in 2002. As I said, I think that category has reached its bottom, and we now think there are opportunities, particularly in the second half of this year, to grow our share in technology on a profitable basis and recognize technology carries with it a very important market basket to Office Depot.

Our store operating costs rose slightly in the quarter by 23 basis points. We continue tight control over our expenses, managing our payroll in a very difficult sales environment despite significant wage and healthcare benefit increases. We have flexed our payroll hours in response to softer sales, but we believe we are investing more payroll hours in our store model than our competitors, we believe that's why we're getting higher customer service levels, and we believe that leads to a better shopping experience.

We have completed the roll out of our new store label model in almost 100 of our stores, we'll complete that roll out in the next quarter or two. We do expect to get savings as we've talked about. We're reinvesting part of those savings back in to better customer service to go along with the re-launch of our brand, which basically says what you need, and what you need to know, and we're investing our people so they get what they need to know to help customers.

At the end of the first quarter we had 857 North America retail stores. We relocated two stores during the quarter, and closed two previously announced under-performing retail stores.

Turning to our business service group sales, total sales in this sector increased one percent. As I said earlier, our contract division had strong growth in the Northeastern Southeast regions, but continued softness in the Western part of the United States and some parts of the Central region, in particular, Northern California continues to be heavily impacted by the decline in the technology industries of Northern California. We had, and continue to have, a very large presence in that sector, and that's been particularly soft for the last two or three quarters.

Our revenue per order is down a bit from last year's levels, but rose slightly over the course of the first three months of this year. Again, another small sign of encouragement in terms of our delivery business, as our average order value went up slightly during the first quarter.

Domestic e-commerce sales rose 35 percent. Our customer service indexes out of our North American delivery centers were their best ever, and rose to the highest levels in the history of Office Depot. Our warehouse customer complaints are down. Our call center complaints are down. Simply put, we're servicing customers better than we have ever in the past, and we're doing it with lower costs and that's a result of higher quality.

Our operating profit in this segment was 9.9 percent for the first quarter, compared to 5.8 percent of last year. It is simply the best operating performance in our history in this segment. It improved by 402 basis points year over year. We had 178 basis point gross margin improvement in this business, as a result of our continued focus on contract pricing and account profitability. We do expect to see a slight reduction in gross margin percentage as we move through the balance of this year, as our growing national account sales begin to filter in to our sales mix.

Our selling and operating costs were down 224 basis points versus last year. That's the result of the call center consolidation we completed last year, in which we said it would give us higher quality, better customer service and lower costs, and it has. And we also invested heavily last year in warehouse technology to improve quality and efficiency, and those improvements continue to flow through our operating expenses in spite of negative sales.

March was the 15th consecutive month of record expense percentage in our North American warehouses. Our expenses per order continue to move down and we still believe that we can reduce our total warehouse operating costs year over year, by 100 basis points. The results could obviously be offset by a lack of sales leverage, but we're pretty proud of our performance in this segment, given the fact that we've been up against negative sales the last two quarters.

As I said, our DSO in this segment was its best ever. It improved by six days. We tied this measurement to sales compensation, our sales force has responded positively. It's one of the reasons why our cash, our balance sheet, and our operating cash flow continue to remain strong.

Internationally, total international sales in U.S. dollars were flat, and comp sales were down one percent. In local currencies, international sales rose five percent total, and comps four -- five percent a total increase, and comps rose four. Currency is still plaguing us. The strong U.S. dollar negatively impacted sales in this quarter by almost $20 million, and over $2 million of operating profit.

We did see, in the quarters, some softness across most all of our European Viking catalog operations, and as I said earlier, with the largest impacts in the U.K. and France. Japan continues to under-perform as a result of their economy which remains in our viewpoint, in disarray. While we are seeing softness in our international catalog businesses, our BSD contract sales are still meeting or exceeding our initial plans in each of the four new countries in which we have an Office Depot BSD presence.

Our retail business in France continues to encourage us. Comps in our French retail business in local currencies were up seven percent. We will open eight new stores this year, down slightly from our earlier target only because we're making certain we find great retail locations. We did have negative retail comps in Japan, down nine percent in the quarter in local currency. We did open two new Japanese stores in the first quarter, bringing us now to a total of 11 stores in Japan.

