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ODP.OQ - Q4 2005 Office Depot Inc. Earnings Conference Call

EVENT DATE/TIME: FEBRUARY 15, 2006 / 9:30PM GMT

OVERVIEW:

The Co. reported that 4Q05 GAAP net earnings were $106m. 4Q05 GAAP EPS on a diluted basis was $0.34. FY05 GAAP earnings were $274m. GAAP EPS on a diluted basis were $0.87 for 2005.

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PRESENTATION

Operator

Welcome to the fourth quarter and full year earnings conference call webcast for 2005. [OPERATOR INSTRUCTIONS] At the request of Office Depot today's conference is being recorded. I would like to introduce Mr. Ray Tharpe, Director of Investor Relations who will make a few opening comments. Mr. Tharpe, you may now begin.

Ray Tharpe - *Office Depot Inc. - Director, IR*

Good afternoon. Before beginning today's conference call I would remind you that certain statements made on this call are forward-looking statements under the Private Securities Litigation Reform Act. Except for historical financial and business performance information comments made on this call should be considered forward-looking. Actual future results may differ materially from those discussed on the 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 this afternoon.

During portions of our call, our Chairman and CEO, Steve Odland; and Pat Mckay, Executive Vice President and Chief Financial Officer, will refer to results of our fourth quarter and fiscal year 2005 which are not GAAP numbers. A reconciliation of non-GAAP numbers to GAAP results is available on our website at www.officedepot.com. Now I'd like to introduce Office Depot's Chairman and CEO, Steve Odland.

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

Good afternoon and thank you for joining us today for Office Depot's fiscal year 2005 conference call. With me today are Pat Mckay, our Chief Financial Officer; Chuck Rubin, our President of North American Retail; and Ray Tharpe, from Investor Relations. I hope you've had an opportunity to read our press release and learn about the fourth quarter and full year results. If not the press release along with the accompanying webcast slides are available on our website at www.officedepot.com, and just click on company information at the top of the screen.

Our fourth quarter sales grew by 7% to $3.7 billion when compared to the fourth quarter of 2004. All three divisions realized benefits in both revenue and operating results from the effect of a 53rd week in 2005. As I discuss the results of each of our business divisions, I'll highlight the effect of the 53rd week on the quarterly revenue numbers. Sales growth on a 13-week to 13-week basis was 2% in the fourth quarter of 2005. Net earnings for the quarter on a GAAP basis were $106 million compared to earnings of $52 million in the same period of 2004. GAAP earnings per share on a diluted basis were $0.34 for the quarter, up from $0.17 in the fourth quarter of 2004. GAAP earnings for the fiscal year 2005 were 274 million compared to earnings of 336 million in the same period of 2004. GAAP earnings per share on a diluted basis were $0.87 for 2005 compared to $1.06 in the prior year.

We took charges in the fourth quarters of 2005 and 2004. Fourth quarter charges in 2005 had a $0.09 per diluted share negative impact on the results and 2004 fourth quarter charges reduced diluted earnings per share by $0.12. So without these charges and the benefits of the 53rd week, our fourth quarter 2005 net earnings were $117 million or $0.38 per share, which were up 31% from the adjusted earnings per share for the fourth quarter of prior year. Excluding charges and the benefit of the 53rd week, non-GAAP earnings per share for the full fiscal year 2005 were $1.41, up 19% from the adjusted earnings per share of $1.18 in 2004.

Company gross margins were 31.1% for the quarter compared to 31.8% for the same prior -- same period of the prior year. The negative gross margin impact was primarily attributable to a decline in the international division gross margins as the gross margins for North American retail and the North American business solutions division were relatively flat quarter over quarter. Total operating expenses as a percentage of sales were 27.4% which improved 150 basis points from the same period in 2004. Excluding fourth quarter charges in both periods, operating expenses as a percentage of revenue improved 160 basis points year-over-year. The effective tax rate for the fourth quarter was 27.9%. Our effective tax rate as well as interest costs benefited from the settlement of various worldwide tax audits which reduced the need for certain interest in tax accruals.

