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ODP.OQ - Q1 2005 Office Depot Inc. Earnings Conference Call

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OVERVIEW:

The Co. reported that 1Q05 sales were $3.7b, a 3% increase over 1Q04. 1Q05 net diluted EPS remains unchanged at $0.37. ODP ended 1Q05 with $830m in cash and short-term investments. Q&A Focus: Inventory, International, and working capital.

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PRESENTATION

Operator

Good morning. We'd like to welcome you to the Office Depot first quarter 2005 earnings conference call. All lines will be on a listen-only mode for today's presentation, after which instructions will be given in order to ask a question. At the requests of Office Depot, today's conference call is being recorded. I'd like to introduce Mr. Sean McHugh, Director of Investor Relations, who'll make a few opening statements. Mr. McHugh, you may begin.

Sean McHugh - *Office Depot Inc. - Director, IR*

Thank you, and good morning, everyone.

Before we begin, I'd like to say that certain statements made during this presentation are forward-looking statements under the Private Securities Litigation Reform Act. And except for historical, financial and business performance information, comments made during this presentation should be considered forward-looking. Actual future results may differ materially from those discussed on this call due to risks and uncertainties, both foreseen and unforeseen. Certain risks and uncertainties are described in detail on our report on form 10-K filed with the SEC on March 10th, 2005 and in our form 10-Q filed with the SEC this morning. During portions of today's presentation, Office Depot executives may refer to results of our first quarter 2005 which are not GAAP numbers. The reconciliation of non-GAAP numbers to GAAP results is available on our web site at www.officedepot.com.

Now I would like to introduce Office Depot's Chairman and CEO, Steve Odland.

Steve Odland - *Office Depot Inc. - Chairman & CEO*

Thank you, Sean. Thank you for joining us today for Office Depot's fiscal 2005 first quarter conference call. With me today are Charlie Brown, Officer Depot's President of International and Chief Financial Officer; Chuck Rubin, our Executive Vice President and Chief Merchandising and Marketing Officer; and, of course, Sean McHugh, our Director of Investor Relations. I hope you've had an opportunity to read our press release and learn about this quarter's results. If not, the press release, along with the accompanying webcast slides are available on our website at www.officedepot.com. Just click on the investor relations tab.

First, let me begin by saying how pleased I am to be here today at Office Depot. I came on board at the end of quarter one, but I have been working very quickly to come up to speed on the business. I must say that I've been very impressed so far with the depth and the quality of our management team, and I look forward to working with them to accelerate profitable growth at Office Depot.

In review of the first quarter, we reported sales for the Company of $3.7 billion, a 3% increase over fiscal first quarter 2004. North American Retail and North American Business Services drove the increase, but were partially offset by sales declines in our International Division. Company gross margins declined 41 basis points for the first quarter. The benefit from the higher North American Retail sales volume and margin was offset by the cost of goods increase in North American Business Services, and sales volume and margin declines in our International Division. Total operating expenses as a percent of sales remain flat for the quarter. We improved G&A expenses as a percent of sales by 31 basis points, a trend that we hope to continue as we take action to improve our overall cost structure. The reduction in G&A expense was offset by store and warehouse operating and selling expense deleverage in our International Division. As a result, consolidated operating profit declined 5% versus the first quarter of last year.

Now, taking into account our net miscellaneous income, EBIT for the quarter was $170 million, down 5% from the same period in 2004; but net earnings remained flat compared to the prior year because of reduced interest expense following the repayment of high interest rate debt last December. Net earnings per diluted share remain unchanged at $0.37 a share. Return on invested capital for the trailing four quarters was 10.6%, unchanged from the same period in the prior year and above our cost to capital. We need to demonstrate even greater capital discipline in the future as we seek to widen the spread between our returns and our cost of capital. Office Depot is committed to improving this metric going forward as we take actions to increase shareholder value.

Now let's discuss our division results. I'll begin with our North American Retail Division. First quarter sales in the North American Retail Division increased 6% compared to the same period last year. Comparable store sales in the 894 stores in the U.S. and Canada that have been open for more than one year increased 1% for the first quarter. This represents our fifth consecutive quarter of positive comparable sales. Improved technology category sales led the comparable sales improvement. Comparable average ticket size increased, but comparable transaction counts decreased for the quarter. Gross margin as a percentage of sales increased during the first quarter to 27.0% versus 26.7% in the same period last year. Broad based product category gross margin percentage improvements and increased vendor program support were partially offset by an increased sales mix of the lower margin technology products. Cost controls produced a 40 basis point decline in store and warehouse operating expenses. Payroll and related net -- related costs decreased as a percentage of sales. The cost of adding stores during the period, net of labor efficiencies put in place during 2004, was absorbed by the higher sales volume. Division operating profit increased 17% in the first quarter compared to the same period in 2004.

I'd like to just highlight some of the many marketing achievements during the first quarter. In early January we launched our Taking Care of Business strategic marketing campaign. This reintroduction of our brand to the marketplace under our most successful business theme in the history of our Company reflects our unwaivering commitment to the by customer, the customer segment that is most critical to our success. This strategy returns Office Depot to the customer commitment made during our period of greatest growth and strength, and we are confident that it will serve us well in our next growth period. We developed new TV and radio creative programming to support the effort, and we also communicated this change directly to our customers and key vendors. The response from our customers has been outstanding.