In spite of that softness, our first quarter operating profit internationally was 14 percent, albeit down 80 basis points from last year. Gross margins in this business are trending strong, up 51 basis points despite the addition of a growing retail business in France, our introduction of our BSD contract business in four countries, and our new prospecting efforts in our two newest countries, Switzerland and earlier this quarter, in Spain. We believe we'll continue to buy better throughout Europe as we leverage our supply chain, and we're making better use of our global purchasing, our global brand, and our emphasis on private label throughout international and domestic businesses.

Our store and warehouse operating costs increased in this business 131 basis points in the first quarter, reflecting the addition of the start-up costs in Switzerland, which we opened in early January, costs associated with the launch of Spain, which we opened during the first week of April, and three new countries which we have an Office Depot BSD presence that weren't in our numbers in the first quarter year ago.

While softness in Japan did result in negative retail comps, we did improve our operating performance in Japan, and our losses this quarter were about $800,000 less than in the same quarter a year earlier, as we get our arms around our operating model in Japan. We still generate losses, we're still optimistic about Japan in the long term, we opened two stores and we're making progress, albeit we're still losing money in Japan.

As I said earlier, we began operations in Switzerland early January, with encouraging results. We launched Spain with a direct-mail Viking business the first week of April, and we are very encouraged by our first week of results. First week's not a quarter, not a year, but we've got some encouraging signs about Spain. And we continue to invest, and will continue to invest, in this high performing, high return on asset, high return on sales business, as it still remains a key growth vehicle for our company in the future.

In summary, we simply had strong performance across all of our business segments. We believe this proves the sustainability of all the actions we've taken to improve our business model that began over 18 months ago. All of this consistently improving performance has been achieved during a very challenging and difficult economic environment. Our balance sheet has never been better, our operating cash flows are strong, and we now have more access to more capital to grow our business than we've had in the past.

During the quarter we successfully completed a $600 million credit facility over three years, which gives us the ability to have cash and credit to grow and invest in our business. We've enhanced our executive management team through the addition of two new outstanding executives, a CIO and a CMO, and we also added two new impressive board members to our already great board of directors. The consistency of our earnings performance has proven that when revenue overall begins to grow, we are able and capable, and have the physical discipline and controls to accelerate our earnings growth capacity.

As I said at the beginning of the call, we do remain confident in our ability to grow earnings in 2002, in the 30 percent range. As we look forward to 2003, we must see acceleration in our sales growth to sustain future earning growth and trends, and this organization is highly focused on finding new ways to grow. We have lots of new ideas, we have a number of new tests, none of them are at a stage where we're ready to talk about them, but we are focused on growing our business, growing market share in North America, continuing our market share growth outside the United States.

We are seeing some early signs of small improvements in the domestic economy, somewhat offset by the softness in our European catalog operations. As I said earlier, in the quarter we saw a small up tick in our average order size in our North America retail stores. We saw our technology sales, while declining, to be the lowest level of decline in the last five quarters. We've seen a small improvement in average order size in our North America contract business, and we continue to make improvements in our cost structure in spite of lower sales volumes.

In summary, we think we had a great quarter. We still are focused on improvement, we have an organization dedicated to make Office Depot the most compelling place to work, shop and invest, in our sector, and as I said, now almost two years ago, I wouldn't bet against this company in the long term, and I still wouldn't do it.

On that basis, I'd like to turn the call over to all of you for any questions you might have about the quarter and the comments I've just made.

QUESTIONS AND ANSWERS

Operator

And at this time we'll be in the question and answer portion of today's call. If you would like to ask a question, press star, one on your touch-tone phone pad. If you are using speaker equipment, you may need to lift your handset prior to pressing star one. To withdraw your question, press star two. Once again that is star one to ask a question, and star two to withdraw your question. And our first question comes from B i l l J u l i a n (ph) of Salomon Smith Barney.

Bill Julian - *Salomon Smith Barney*

Thanks. Good morning Bruce. Let me start just by asking for a point of clarification. When you talk about 30 percent earnings growth for 2002 with no improvement in the domestic economy, are you essentially saying you can do that without any sales growth in your North American businesses?