EBIT for the quarter was $143 million as compared to $107 million in the prior year. Fourth quarter charges included in the EBIT number totaled $45 million in 2005 and $33 million in 2004. Return on invested capital was 9.5% versus 10.6% in the same period of prior year. On a non-GAAP basis, fourth quarter charges negatively impacted the calculation of our current return on invested capital by 310 basis points and by 60 basis points in the same period of the prior year. We have provided a reconciliation of GAAP to non-GAAP results that you can access them on our website www.officedepot.com under the Company information tab and then Investor Relations.

Fourth quarter sales in the North American retail division were $1.7 billion, a 15% increase compared to the same period last year, including the benefits of the 53rd week, retail sales in the fourth quarter increased 8% over the same period last year. Comparable store sales in the 945 stores in the U.S. and Canada that have been open for more than a year increased 5% for the fourth quarter. Our comparable store sales results exclude the effect of the 53rd week. This represents our 8th consecutive quarter of positive comparable sales led by the continued strength in the technology segment. Our comps for the fourth quarter reflect solid promotional and merchandising calls that were made and which were particularly effective during the more heavily consumer based holiday season. Given the strong impact of the holiday season on this comp we would suggest that people not expect this level of performance going forward. During the fourth quarter we reported North American retail division operating profit of 119 million, which was a 20% increase over the same period last year.

Fourth quarter charges negatively impacted operating results by $7 million in 2005 versus $2 million in 2004, which was an increase of 30 basis points from the same period of the previous year. Comparable average ticket size continued to increase, and average sales per square foot was $248. As a percentage of sales, operating profit for the quarter was 6.9% up 30 basis points from the same period last year. Broad-based product category management improvement and higher levels of private brand sales contributed to the favorable gross margin performance. A continuation of effective advertising and expense control as well as the leverage from the 53rd week delivered cost efficiency's in the quarter and more than absorbed the incremental costs associated with adding stores during the period as well as the compensation costs associated with our early adoption in the third quarter of FAS 123R regarding stock options.

I'd like to just highlight a few of our ongoing initiatives to drive profitable growth in North American retail. We continue to base our initiatives around the successful advertising campaign that we relaunched in the beginning of 2005 under the "taking care of business" theme. In fact, we've just completed refining the look and feel of all of our marketing materials to ensure that we have a consistent message to our business customers. We previously announced that we were expanding our partnership with NASCAR and the Roush racing team to be a full time sponsor. Just to help you understand why we're excited about this partnership I just wanted to share a couple of results from a recent survey.

Office Depot among NASCAR fans was the fifth most mentioned company in terms of unaided awareness. More than 80% of those fans polled felt that NASCAR sponsorship positively affects their image of Office Depot, and one-third of non-Office Depot primary shoppers said they'd switch supply -- office supply companies now that that they know that Office Depot's a sponsor and finally we're proud that NASCAR has named Office Depot the marketer of the year for 2005. Needless to say we're pleased with the results of our NASCAR related marketing promotions as they provide us with an opportunity to attract greater interest from small business customers. But overall marketing effectiveness remains a priority for Office Depot. We will continue to review the return on investment of all of our advertising vehicles to ensure that we concentrate on the highest yielding activities.

The Advantage Loyalty program continued to grow at a healthy pace during the fourth quarter. During the quarter we made several changes to the program that have generated cost savings while improving the effectiveness with our best customers.

In merchandising our ongoing initiatives continue to deliver results as well. We continued to expand the number of private brand products that we offer to customers, we conducted an additional global bids in several product categories during the quarter and that resulted in lower cost of goods for selected items. We plan to continue to focus on global sourcing opportunities throughout 2006. Our category management initiatives continued to deliver results in the fourth quarter as we continue to refine our product and pricing strategy and the needs of our retail and business solutions customers while delivering returns for our shareholders.