Also in January we announced our partnership with NASCAR and with the Roush racing team. As many of you know, NASCAR fans rate among the best in the world in terms of brand loyalty. We will continue to leverage our association at both local and national levels with this premier high growth sport and top tier racing team. Watch for more great things from Carl Edwards in the No. 99 Office Depot Ford Taurus over the course of the coming racing season.

Marketing effectiveness remain as priority for Office Depot. During the first quarter we reduced our spending on less effective media, yielding a lower first quarter spending rate year-over-year with absolute spending remaining essentially flat. We will continue to review the ROI of all of our advertising vehicles to ensure that we concentrate on the highest yielding vehicles. The Advantage Loyalty program reached its first anniversary in March. The program now comprises 2.2 million active members. Our Advantage members demonstrate a higher purchase frequency compared to the non-Advantage members, and we have also observed strong double digit sales lift among manageable members.

Now turning to the merchandising side in North America, our on going initiative continued to deliver results as well. Private brand sales increased to 17% of total sales, up from 14% during the first quarter of 2004. Private brand IMU rate also improved significantly over the same period. We expect to continue to expand our private brand SKU count in all channels. Global bids were conducted in several product categories during the first quarter, resulting in a lower cost of goods for the selected items. Additional product categories are scheduled for bid every quarter for the balance of 2005. Pricing initiatives from 2004 also delivered results in the first quarter; and in addition, we expanded the scope of our efforts to include catalog pricing. The Magellan system's capabilities continue to support more analytical and disciplined merchandising processes. During the quarter, we rolled out the merchandising data warehouse reporting system and integrated several other existing modules. The merchandising data warehouse reporting system provides us with a single view of our information by a web interface to support improved strategic performance analysis.

The North American Retail team has done a great job in delivering operational cost savings over the past year, and here are some examples of the cost saving programs that are currently underway. First we're retrofitting the stores with energy efficient light fixtures in the high energy cost stores. We're also upgrading energy monitoring systems that will allow store -- allow us to adjust the store electricity usage realtime, and we're also executing more favorable lease agreements for store technology hardware like the POS system and the Copy Center equipment.

During the first quarter, the Company opened 29 stores, closed 3 and relocated 1 office supply store. At the end of the first quarter, Office Depot operated a total of 995 Office Products Superstores throughout the United States and Canada. Our first quarter store count grew 2.7% over the end of the fourth quarter, but gross square footage increased 2% reflecting the opening of smaller than average footprint stores during the quarter. We are pleased with our North American Retail results. However, we need to continue to improve our performance in this division over time. To that end, we have recently created the position and have begun a search for a president of North American Retail. With collective and oversight of store operations, merchandising, marketing, supply chains, this executive will be responsible for ensuring that all of our critical functional areas work in concert to achieve our performance goals.

Now turning to the North American Business Services Division. Business Services' sales increased by 2% in the first quarter compared to the same period last year. E-commerce sales increased significantly during the first quarter. Gross margin as a percentage of sales decreased during the first quarter to 31.7% versus 32.4% in the same period last year. The absorption of higher cost in key product categories, largely fixed contract selling prices, and competitive market conditions, along with the promotional activity and an increased mix of lower technology sales contributed to the gross margin decline. This gross margin pressure was more than offset by an 84 basis point improvement in store and warehouse operating and selling expenses for the first quarter. A decrease in supply chain costs from staff and transportation optimization more than offset added payroll costs related to the expansion of our sales force. Also included in the first quarter results are $3.4 million in expenses related to the call center optimization effort that we announced in the fourth quarter of 2004. This outsourcing activity is expected to be complete by the third quarter of 2005. Division operating profit increased 4% in the first quarter compared to the same period in 2004.

Our North American Business Services team remains focused on several key initiatives to drive profitable growth in our efforts to increase our market share. First, we are emphasizing private brands to deliver value and to provide differentiation in the eyes of our customers. Second, we are providing our selling team with the proper tools and improved processes to increase their effectiveness and support their account growth goals. Third, we're establishing a customer-centric delivery team to ensure that we continue to meet and exceed the expectations of our customers. And finally, we're using telephone account management resources to drive efficient demand creation and existing account management. So good progress this quarter in Business Services.

Now turning to the International Division. In International, our first quarter sales decreased 2% in U.S. dollars, which was a decline of 6% in local currencies compared to the same period in 2004. The favorable change in exchange rates from the corresponding prior-year period increased sales reported in the U.S. dollars by $40 million for the quarter. Our International Division continues to operate in a very challenging business environment, as sales declined in all major geographic markets. Gross margin as a percentage of sales also decreased during the first quarter to 37.7% versus 38.6% in the same period last year. Increased promotional activity and cost pressures in key product categories contributed to the decline. First quarter selling and warehouse expenses as a percentage of sales increased 282 basis points compared to the prior year, primarily because of deleverage associated with our lower local currency sales volumes and increased expenses related to warehouse closures and relocations in Europe. Division operating profits climbed 28%, which was a decline of 31% in local currencies in the first quarter compared to the same period in 2004. International Division operating profit, when translated into U.S. dollars, benefited from foreign exchange rates by about $4 million during the quarter.