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

No. What I'm saying is that I don't -- I think the 30 percent growth comes on with the outlook we have for the second half of the year. And that basically says we believe our North America retail comps, when we finish 2002, will be basically neutral. We had negative 1.7 in the first quarter. We believe that we're a n n i v e r s a r y i n g (ph) some softer retail comps. We believe that technology has somewhat bottomed. We think we'll see an uplift in that in the second quarter. So we're saying if the economy stays the way it is, it doesn't go up much, and it doesn't go down, we're confident of our ability, given the sales levels we've anticipated in each of our business segments, that we will deliver this year the 30 percent plus growth in our, in our EPS.

Should we get an uplift in the economy, we think it's more than that, I'm just not today ready to sit back and say we're ready to tell you that the economies turned itself around. As in the past, I plan on a mid-quarter update towards the end of May, when I'll give all of you more color and insight into our performance in the second quarter. And I'll give you a better feel again, but basically what we're saying B i l l (ph) is the economy stays the same, this is the earning capacity of the company, if sales were to begin to accelerate, our earning capacity can accelerate.

Bill Julian - *Salomon Smith Barney*

OK, that's fair. You're obviously pushing up against old high-water margins, and pushing beyond them. Can you comment a little bit on how far you think those might go over the next couple of years?

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

Well I think that on the gross margin side, I think we've got one quarter left, this one, in which the delta between the quarter a year ago and this quarter will be fairly significant. Again, we're anniversarying the SKU rationalization we did in our retail stores, we very basically re-merchandised our entire chain in the second quarter of last year. I said that would lead to higher margins, better mix, a better market basket and it has. We anniversaryed that starting in the third quarter.

We also have been more disciplined about our pricing, we've used our data warehouse to be smarter about our pricing, we've focused on our contract account profitability. I think our margin levels beyond the second quarter are sustainable outside of mix changes, either technology mix or some contract mix. I don't look for gross margin expansion after the second quarter compared to previous quarters. The -- any change will be a mix change. And be small changes.

Bill Julian - *Salomon Smith Barney*

OK, thank you.

Operator

And our next question comes from D a n W e w u r (ph) of Deutsche Bank Alex Brown.

Dan Wewur - *Deutsche Bank Alex Brown*

Good morning. Question on the business service group, at the end of 2001 that division was generating a margin of about 7.9 percent which was always thought to be the high-water mark potential in that business. Clearly with the results you achieved in the first quarter we have to rethink the ultimate profitability in BSG. Now Bruce when you think about the art of the possible, you know, how high is high now in BSG?

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

I think that D a n (ph) , that's a good question D a n (ph) . I think that clearly we had a great quarter performance. We're continuing to anniversary improvements that we started to make -- those improvements have accelerated so some of the improvement gets more difficult, second and third quarter, because we've made drastic changes in this company for the positive. I think this business is still, and I've said all along, I think it's an eight to a nine percent business.

You say, well geeze it was 9.9 in the first quarter, well I've said all along, we're going to use some of our efficiencies and some of our leverage in improvements to try and grow our business. We backed a little bit away from the large account segment a year and a half ago, I wasn't comfortable about our ability to do it profitably. I am today. That tends to have a lower gross margin mix with it, and tends to come with it a little operating cross reduction compared to medium and smaller sized accounts.

The other point is, there's a point where frankly, I mean you may not want to hear this as a shareholder, but this business can get too profitable, it creates an umbrella, I don't want to invite. But this is still, you know, a plus eight percent business, we've said it all along, I still think it is, I don't think it's a ten percent business. I think if we get it to that point we'll use our buying power which we think we have, our efficiency which we think we've got, and we'll be more aggressive on market share account by account, and do it smartly. But this is a eight percentage, eight percentish operating performance business.

Dan Wewur - *Deutsche Bank Alex Brown*

Well just if I follow up, just one question on that. You know in the past you've talked about being rational on pricing for contract accounts. I think they've been how you've talked about, you know, trying to get a 21 or 22 percent margin on that business. Given that you've made so much progress in reducing your cost structure, could you not get more competitive in pricing for the contract accounts, and thereby enhancing your top line? And still, you know, get that eight or nine percent division margin?