Finally, the North American retail team continues to deliver operational cost savings. In the last few quarters, we have mentioned many examples of these cost saving programs. I'll mention some of those now. We've retrofitted energy efficient light fixtures in our high energy cost stores upgrading the energy monitoring systems that allow us to adjust store electricity usage in real time, we're executing more favorable lease agreements for our store technology partners. For example, the cash registers and copy center equipment. We're shifting store broadband communications from frame relay to the less expensive DSL. We've reviewed an adjusted shopping bag specifications, we've shortened the customer registry receipt printout and that resulting in register tape savings across the chain. We're optimizing the utilization of printing equipment in our copy print and ship operations by digitally moving print jobs to the most cost effective resources. Consolidated the number of vendors who are -- who supply our finishing equipment for copy, print, and ship, rationalized the amount of the number of inserts that's shipped directly to our stores.

But just a few additional examples of some of the cost savings that we've achieved. We've consolidated our armored car service providers, we've optimized our guard services at various facilities and we've reengineered our corrugate specifications for our delivery targets. So any one of these doesn't seem like a big deal, but these savings add up to millions and millions of dollars in cost savings. As I hope you're starting to see, the number of cost savings initiatives are starting to accumulate and we've begun to measure their positive impact to the bottom line.

During the fourth quarter the Company opened 41 stores, closed 1 office supply store. As of December 31, 2005, five stores remained closed as a result of the damage sustained during the hurricanes. Since the beginning of 2006 we've opened two of these stores, so at the end of the fourth quarter Office Depot operated a total of 1047 office product stores throughout the U.S. and Canada. In 2005 we opened 100 new stores and closed 22 for a net of 78 new stores. We're putting the finishing tops on our M2 store format and plan to begin remodeling our current stores in this fiscal year. We remain committed to profitably expanding our presence in existing markets as well as targeting new markets where we see opportunities for growth. We're pleased with our North American retail results this quarter, starting to make real progress but we have a lot of work ahead of us to achieve consistently improving operations results.

I'm very pleased to have announced a few weeks ago that Chuck Rubin has become President of North American retail. You may recall that Chuck formerly was our EVP of Merchandising and Marketing and we will look to him to build on the eight consecutive quarters of comparable sales growth that he has achieved in the last couple of years with improving profitability over time.

Now turning to North American business solutions division. The sales in that division increased by 11% to $1.1 billion in the fourth quarter compared to the same period last year. Now excluding the 53rd week sales grew by 6% over the same quarter. We experienced broad-based revenue growth in all customer segments. Division customer transaction counts and average order values both increased compared to the fourth quarter of 2004. Division operating profit increased 24% to $130 million for the quarter as compared to the prior year and as a percentage of sales was 11.8% during the fourth quarter versus 10.5% same period last year. Fourth quarter charges in 2005 as a percentage of sales increased 20 basis points on a relative basis versus the same period of the previous year. Gross margin for the division was relatively flat despite the higher growth in lower margin contract business. Selling and warehouse expense as a percentage of sales was lower due to call center optimization and the effect of the 53rd week and lower costs from the integration of our Office Depot and Viking catalog brands.

The North American business solutions team remains focused on several key initiatives to drive profitable growth in our efforts to increase our market share. First is private brand. We continue to emphasize our private brand to deliver value and provide differentiation in the eyes of our customers. Second is direct marketing. We've refined our circulation plans and we've expanded the use of our telephone account management. Third is the Viking brand. We successfully completed a majority of the customer facing elements of the integration of the Viking and Office Depot catalog businesses. The migration plan associated with this effort has made the transition effortless for our customers. Our goal is to create unparalleled shopping experience for all of our direct marketing customers whether they currently shop with Office Depot or use the Viking catalog.

Now turning to international. The international division's fourth quarter sales decreased 8% in U.S. dollars to 892 million compared to the same period last year. However, in local currencies sales decreased only 1%. Now, excluding the 53rd week, sales decreased 10% in U.S. dollars and 3% in local currencies to $871 million. Our international division continues to operate in a very challenging economic and business environment, with local currency sales declining in most major geographic markets compared to the fourth quarter of the prior year. Gross margins also experienced declines as the result of continued pricing pressure in key product categories and continued competitive activity.