These results in International clearly are not up to our expectations. We see great potential outside of North America, and we believe that we can grow this business at a more rapid rate and deliver higher profitability in the future. To help us achieve our profitable growth goals, we have promoted Charlie Brown, our Chief Financial Officer, to President of International. Charlie's deep knowledge about our Company, including our global operations, his strong strategic skill set and passion for results make him an excellent fit for this new role. Charlie will oversee all of our operations in Europe and Japan as well as our joint venture and license agreements in 7 other countries. Charlie will retain his current Chief Financial Officer responsibility short term as we search for a new CFO.

In the meantime, we are taking action to improve the performance of the International Division. First, we are expanding the use of telephone account management to deliver more cost effective customer relationship management in demand generation. We're pleased with the results of our preliminary telephone account management test conducted in the United Kingdom, Germany, and the Benelux countries. We will continue to rationalize our supply chain assets as part of the Guilbert post merger integration process; and finally, we remain committed to streamlining our overall processes and cost structure to ensure that we remain competitive in the marketplace.

Now I'll turn it over to Charlie Brown to take us through the cash flows and the balance sheet. Charlie?

Charlie Brown - *Office Depot Inc. - President, International & CFO*

Thanks, Steve.

Let me start with the cash flow discussions. This quarter our operating activities used $61 million in net cash. This compares to our generation of 256 million of operating cash flow in the first quarter of 2004. This year-over-year change reflects an increased inventory position related to new store openings, higher in-stock levels, and forward purchasing in advance of anticipated cost increases in certain product categories. During the quarter, our settlement of accounts payable occurred faster than our inventory turnover and our collection of receivables, resulting in a use of cash. We plan to take a hard look at both of these in the weeks ahead. Depreciation and amortization totaled $72 million for the quarter, up over last year primarily because of increased store openings in North America. First quarter EBITDA was 241 million, down slightly of the first quarter of 2004. Capital expenditures amounted to 80 million for the quarter. North American Retail new store openings represented the biggest capital investment area. For the full year 2005, we anticipate CapEx in the 325 to $375 million range. We will continue to identify and execute on investment opportunities that drive returns above our cost of capital. We recorded negative 141 million of free cash flow in the first quarter. This year-over-year change is primarily attributable to the reduction in cash flow provided from operating activities discussed earlier.

Last fall we announced a $500 million share repurchase authorization to be conducted over a two-year period. We commenced purchasing under this authorization in November of 2004. During the first quarter, we repurchased $28 million worth of stock. On a cumulative program basis, our share repurchases totaled 44 million. I would like to remind everyone that we have been out of the market for several weeks because of material nonpublic information related to our leadership change and the subsequent end of quarter quiet period. We remain committed to our buyback plan over the long-term and we intend to continue to seek disciplined buying opportunities over time.

Now let's turn to the balance sheet. We ended the first quarter with 830 million in cash and short term investments. Our investment in merchandise inventory totaled 1.4 billion, up year-over-year because of three main factors. Our investment in new stores in North America, with 52 new store openings in the fourth quarter and 29 new store openings in the first quarter; additional inventory investment related to our commitment to improve our already strong customer facing in-stock levels in North America; and selected forward purchasing in advance of anticipated product cost increases. However, inventory per store remains generally consistent with historic levels. Working capital increased year-over-year, generally as a result of higher inventory levels and increased receivables.

Our long-term debt declined substantially compared to last year as we redeemed 250 million in senior subordinated notes this past December. This action reduced our interest expense and eliminated restrictive covenants associated with these instruments. At the end of the first quarter, our long-term debt to shareholder equity ratio was 17%. Our outstanding 2013 senior notes are rated investment grade by both Moody's and S&P. With our positive net cash position, our balance sheet remains very strong.

Our return on equity for the trailing four quarters was 11%, down from 11.9 for the comparative prior period ended in fiscal 2004. As we announced last year, we have been reviewing the composition of our general and administrative expenses and assessing the appropriateness of additional allocations to the operating units. As a result of this analysis, we planned to reclassify certain amounts previously presented as general and administrative expenses into operating and selling expenses and other line items, possibly beginning in the third quarter of 2005. These reclassifications will affect measures of division profitability, and prior periods will be reclassified to allow for a meaningful year-over-year comparisons.

I would like to make one final comment. As all of you know, the SEC last week postponed the mandatory expensing of stock options until our next fiscal year. As a result, we now plan to begin expensing stock options in the first quarter of 2006 or whenever this becomes mandatory for all public companies.

That concludes the cash flow and balance sheet discussions. I'd like the turn the call back to Steve for some final remarks before we open it up for questions.

Steve Odland - *Office Depot Inc. - Chairman & CEO*

Thanks, Charlie.

Before I conclude, I want to share with everyone our strategic growth priorities. I -- I've spent a lot of time over the past few weeks with our executive team. They've done a fantastic job of getting me up to speed on the industry and our Company and on their areas of responsibility. While I clearly have a lot more to learn, I'm confident in outlining the following profitable growth priorities for Office Depot.

First of all, North American Retail continues to be our number one priority. We intend to improve store productivity while continuing our store buildout program. Secondly, our second priority is the North American Business Services group. We plan to profitably grow our market share through new customer acquisition and new product and service offerings. And our third growth priority is in International. We need to improve profitability in International, but at the same time we need to grow our European contract business and in the longer term increase our geographic reach. All across our Company we need to reduce unnecessary costs and improve our return on invested capital. We can deploy our considerable cash flow to drive profitable growth and also to buy back our shares. The Company is clearly headed in the right strategic direction. I believe that our clear prioritization, along with improved execution and a sharp focus on costs, will be the key to achieving our industry leadership goal.