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

Pricing for contract accounts is somewhere between an art and a science. I've been in this business a long time, and you have to look an account by account basis in addition to pricing D a n (ph) you've got to look at the service requirements of the accounts, some accounts you can take lower margins and make money based on their service requirements, some accounts are higher margins. I just think this segment is an opportunity up for us to grow share in. As I said, we over the last year have been reluctant to go at it heavily. We've added some resources to it, it's partly reflected in our G&A costs, as we've added sales resource to this channel.

I don't, I don't, I don't mean to portray we're going to get irrational on pricing, because we're not. This is a company driven to get return on assets, return on net assets and profitability. We'll do it wisely, we'll do it smartly, we'll do it account by a time, we'll do it strategically. And this is, this is a segment that we're investing in because we believe we can generate good margins, good r o l l (ph) up, but to talk about pricing strategy in a broad aspect beyond that isn't appropriate for a call like this. I -- rationality is important to all of us, but where we can, we want to grow our business, and we're focused on growing that business.

Dan Wewur - *Deutsche Bank Alex Brown*

Great. Thanks a lot. Good luck.

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

Thanks.

Operator

And our next question comes from E r i n R u b i n s o n (ph) of UBS Warburg.

Erin Rubinson - *UBS Warburg*

Hey guys, two questions on the sales side. Number one, you talked about, while the comps were down 1.7 percent at retail, you mentioned furniture was down four, technology was down 13, and then at least in the body of the release it says a number of core office supply category comps were positive. What was I guess, north of the minus 1.7 to have pulled it up that much given you've only given us the categories that were low?

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

Well, I would answer generally are -- first of all, just kind of a parenthetical for a minute, I think we tend to break out more details about our business than any of our competitors by product category. I don't want to go beyond what I've broken out. Furniture and technology are important because they're high-ticket items, they're somewhat indicative of the economy. Needless to say, if you do the math, and I'm now telling technology the way I define it, which is laptops, desktops, monitors, printers, digital cameras, are now 15 percent of our North America retail mix, down from 25 almost a year ago.

I say if you do some math on that, you'll find that our, that over half our business is core office supplies, and by definition in totality, you have to be comping up. It doesn't mean every category is comping up because it's not, but the, but we got, but the core of our supply business, our basic supply business is obviously positively comping. It varies by category. As much as all of you would like to know exactly by category, I'm not prepared to talk at it more category than what I already do. It's already, as I said, more than most of our competitors do.

Erin Rubinson - *UBS Warburg*

OK. And then on the average ticket and transaction, you mentioned that your ticket was a little bit better. Is that average selling price, or reduction in deflation versus items per transaction, and on the transaction side would you have thought that your transaction count would be up, given your new ad campaign? And then I'm done.

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

OK, thanks E r i n (ph) . You know, because averages get you in serious trouble when you look across the chain of the number of transactions we have in retail. I don't think we've seen any real price degration in technology. The average items tends to be about the same as it's been. I think it's a very small encouraging sign at this moment, but in the aggregate, our customers when they aggregate up, are buying a little bit more.

Two, as it relates to your comment about an ad campaign. We re-launched our brand, what we stand for, we're three months into that re-launch. I don't think that you can measure a brand and advertising in a three-month period of time, as to whether it drives transactions or traffic. Frankly one of the things about some, companies like Office Depot where we have multiple channels, our brand advertising has the impact of far more than just retail. Clearly it helps our e-commerce sales, clearly it helps our small to medium sized account sales.

So I think from our perspective we're pleased today with the performance of our ads. It's still early in the process. We've got some new ones coming out for back to school and holiday, but I think branding and advertising is a long-term thing, not a month-to-month, quarter to quarter thing. Somebody once said you waste 50 percent of what you advertise you just don't know where you waste it. That's probably a true statement. But overall I think our advertising campaign is doing what we it to do, three months in to what we plan for it to do both internally and externally.

Erin Rubinson - *UBS Warburg*

Thanks Bruce.

Operator

And our next question comes from M a t t h e w F e s s l e r (ph) of Goldman Sachs.

Matthew Fessler - *Goldman Sachs*

Thanks a lot. Excuse me, good morning. Just a couple of quick questions here. First of all Bruce, to get a little more specific about your earnings potential of BSG, clearly you delivered expenses at a lower level than you've seen at any point in time recently. Is there anything seasonal about the rest of the year that would suggest that the expense ratio would need to be any higher than it was in the first quarter?