The division operating profit in the quarter was 71 million or 7.9% of sales compared to 92 million or 9.4% of sales in the prior year's fourth quarter, but the fourth quarter charges in 2005 as a percentage of sales increased by 180 basis points on a relative basis versus the same period of the prior year. Operating costs were leveraged by the existence of the 53rd week and we've realized benefits from cost savings initiatives.

While somewhat improved from prior the quarter's trends these operating results still are not up to our expectations and as we've discussed in the last few quarters, it may take us some time to stabilize this situation. In the meantime we have taken many actions to improve the performance of the international division. Today, I'm pleased to announce the appointment of Dirk Collin to the position of Executive Vice President and Managing Director of Europe. Dirk comes to Office Depot from Storage Tech Corporation in Brussels where he led their northern European operations and previous to that he had over 25 years of experience with Xerox in Europe. Dirk has an extensive operating experience in developing and growing strong sales teams as well as successfully managing organizations through periods of change. We are excited to have Dirk join our team and look forward to leveraging his management skills as we strive to improve our results in Europe.

In Europe also we're continuing our roll out of telephone account management to deliver more cost effective customer relationship management and demand generation. We're streamlining our overall process and cost structure to ensure that we remain competitive in the marketplace. The international division completed its review of efficiency opportunities that we had discussed in the third quarter, and as a result we've identified a number of organizational and centralization opportunities as well as determined that we would phase out the use of the Guilbert brand in Europe. These actions will necessitate additional charges above those disclosed in our third quarter reports on Form 8-K and 10-Q. Part of the cost associated with these activities has been recorded in our 2005 results and the remainder will occur in future periods through 2007 and beyond as the events occur. I would encourage you to read our 10-K filed earlier this afternoon for a more detailed explanation of our plans and these charges.

We remain optimistic on the long term potential of our international business but cautious regarding the expectations of the immediate market improvements in division performance based on the modest changes in the broad economic conditions in Europe. On a different note 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 over time.

I'm pleased to announce that we're in the process of acquiring a majority stake of a leading office supply company located in South Korea. Best Office operates a network of over 70 franchised and company-owned retail stores and also has a delivery sales channel. We will purchase 61% of the Company for $15 million and consolidate this $44 million revenue business into our P&L. Acquiring a majority ownership of Best Office will strengthen Office Depot's global presence in a rapidly growing area of the world and extend our ability to service our global customers. This transaction of course is still subject to normal regulatory approval. Now I'll turn it over to Pat Mckay to take us through the cash flows and balance sheet.

Pat Mckay - *Office Depot Inc. - EVP, CFO*

Thanks, Steve. Let me start with cash flow. In 2004, cash flow before share repurchases was $646 million versus 656 million in 2003. In 2005, cash provided by operating activities was $636 million. Depreciation and amortization totaled $268 million for 2005 and relatively consistent with 2004. EBITDA was 640 million for the year. However, adjusted for 2005 charges EBITDA was $922 million, up 9% versus adjusted EBITDA in the same period of 2004. Capital expenditures for 2005 amounted to $261 million. North American retail, new store openings represented the biggest capital investment area. We will continue to identify and execute on investment opportunities to drive returns above our cost of capital.

We achieved a $375 million of free cash flow in 2005 as compared to 255 million in 2004. This year-over-year increase is attributable to a more focused effort to ensure that all capital expenditures meet or exceed our return on investment requirements. Last October we announced that the Board of Directors had authorized an additional 500 million in share repurchases and during the fourth quarter we repurchased 11.5 million shares for $330 million. For the year share repurchases totaled $815 million or 29.8 million shares. Today our Board of Directors has authorized the repurchase of an additional $500 million in market value of our common stock.