Finally I'm sure that many of you have questions regarding our outlook for the balance of 2005. Several months ago, we suspended our practice of issuing formal business performance and earnings guidance. But going forward, we will strive to provide you an understanding of our business model as we make decisions and take actions consistent with the long-term interests of our shareholders. So in closing, I'd like to say that I'm very excited about being here, and I see a enormous potential for our Company.

Now I'd like to open up the call for questions.

QUESTIONS AND ANSWERS

Operator

[OPERATOR INSTRUCTIONS]. Bill Sims, Citigroup Smith Barney.

Bill Sims - *Citigroup Smith Barney - Analyst*

Good morning. Thank you. I have two questions. The first one is on inventory, Steve. Inventory was up 17% versus sales up low single digits, You mentioned higher in-stock levels in inventories for new stores contributing to that increase. Was this the inventory level you were expecting for the end of the quarter? Or in fact, are there still excess inventory out there and we didn't need to see further promotional activity?

Steve Odland - *Office Depot Inc. - Chairman & CEO*

Thanks, Bill. Inventory is up 17%, and it was very deliberate increase in the -- in the inventory in order to return us to our historical levels of inventory per store. So some of that increase was due to the new stores, but some of it was to get the inventories back up to the historical levels. We think now that those inventories are where they belong, and our service levels have improved as a result.

Bill Sims - *Citigroup Smith Barney - Analyst*

All right. The same questions on International. Clearly we're all aware that the environment has been extremely challenging for numerous quarters now. When you look at the business in this most recent first quarter, did overall business conditions decline in Europe and if not, what are you seeing? You were more promotional, yet your comps declined further. What are you seeing from a company perspective versus what's going on in the industry? Thank you.

Steve Odland - *Office Depot Inc. - Chairman & CEO*

Thanks, Bill. Clearly, we are not happy with the performance in International. Most of our International business and profitability is in Europe. We are experiencing very difficult economic conditions there compared to North America, and at the same time we've got gyrations from currency fluctuations. But I think the point is that we do believe long-term that Europe as well as other regions of the world provide us with great opportunities. We have not really acted upon our plans with driving the costs out of the business following the Guilbert acquisition. We have largely country operations in Europe that need to become a pan-European operation and so I just see a tremendous opportunity to take cost out of the business while at the same time providing better customer service. And that's one of the main reasons why we promoted Charlie Brown in order to focus on this. At this point we've had local management in each of the divisions, in each of the regions sort of running their own businesses; and we really do need to take a global approach to our business from a brand standpoint, from a business development standpoint, from a culture standpoint, and in Europe in particular, we need to drive the efficiencies that we foresaw when we made the Guilbert acquisition.

Bill Sims - *Citigroup Smith Barney - Analyst*

Thank you, Steve, and good luck.

Steve Odland - *Office Depot Inc. - Chairman & CEO*

Thanks, Bill.

Operator

Dan Binder, Buckingham.

Dan Binder - *Buckingham - Analyst*

Hi. Good morning. A couple of questions for you. First, I'm wondering if you can sort of maybe quantify by major item the inventory increases related to forward buys and increased facings? We've noticed it in the stores, so I'm just kind of wondering if that was a bigger piece or with the new store growth a bigger piece? And then secondly, with regard to pricing, Office Max also released today indicating more targeted promotions, their gross margin rate was up. Your gross margin rate was up at retail. What are you seeing on the environment? Are you still going through this price optimization period that I think you were -- an initiative you had employed last year? And then lastly, if you could comment on traffic and ticket.

Steve Odland - *Office Depot Inc. - Chairman & CEO*

Okay, Dan. Thank you. From an inventory standpoint a big chunk of our inventory growth was driven by the number of new stores as we have continued to expand those stores. I think we -- we've said publicly that we plan to open about 100 new stores during our fiscal year, and we got a good jump on that in the first quarter. Other increases really are across the store in order to make sure that our service levels are appropriate; and again, this just simply returns us to the -- the historical per store inventory levels. There's nothing to call out in that regard.

From a pricing standpoint, remember that -- that our mix is -- is challenged in the stores driven by technology. Technology products are lower margin products and so forth, so from a price -- from a pure pricing standpoint, we have tried to make sure that we maintain our everyday value on our products. We have certainly targeted promotions, but it's not our goal to drive unprofitable volume. Our goal is to optimize the mix and make sure that we have a value equation for our customers, but margin pressures as sales mix changes and shifts towards technology, clearly will be impacted and that's what we really saw this quarter.

Your final question on traffic and ticket, again, we -- we did see some -- some pickup in tickets and we were challenged a little bit by traffic in the quarter, but that -- our challenge is always to make sure that we -- we get the right customers and continue to build traffic in the stores.

Dan Binder - *Buckingham - Analyst*

Okay. And then just one last question. With regard to the costs on the International business, can you sort of break out for us what piece of it was more nonrecurring in nature related to the relocation and closure of warehouses versus what was more just deleveraging on soft sales?

Charlie Brown - *Office Depot Inc. - President, International & CFO*

Hey, Dan, this is Charlie. The vast majority of that cost was really the deleveraging. As you can see, if you look at the segment reporting, costs in dollars were up only a little bit. And it was mostly due to the -- the bulk in volume, so that -- that would be probably more than 80% of it.

Dan Binder - *Buckingham - Analyst*

Great. Thanks.