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

The only seasonal thing is we get into leverage M a t t (ph) . We do get our first quarter tends to be, in BSG, one of our higher quarters in absolute sales performance. One of the things that we said, I said, we would do 18 months ago, is we'd prove to all of you that there is such a thing in our warehouse's fixed and variable costs. 18 months ago all of our costs, up to 100 percent variable, revenue went up 20 percent, costs went up 20 percent. We do have a fixed element of our costs in our North American warehouses, and as the absolute sales dollars in a quarter decline, not necessarily in comps, but just in quarter, it gets more difficult to leverage and therefore the expenses as a percentage get different.

If you're asking do I think we're going to keep our handle on absolute dollar costs, absolutely I do. And I still think there's improvement left in our North American business. This comes at a time by the way, when we're getting enormous pressure on delivery costs. I mean, delivery costs in the form of the aftermath of September 11th still means that the carriers that deliver packages for us, and our own delivery systems are more expensive and we've gotten this improvement even facing that pressure. So I think its impact is based on leverage, if you will, as quarters vary somewhat in their total revenue.

Matthew Fessler - *Goldman Sachs*

Now just to make sure that we understand the direction in which BS, business system moving, you talked about some softness on the West coast, but nonetheless it appears as if your same location growth in this business is a bit better than it was in the fourth quarter.

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

It is an improvement over the fourth quarter levels.

Matthew Fessler - *Goldman Sachs*

OK, so ...

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

...financial statement.

Matthew Fessler - *Goldman Sachs*

So it's not as if we have to fight the tide of eroding business condition in BSG as we think about the expense ratio?

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

Yeah, I think, this is a business I think that's significantly impacted by the overall domestic economy, and in particular, the outlook of the Fortune 300 accounts, Fortune three or 400 size accounts that either grow and add on people, or they continue to lay people off, and so this is still a business because of the large account segment, that's highly dependent upon a better North American economy, and I don't pretend to be able to understand the economy well enough to be able to give you more insight. I just think we've got some larger accounts that will come into our business now, beginning in the second quarter. These are wins that we got late last year. I think that's going to help our business somewhat.

So we've got improving trends in this segment sequentially for each of the next three quarters. We believe the comps if you will, sequentially in the second quarter will be better than the first, third better than the second, and fourth better than the third. Part of that's the anniversarying and part of that's some things we think we're doing.

Matthew Fessler - *Goldman Sachs*

Got you ...

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

And that's not anticipating a huge benefit from an improving North America domestic economy.

Matthew Fessler - *Goldman Sachs*

Now, say that's what's in the contract business which you've been discussing, it seems like you are refocusing to some degree on the large national accounts. What kind of competitive environment do you find yourself stepping into in that business, and how does it compare with where it's been over the past couple of years?

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

I would say it's a very strong competitive environment. We've got three very strong competitors that are good at what they do. I mean this is a scratch, dig and claw business. You've got to earn the business one account at a time, and you've got to do it with a total package that goes beyond price. I think it's a relatively rational marketplace in totality. You clearly get some marquis accounts in this business segment, that irrationally takes place on a marquis account or two.

But overall I think the competitive nature of this business is that all of us want to deliver shareholder returns, at least it appears that way in the public stuff they all talk about, and I mean BT, or Corporate Express, excuse me, Boise Cascade and Staples. So I don't, I think it's a more consolidated environment than it was three years ago. Sure there's some people that aren't here, that were here three years ago. It's a tough environment, it's a competitive environment, we've got great competitors. And I think we've got to, I think we can, I think we can grow share in this segment.

Matthew Fessler - *Goldman Sachs*

My final question. You find yourself here at the end of the first quarter with an awful lot of cash. If your stock continues to do well, and your convert is not put to you later this year, you're going to find yourself sitting on more than you might have expected just a few months ago. You know, what is your plan for deploying that cash, it's certainly more you can deploy in the existing business, there's not a lot of, there's not a lot of bank debt to take out here, so are you thinking about buying back additional stock -- what would your deployment look like?

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

Well first of all I want you to know this is a very high quality problem.

Matthew Fessler - *Goldman Sachs*

Fair enough.