Steve Odland - *Office Depot Inc. - Chairman & CEO*

Next question?

Operator

Matthew Fassler, Goldman Sachs.

Matthew Fassler - *Goldman Sachs - Analyst*

Thanks a lot, and good morning. I'd like to start off with a couple follow-up questions on working capital. On the inventory side, you talked about returning your retail per store inventories back to where they'd been historically. Can you talk about how much those are up year-to-year, and also where the inventory sits kind of on a divisional basis? Whether most of the increases were in fact in North American retail or whether it's balanced across the three businesses?

Charlie Brown - *Office Depot Inc. - President, International & CFO*

Hi, Matt. This is Charlie. Most of that inventory increase is at retail and when we say historic levels, we're talking about levels that were a couple of years ago. One of the things that we're taking a sharp look at is as we bring Magellan online, some of the modules in Magellan are specifically focused around inventory optimization; and we expect that number to work its way down.

Matthew Fassler - *Goldman Sachs - Analyst*

So you -- you expect the inventory number to work its way down?

Charlie Brown - *Office Depot Inc. - President, International & CFO*

It will work its way down.

Matthew Fassler - *Goldman Sachs - Analyst*

Got you. So in other words -- in other words, you wanted to -- you wanted a rebound but maybe not quite to the magnitude that you saw this quarter?

Charlie Brown - *Office Depot Inc. - President, International & CFO*

That's right, and the other thing I'd point out -- sometimes you get -- you get concerned about whether the mix is being driven by tech and therefore creating an exposure. That's not the case here. Most of it -- almost all of it, as a matter of fact, is in supply items and increasing the facing there. So I think we're in good shape in terms of the health of the inventory, and so we will use Magellan to work it back.

Matthew Fassler - *Goldman Sachs - Analyst*

That's very helpful. Second question on working capital, your receivables number was up, I believe, about 13% year-to-year which exceeded your sales growth. Can you talk about whether that was focused in International or in domestic, and kind of what was behind that increase?

Charlie Brown - *Office Depot Inc. - President, International & CFO*

Yes, Matt. There's a couple of drivers for that. One was we -- we had a burst in our vendor program monies towards the end of the year. That was a little piece of it. The bigger piece was actually a little softness in some of our collections internationally. We also in the -- in the first quarter, started a process to outsource some of our credit and collection activity; and so we had a little bit of a handoff problem in Viking; but the good news is those numbers are coming back in line now, particularly in the Viking area.

Matthew Fassler - *Goldman Sachs - Analyst*

As you think about International, just to follow up on your answer there, you're talking about collections. To what degree have you reflected that reality, I guess, in your International accruals?

Charlie Brown - *Office Depot Inc. - President, International & CFO*

They're up a little bit, and that was flowed through in the quarter, so the -- the reserve for uncollectibles is up a little bit, but it's not much. We typically have very, very good experience. Our cost of credit and write-offs has been coming down consistently over the last four or five years, so the issue was just in terms of follow up and collecting the money.

Matthew Fassler - *Goldman Sachs - Analyst*

And do you feel like that has turned the corner, or is International still kind of drifting?

Charlie Brown - *Office Depot Inc. - President, International & CFO*

No, it's turned the corner.

Matthew Fassler - *Goldman Sachs - Analyst*

And my final question relates to International, kind of a bigger picture question. Over the past couple of quarters when you all have talked about Europe and Guilbert, it seemed like there were organizational challenges as the -- as the Guilbert sales force was turning over to some degree. You were losing some people; and just from a cultural perspective, it seems like that organization hadn't quite recovered, if you will, from the merger. I'm kind of curious, Charlie, especially as you move over there; and, Steve, as you've taken your first look, what's the shape of the organization right now and what are some of the moves that you think you can make in order to shore that up?

Charlie Brown - *Office Depot Inc. - President, International & CFO*

Well, I think the -- the challenge in Guilbert has been -- versus our initial expectations has been on the speed of some of the integration and yes, changing the culture within the sales force to be a more aggressive outbound type selling force rather than just an account management sales force. I -- I think that the folks in Europe, we have a strong management team there led by Rolf and Rob Vale. I think that the issue here is just to pick up the pace of change. Things tend to move slower in Europe, and we're going to see what we can do to accelerate that.

Matthew Fassler - *Goldman Sachs - Analyst*

Okay. Thanks so much.

Charlie Brown - *Office Depot Inc. - President, International & CFO*

Thank, Matt.

Operator

Thank you. Next question --

Steve Odland - *Office Depot Inc. - Chairman & CEO*

We're not hearing a question, if we can try again.

Operator

Okay. It will be one moment, sir.

Steve Odland - *Office Depot Inc. - Chairman & CEO*

Thank you.

Operator

Michael Baker, Deutsche Bank.

Michael Baker - *Deutsche Bank - Analyst*

Thank you. Steve, a high level question for you. Can you maybe tell us what are some of the challenges you see in the office products business, relative to some of the other businesses that -- that you've led in the past?

Steve Odland - *Office Depot Inc. - Chairman & CEO*

Well, I think this is -- this is a -- first of all, a huge and growing sector of business, not only in the United States and Canada, but almost in a more exciting way outside of North America. Our business tends to track from a macro standpoint to economic expansion and particularly small business development. So as we see the North American economy evolve from a -- the early recessionary times into more full-blown development, we're seeing more and more small businesses come forth. Also, as we see large businesses sell off divisions and -- and split their -- their businesses out, we see a greater opportunity for growth in our business.

Clearly outside of North America as we see regions and -- and nations move from -- up the development cycle for developing more and more small businesses, moving more towards capitalism, we see greater and greater growth in our sectors. So if you look at areas in east Asia and south Asia and you look at areas in Latin America, we don't have any business there and we don't compete. So I just see a tremendous amount of growth across our three priorities, really, North American Retail, Business Services in North America, but also International. So I think that we're -- we're very fortunate to have such great profitable growth opportunities. Our short-term challenges continue to be, quickly, to get the costs out of the business and get those aligned so that we can focus on those profitable growth opportunities.

Michael Baker - *Deutsche Bank - Analyst*

Great. So if I could follow up then on a more micro related question, do you see any structural differences between your company and some of the competitors, whether it be real estate or -- or mix skewing toward technology or just in the corporate G&A? Any structural differences that may make it difficult for you to close the margin gap? And then one final question, just if you can comment on trends regarding your move into the northeast?

Steve Odland - *Office Depot Inc. - Chairman & CEO*

No, I -- I really don't see any structural differences or unique challenges to our Company. I think we're very, very well positioned. We've got terrific real estate across 49 states now, and the -- the lower states in Canada. We have a great acquisition last year of the KRU stores, Kids R Us stores, which gives us a toehold into the northeast, and that clearly is a growth opportunity area for us as that region of the country is understored. So I think then you couple that with the ability to more effectively use our invested capital, if you think about it as from a retail base, use our inventory and our supply chain more effectively and leverage that across our business services group, which is essentially a direct business operation that is obviously marketed through catalogs, the Internet and direct selling. So this is really a -- a terrific opportunity, I think, to -- to effectively contour our business so -- and leverage what I think is a structural advantage versus other kinds of retailers who are really locked into one growth opportunity or one business model.

Michael Baker - *Deutsche Bank - Analyst*

Great. Fair enough. Thank you for the comments.

Operator

Colin McGranahan, Bernstein.

Colin McGranahan - *Bernstein - Analyst*

Thank you. Good morning. Two questions. Wanted to follow up on the northeast expansion. If you could comment specifically on the productivity of the stores in the northeast relative to the productivity of the new stores in regions outside the northeast that opened this quarter and last quarter. Also if you could comment on what kind of cannibalization impact you incurred in the last quarter or two given the acceleration in stores? And then any comment on trend of the retail comps and business through the quarter. And then wanted to follow up with an International question.

Steve Odland - *Office Depot Inc. - Chairman & CEO*

Thank you, Collin. Clearly we're excited about our northeast expansion; and as I mentioned, the acquisition of the Kids R Us stores gave us a jump start into that area. But like every other retailer, when you enter a new market, those stores tend to have a little longer development curve and particularly in the northeast where the Office Depot brand was not there, it's -- you know, it will -- it will act like any new market acts for us. So we're experiencing the expected kind of rate of development there, and we're pleased with the store results there. So the productivity is coming according to plan. Most of our growth has been in new markets over the past quarter, so as we have added stores, fill-in kind of stores, which normally do provide us with a little bit of cannibalization, that has not been the majority of our stores and so therefore we've not seen great levels of cannibalization. But as you fill in, you deliberately cannibalize yourself in order to provide better service and better coverage to the customers going forward. You had -- you had another question, then, Collin?

Colin McGranahan - *Bernstein - Analyst*

Yes. In the International, you commented that it was weak across all geographies. Were there any particular highlights in terms of countries that were better or worse, and any particular highlights in trends between Viking, the catalog business and the contract business?

Steve Odland - *Office Depot Inc. - Chairman & CEO*

We -- we were particularly challenged if you look across the European economies, there is some variation in where we saw economic difficulty that was -- that was greater than other countries, we also experienced that level of difficulty. I'll just call out Germany, for example, which has experienced, I think, the highest levels of employment since World War II, and I think we're over -- at about 12% unemployment there, so that -- that provided a little bit of difficulty. Conversely, in France we saw a little better than average trend there. But the business, if you think about from a macro standpoint when I described it before, the business does respond and does correlate with economic conditions that -- that therefore impact small businesses and -- and our business seems to follow very rapidly around that correlation.

Colin McGranahan - *Bernstein - Analyst*

Fair enough. And, Charlie, it sounded like you'd been out of the market given Steve's arrival in the first quarter, but it sounded like you were alluding that you'd be more aggressive than 28 million in the second quarter. Is that a fair assumption?

Steve Odland - *Office Depot Inc. - Chairman & CEO*

It's the share buybacks. Yes.

Charlie Brown - *Office Depot Inc. - President, International & CFO*

Oh, yes. Oh, absolutely. We have been out of the market, one, because of Steve's -- the change which we knew about beforehand, and then that took us right up to the end of the quarter, but for -- yes, as a matter of fact, we will be more aggressive.

Colin McGranahan - *Bernstein - Analyst*

Excellent. Thank you.

Operator

Dana Telsey, Bear Stearns.

Dana Telsey - *Bear Stearns - Analyst*

Good morning. Can you talk a little bit about your store remodeling program, what your plans are there going forward, and how do you target which stores are eligible for a store remodel program? And lastly, can you talk about usage of cash and obviously of the share repurchase program, what else would be on your agenda as you look at the business going forward? Thank you.