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

Somewhat different than I faced 18 months ago, had some other problems that weren't high quality ones. This one is a high quality one. Two is, it's not a long history yet, it's a couple of quarters. There is, without getting specific, I do think there are opportunities to grow this business both domestically and outside the United States that may require some use of our cash. Fourth, I am, and we are committed as a company to improve our credit ratings. I've said that 18 months ago, we have continuous dialog with the credit rating agencies. I want them to look at Office Depot and I want them to say these, this company has earned a higher credit rating. That takes a pristine balance sheet, cash.

As it relates to the long-term thing, what you do with cash, the reality is as I've said before, this executive group of managers is committed to growing shareholder value. Period. If you want to see how that works, take a look at our proxy where we think we have aligned the interests of shareholders very much with the interests and the motivation of our leadership. And we will use that cash in one way or another, over a period of time, to drive shareholder value. Period.

Matthew Fessler - *Goldman Sachs*

Thank you very much. Thanks a lot.

Operator

And our next question comes from C o l i n M c L a n a h a n (ph) of Sanford Bernstein.

Colin McLanahan - *Sanford Bernstein*

Hey Bruce, was hoping you could give us maybe a little bit more color on Europe. What's the situation kind of look like on the ground there, any sense of when you think comps might improve? And then longer term, you know, kind of the BSD question as well, you knew you'd talked about that being a 13 to 15 percent operating margin business. Is there any change in the pace of investment you're planning that would impact that outlook? And then again, longer term any change in thinking the pace of the growth for Europe?

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

OK, several questions. The first one is, when do I think comps are going to improve in North America retail. C o l i n (ph) I've been working at this for 18 months and haven't got it right yet.

Colin McLanahan - *Sanford Bernstein*

Bruce, international, not in A.R.

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

International? Well, you know, first of all this softening that took place in the first quarter is really the first signs of some softening across the continent in Europe. And it's across most the countries so I know it's not operational, I know it's not executional. Our own view at the moment is that's at least for the next two quarters that we'll see that softness in our catalog business. As I, as we commented in our release, I think we can mitigate some of that softness through our growing BSD business.

From our own perspective that softness is likely to put a two to three, two to three cent pressure on our own numbers about profitability to give you the magnitude of it. We think we can make some of -- by that, that includes the continued currency issues that we have. If you'd have said to me I thought we'd have a euro of 88 or 86 cents right now I'd have said no way.

Colin McLanahan - *Sanford Bernstein*

Didn't think so either.

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

Yeah, so, I don't like -- that continues to impact the translation results. So I think some softness, at least for the next two quarters in our own forecast throughout Europe and the rest of the world in the Viking catalog model. This had offset by the growing BSD presence.

To your question about invest in the long-term, this is still a 13 plus percent return on investment, or return on sales business over time. We continue Colin (ph) to look for ways to grow in Europe. I've said all along it's a market that's larger than the U.S., it's more fragmented. I believe there are opportunities to accelerate growth in Europe, either by accelerating the entry of new countries, and/or looking at opportunities to maybe acquire in certain segments. Retail is not our primary strategy in Europe.

We do have a retail strategy in France, that we're delighted and excited about. We're investing in it. So I think, I think we have a lever called how much do we want to spend how fast. We do have a commitment to grow shareholder value, we have to blend that always. And so we'll accelerate sometimes, we'll slow down sometimes, particularly our entry into new countries. I mean at one point we had plans to enter another new country late this year. We've moved that off a little bit, probably more until next year, as a result of the softness we've seen, plus our desire to continue to generate consistently improving results.

This is a business we're proud of, it's a business we make a lot of money in, it's a high return on net asset business, it too has very positive cash flow. Our building cash balances are not only domestically, they're internationally. This is a good business segment, we think we know how to manage it and lead it. We'll grow our share in it over a period of time. It still represents a unique opportunity for Office Depot and frankly, differentiates us in terms of growth from our two primary superstore competitors in North America.

Colin McLanahan - *Sanford Bernstein*

Thanks Bruce.

Operator

And our next question comes from Gary Bolter (ph) of Credit Suisse First Boston.

Brian Nagle - *Credit Suisse First Boston*

Hi this is B r i a n N a g l e (ph) for G a r y B o l t e r (ph) . I just have a couple of quick basic questions. First off, your tax rate in the quarter was 35 percent versus 37 percent a year ago. Should we be using that rate going forward now? And what's the reason for the decline?