Steve Odland - *Office Depot Inc. - Chairman & CEO*

Thanks, Dana. Yes, our store remodeling program is not unlike any company's store remodeling program. We want to make sure that our stores look fresh, that they provide the ability for our store associates to provide outstanding customer service. And we have found that our M2 prototype has really provided that mix of products in our stores, that shopping experience, the ease of -- of navigating and so forth that we like as well as better favorable labor in those stores, so we are -- as we -- as we are remodeling our stores, we are moving them to the M2 format. We choose our stores by though stores who can most benefit from remodels, typically our oldest stores that have experienced the most traffic issues, and so we're moving around that way. We clearly do financial analysis on those stores to make sure that the kind of investment that we put into them -- into the remodels will provide a return for us.

From a -- from a use of cash standpoint, it's -- it's no secret that this business has a tremendous amount of cash flow and -- and as we look at our growth opportunities in North America and around the world, we now are focusing on the three priorities that I've discussed. North American Retail, Business Services and then International, in that order. So our -- our cash needs to be deployed first and foremost to profitably grow our businesses by opening new stores and furthering our -- our business in North America, but we can also deploy our cash for acquisitions and joint ventures around the world. And then finally, we have our announced $500 million share buyback program, which we are committed to and as Charlie said, we will begin to return to that -- to that program beginning as early as, I think, tomorrow. Next question?

Operator

Gary Balter, UBS.

Seth Batch - *UBS - Analyst*

Hi. It's actually Seth Batch [ph] in for Gary. If you could just comment, Steve, on what you're seeing in terms of areas to reduce costs outside of International, that would be helpful.

Steve Odland - *Office Depot Inc. - Chairman & CEO*

I -- I think -- I think I got the question. We had trouble hearing you, but I think it -- you were talking about areas to reduce costs outside of International, so I -- focusing then on areas to reduce costs in North America. I think virtually every line item in the P&L is a candidate for review from a cost standpoint. Clearly our G&A is higher than we would like it to be, and we need to attack that. And I look at -- I look at costs from a -- a necessary and an unnecessary standpoint. Those aren't accounting terms, of course, but the kind of necessary investments we need to make are the right amount of labor in our stores, because that's our brand and that provides the service levels. And so we won't -- we won't compromise on the quality of our office people, associates, the level of training that needs to go into those -- to those people in order to provide the customer service levels that we want.

Virtually everything else is up for assessment. We will assess our hundreds of IT projects and make sure that those projects are returning well above our cost of capital and make sure that we're adding value. Our warehousing network, which we have built historically around first -- separate from retail in our business services group is a candidate to rethink and to make sure that we've got the most effective supply chain network and that we're able to provide a product at the right -- at the right time at the right place and at the best cost. Certainly procurement and as we shift to private brands, our ability to procure directly and foreign sourcing potentially allows us to expand those margins. And then you know, basically we -- we have got to look at things like surplus property and -- and other -- other assets that are tying up cash. And so we're doing a complete review of our -- of our entire balance sheet and making sure that -- that we're operating as efficiently as possible.

Seth Batch - *UBS - Analyst*

Okay. Great. Thank you. And one more follow up. We saw your vendor program explode, as Charlie said, in the fourth quarter. Going forward, how much opportunity do you think there is to continue working aggressively with vendors, and do you see the opportunity more on the technology side of the business or the supply side?

Chuck Rubin - *Office Depot Inc. - EVP, Chief Merchandising/Marketing Officer*

Hi. This is Chuck Rubin. The vendor program as we talked about at the end of Q4 was an opportunity for us to improve on in 2004, which we did. I think that it has continued opportunities in 2005, and it's broad based across product categories. It's not localized only to technology.

Seth Batch - *UBS - Analyst*

Okay. Great. Thank you.

Operator

Mike Blahnik, Piper Jaffray.

Mike Blahnik - *Piper Jaffray - Analyst*

Thanks. Good morning. My question is on product acquisition costs. In what categories are you seeing or an anticipating the price increases, and in what categories have you done the forward purchasing to -- to beef up ahead of price increases?

Chuck Rubin - *Office Depot Inc. - EVP, Chief Merchandising/Marketing Officer*

Mike, this is Chuck Rubin again. The raw commodity costs have gone up and that's impacted lots of different products from paper and all paper-related products, manila folders, things like that. We've also seen raw commodity impact the costs of some of our furniture, the end product that we sell as furniture. We have -- I think that market continues to be volatile as we look out. We have take an number of actions to try to manage the impact to our margins, and we have very high hopes of being able to manage that effectively for the balance of the year.

Operator

Joe Feldman.

Joe Feldman - *SG Cowen - Analyst*

Thanks, guys. I was just hoping -- I had a couple of follow-ups. With regard to the Magellan program, can you just refresh our memory, like, where you guys stand in that process? I thought it was like a three-year program, and you're fairly well into it. And then what -- maybe just a little more color on the real benefits that you're seeing from the program, and then I have another follow up after that.

Charlie Brown - *Office Depot Inc. - President, International & CFO*

Hi, Joe. This is Charlie. Yes, you're correct that Magellan was a three-year program. We're about 75% of the way through that program. And just to maybe refresh your memory as to what it is, I mean, the central part of this is a -- is a merchandising data warehouse and what spins off of that are all our replenishment and buying and pricing and assortment planning, et cetera, so we're -- we're -- it's -- so far the program has been executed flawlessly. And as I said, we're about 75% of the way through there and on budget.