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

The answer is, as Charlie Brown, my CFO just nodded yes. That is the neighborhood of the tax rate that you ought to use going forward. I'll let him comment as to why that is.

Charles Brown - *Office Depot, Inc. - Executive Vice President and Chief Financial Officer*

It's really the benefit from our international tax planning. And as our international income becomes a bigger part of our total income, that allows us to move our tax rate down, so this rate of 35 percent should be used for the year.

Brian Nagle - *Credit Suisse First Boston*

So is that 35 ...

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

I do, I might add by the way, that with the dramatic improvement in our stock price, we're getting a little more dilution that we planned in our calculation of shares outstanding. If you remember right, this is a company 18 months ago that had 85 percent of its options under water. As the stock has grown more rapidly than frankly most of us anticipated, we hoped for it but didn't anticipate it. We do have some offsetting dilution in EPS calculations as we've got more shares coming into the base as a result of, as the result of improving stock price.

We do have to remind all of you an authorized $50 million buyback on our stock and we're at the end of the first quarter, about 20 some million into that buyback. We continue to buy that back incrementally, it's meant to offset dilution, we frankly have dilution in shares coming at a faster rate than our buying back stock, again it's another high quality problem.

Brian Nagle - *Credit Suisse First Boston*

So Charlie, you guys were planning for the 35 percent tax rate at the beginning of the quarter?

Charles Brown - *Office Depot, Inc. - Executive Vice President and Chief Financial Officer*

Yes.

Brian Nagle - *Credit Suisse First Boston*

OK.

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

In that neighborhood. I mean, appreciate you can't get a tax rate down to a basis point, but we were planning in the neighborhood of 35, 36. I mean you get done at the end of a quarter, that's a, I don't think you can be so finite to say it was 35. Were we planning for a slightly lower tax rate? Yes.

Eileen Dunn - *Office Depot, Inc. - Vice President of Investor Relations and Public Relations*

B r i a n (ph) it's Eileen. I think most analysts have 35 percent in their models now.

Brian Nagle - *Credit Suisse First Boston*

OK, great. Thanks. And the other question is, could someone comment on this, but could you talk about the trend of retail comps as the quarter progressed?

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

The tend as the quarter progressed ...

Brian Nagle - *Credit Suisse First Boston*

The trend.

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

Yeah.

Brian Nagle - *Credit Suisse First Boston*

The trend in retail comps.

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

Yeah, if you look at January, February, March, progressive improvement. So each month was a little better than the previous month. So March was the best comp trend in the first quarter. Meaning less negative than the quarter in total. January was the worst comps in comparison. So improving trend.

Brian Nagle - *Credit Suisse First Boston*

Great. OK, thanks a lot.

Operator

And our next question comes from D a n i e l l e F o x (ph) of J.P. Morgan.

Danielle Fox - *J.P. Morgan*

Thank you, good morning. Could you comment on the 2Q outlook for EPS, and just your general expectations for comps by segment? You mentioned easier comparisons and I'm wondering when this year you expect the two-year comp trend to turn?

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

Yeah D a n i e l l e (ph) I think that, I'm not -- the thing, all of you as analysts have done your best job to take a look at the second quarter. The consensus of the quarter right now sits at 20 cents. I don't have any change from that direction to give you. I will, as I said earlier, we will, as I said earlier, towards the end of May give all of you our traditional mid-quarter update.

At that time, I'll give you insight into comps across business segment, I'll give you insight into earnings trends for the quarter, I'll get more precise if I can on EPS for the second quarter, but I'm going to save those comments until the end of May. But needless to say, remaining comfortable with 30 percent growth targets for 2002 by definition I'm comfortable with the growth targets for the second quarter.

Danielle Fox - *J.P. Morgan*

OK, and just a kind of broader question about the full year, about you know, just the two year comp trend given the easing comparisons when we'll actually see an improvement in the, in the two year comp trend for the total company or any of the individual segments? Obviously international is a little bit weaker.

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

Well, yeah, I think what we sell, you have to do by business segment.

Danielle Fox - *J.P. Morgan*

Yeah.