Joe Feldman - *SG Cowen - Analyst*

Great.

Charlie Brown - *Office Depot Inc. - President, International & CFO*

On time

Joe Feldman - *SG Cowen - Analyst*

And then I -- maybe for Steve, I was just kind of curious since we haven't been able to hear from you about it, just what type of person are the qualities you'll be looking for for the new CFO spot, and also for the new president of North American retail? And then when you might expect to hire those types of people.

Steve Odland - *Office Depot Inc. - Chairman & CEO*

Well, as we've announced, we have a search out for both of those positions. The North American retail president is a new position that we've created in order to bring focus to what we've articulated as our number one growth opportunity. Currently, all of the people leading the functional areas including Chuck and -- and Rick Lepley and Mark Holifield report directly to me, so we're trying to integrate all of their activities under one executive. Consequently, what we're trying -- the kind of person we're trying to find is a true retail veteran, an executive who has demonstrated an ability to drive profitable growth in competitive retail sectors. And that search is just beginning right now, so those kinds of searches usually take many months.

From a chief financial officer standpoint, Charlie Brown, for those people who have met him, provides very large shoes to fill. And we will -- we will search diligently to -- to find an outstanding, proven, seasoned chief financial officer who can step in and add significant value. We -- I've been very impressed with the quality of our finance team, the team that Charlie has built, and we think that we've got many candidates who can be a chief financial officer at some point in the future. We just weren't entirely comfortable that -- that any one of them could take on that burden today, so we're -- we're going to search for that at the same time and that -- these things take many months, and so we'll keep you informed as we proceed.

Joe Feldman - *SG Cowen - Analyst*

Great. Thanks very much.

Operator

Steve Soderberg, Wellington Management.

Steve Soderberg - *Wellington Management - Analyst*

Thank you. Mr. Odland was very clear and explicit and answered my question already when he said the stock buyback program can resume as early as tomorrow. Thank you very much.

Steve Odland - *Office Depot Inc. - Chairman & CEO*

Okay, Steve. Thank you.

Operator

Chris [ph] Sullivan, First National Bank.

Chris Sullivan - *First National Bank - Analyst*

Thank you. Steve, first I'd like to welcome you to the team. We're very happy to have you on. I'm interested on which of the three segments you would expect to see the most improvement from over the next 12 to 15 months. And then, Charlie, if you could review for us what your priorities are in the International arena. Thank you.

Steve Odland - *Office Depot Inc. - Chairman & CEO*

Thanks, Chris. We -- we have not had the clarity, first of all just so that everybody knows -- I know it sounds pretty simple to hang three growth priorities out there, and when you state them as North American Retail, Business Services, and International, it sounds like very obvious things, but we've not really articulated it that way prior to this. I really do see great growth possibilities across all three, and I don't have a sense yet as to which ones provide the greatest growth opportunities, but I will remind people that we're not chasing growth for growth's sake. Growth without profitability really doesn't add shareholder value over the long-term, and so I don't want anyone to think that -- that we are just simply ramping up growth regardless of profit. We want profitable growth, and we want profitable growth in any investment and -- and that's what we believe will -- will drive shareholder value over time. I think we've got the opportunity to -- to add more stores. Clearly we're nowhere near saturation in our store buildout. Tremendous amount of market share there. We believe that we've got opportunities in our store productivity to add new categories, to customize the mix. We're using new tools like the Magellan system in order to help us do that, but Chuck and his team are very strong and put a lot of focus over the past year in developing people with analytical capabilities to make quantitative assessments in order to drive shareholder value.

In the business services area, we've found a great elasticity to sales as we add sales people. Adding people pays out, and -- and we have done so in the fourth quarter in the first of last year and the first quarter that we've just completed, and we hope to see greater growth there. Our market share is very, very small. This is a highly competitive market with lots of different channels. We compete with lots of -- of competition in this area, and so there's just a tremendous amount of market share.

And then in International, when -- when -- you take and you look at the -- at the areas we're in, which is largely Europe, which is -- largely western Europe, which consists of developed nations, the opportunity is almost greater for us in developing nations where small businesses and capitalism is nascent and you've got to look at areas, as I said, in eastern Asia and southern Asia. We won't do that just to -- to go willy-nilly, though, around the world. We're going to be very focused about that, and so maybe, Charlie, you can talk about priorities from that standpoint.

Charlie Brown - *Office Depot Inc. - President, International & CFO*

I think the priorities -- you'd mentioned Europe. Just to remind folks, we doubled the size of our European business just under two years ago; and that, I think, still remains an opportunity for us to accelerate and wrap up that integration and improve our execution. Also, we talked earlier today about some of the economic challenges in Europe from an economic perspective. For us to compete effectively, we're going to have to simplify our business and look at cost reductions, our European model is a fairly expensive model. I don't think that's a secret, and then Steve highlighted the opportunity to expand. We've had in the past a -- a business development function, albeit -- it was not at the level of priority that it should be and that's -- that's the opportunity for us to accelerate that.

Chris Sullivan - *First National Bank - Analyst*

Thank you.

Steve Odland - *Office Depot Inc. - Chairman & CEO*

It appears that we've come to the end of our allotted time. I'd like to thank everybody for joining us today and for your great questions, and we look forward to meeting with you and talking to you in the future.

Operator

Thank you. And that concludes today's conference. You may all disconnect at this time. Thank you.