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

The second quarter retail will be better comps than the first. The third quarter could be about the same, maybe a little worse than comps than the second. We got a back to school anniversary we did extremely well on. That directionally is the same. We think our fourth quarter retail will be our best comps in quite some time, and they'll be positive. And that gets you to basically neutral for the year. We said earlier our BSG comps we anticipate quarter by quarter improvement in the BSG business.

International, we in spite of the softness, we do anticipate better comps in the second quarter. That's got to do with mailing plans, holidays in Europe and a variety of other things, and a growing BSD business and the growing impact of our two new countries, Switzerland and Spain. And we think those comps continue to improve throughout the year, and when you get done with the year we think on comp basis for the year, we'll be in the neighborhood of, hold on a sec here. For year comp for the company. Yeah, a couple points -- well let me -- D a n i e l l e (ph) we'll get back to you off line on that.

Danielle Fox - *J.P. Morgan*

That'd be great.

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

That segment and I don't, I haven't looked at how that rolls up yet.

Eileen Dunn - *Office Depot, Inc. - Vice President of Investor Relations and Public Relations*

Rolls up to a total sales growth for the year of around mid-single digits.

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

A total sales growth mid-single digits for the company for the year.

Danielle Fox - *J.P. Morgan*

OK, great. Thanks very much.

Operator

And our next question comes from J a c k B e l o s (ph) of M i d w o o d (ph) Research.

Jack Belos - *Midwood Research*

Hi. Regarding the office supply business, just that category in total. What's been the trend in sales in that category this quarter and the past few quarters?

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

Well I think as our, as our negative comps have declined in North America retail, since we completed the re-merch and the SKU and the rationalization we completed in the second quarter in North America last year, we said that that would drive better comps and better margins, and our supply categories have positively improved sequentially third quarter, fourth quarter, first quarter. So we continue to see directionally signs of that business improving.

I think that's a couple of things. I think one is that when we did re-merchandise our stores, we got adjacent fees better than we ever had them before. And that's when a customer buys a low margin item like a one inch black binder, they often buy some indexes or other labels to go with it that tend to be higher margin items, and that drives comps. Second of all, we've been focused on driving comps in our core business, and so improving trends sequentially to answer your question.

Jack Belos - *Midwood Research*

Would you quantify that in terms of being low single-digit improvement in this quarter?

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

No, I won't J a c k (ph) only because I said, I said earlier, we quantify far more than our competitors. Directionally our supply sales are positive, they're not positive in every category -- I'm not trying to hide, it's just directionally I'm trying to give you direction. As I said, I don't want to get into the point where we're talking about comp trends by category.

I talk about furniture and technology because they're such high-ticket items, they have such a big impact on the company, they've had a negative impact far greater than anything else on comps. I'll continue to talk about those in the future, and lump the rest of our product sales in our retail into a large basic category called basic office supplies.

Jack Belos - *Midwood Research*

Regarding the roll out of the payroll scheduling. How many stores did you say that's in currently, and when do you expect to have the entire chain that way?

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

It's 100 plus stores, and we'll have the entire roll out done by late May, early June.

Jack Belos - *Midwood Research*

Oh, OK. Thank you very much.

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

You're welcome.

Operator

And at this time I would like turn the conference over to Miss Eileen Dunn and Mr. Bruce Nelson for closing comments.

Bruce Nelson - *Office Depot, Inc. - Chairman and CEO*

Thanks for taking your valuable time to listen to our results for the first quarter. As I said, I think I'm encouraged by all the progress the company's made over the past 18 months. I think you can see it in consistency, I think you can see it in quality, I think you can see it in our results. We're still faced with some uncertainty in a domestic economy, some softness in the European economy, in spite of that we continue to do well.

Our ability to accelerate earnings growth beyond the 30 percent is, as many of you pointed out, dependent on increasing growth here in North America. We see some signs of it, hopefully that will continue. We will give you more insight to that at the, towards the end of May. In the meantime, this is a management team committed to making Office Depot the most compelling place to work, shop and invest. We think we've done an admirable job of improving our metrics. We continue to focus on the things that drive shareholder value. That's what it's about. Thanks for listening and thanks for your support.

Operator

Thank you for attending Office Depot's first quarter 2002 earnings conference call, and have a good day.