Now, moving on to certain tax matters. Our fourth quarter effective tax rate was impacted by the charges that we recorded in the quarter in addition to the mix of income of our businesses for the quarter and for the year. The effective income tax rate for our base operations was 31.3% for the fourth quarter. After considering the fourth quarter charges, the overall effective tax rate reported was 27.9%. As we have disclosed previously our effective tax rate in future periods can be affected by variability in our mix of income, the tax rates in various jurisdictions, and our assessment of the need for accruals for various matters and therefore may be higher or lower than it has been in the past. As a starting point for 2006 you should consider an effective tax rate of 33%.

We ended the fourth quarter with 703 million in cash and short-term investments. Our investment in merchandise inventory totaled $1.4 billion. Our fourth quarter inventory balance includes the year-over-year impact of opening 78 new stores in the year, expanding assortment in key categories in North American retail, and improving our in-stock positions across all channels. For the fourth quarter inventory per store was approximately 970,000, 10% lower than a year ago. Working capital increased slightly as compared to the fourth quarter of the prior year. We ended the fourth quarter with accounts payable to inventory ratio of 97%. We have initiatives in place to improve the payables to inventory relationship in the future which will drive improvement and working capital. Our long-term debt at the end of 2005 was $569 million, down 3% from the prior year. At the end of the fourth quarter our debt to total cap was 17%.

Our outstanding 2013 senior notes are rated investment grade by both Moody's and Standard & Poor's. With our positive net cash position our balance sheet remains very strong. Our return on equity adjusted for charges for the trailing four quarters improved by 220 basis points to 14.6% as compared to 12.4% for the comparative period in fiscal 2004. Return on invested capital adjusted for charges increased to 12.6% from 11.2% in the prior year.

Finally we've been analyzing and developing methods to allocate G&A to the divisions and refine other existing allocations and line item classifications. We may implement this revised process in the first quarter 2006. These revised allocations may impact individual line items and prior period results would then be reclassified for meaningful comparison. That concludes the cash flow, tax rate, and balance sheet discussion and I'd like to turn the call back over to Steve.

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

Thank you, Pat. During 2005, we refocused our efforts on reaching our customers and growing our business while streamlining our operations. We've reviewed our balance sheet and future commitments and identified some assets and activities that did not fit with our vision for the future. We believe progress has been made in reshaping our company but we also believe that much work lies ahead of us. I'd like to spend just a few moments highlighting some of the achievements of 2005 and then I'll follow with comments on our future areas of focus.

The full year sales in 2005 excluding the 53rd week grew by 4% over 2004 to 14 -- to over $14 billion in sales. The North American retail division reported 3% comparable sales for 2005 representing, as I said before eight consecutive quarters of positive comparable sales. We opened 100 new stores in North America for 2005 and we see plenty of opportunity for future new store openings with at least 100 planned for 2006. Our North

American business solutions division increased sales by 5% for the year excluding the 53rd week. They added to their sales force and they continued to lower supply chain cost.

In international, we experienced declines in revenue and gross margin in 2005 but the division is working to enhance the top-line growth and implement our operational efficiencies. So excluding the charges in 2005, operating profit as a percentage of sales increased 30 basis points over last year. Selling, general, and administrative expenses decreased year-over-year, which more than offset gross margin pressures experienced by our international division. All of these achievements helped us to drive an adjusted non-GAAP earnings per share increase of 19% in 2005 compared to the prior year.

I want to remind everybody again of our three key strategic growth priorities. First, of course is North American retail, hope to continue to improve store productivity and implement our store expansion and remodel plans. Second, is North American business solutions. We plan on profitably growing our market share through new customer acquisition and new product and service offerings. Finally, international, we need to reignite profitable growth in Europe and over time increase our geographic reach.

I'll remind you that we don't issue formal business performance and earnings guidance. We do remain committed to making decision and taking actions consistent with the long-term interest of our shareholders. We have a business that generates substantial cash flow year in and year out and we can use our cash to profitably grow our business by opening new stores in new markets, by making necessary investments in our core business like store remodels, by acquiring assets or businesses in our key priority areas, and by repurchasing stock as long as we believe it's accretive. Our company is clearly headed in the right strategic direction. We are pleased with the results that we have achieved in 2005 but we also are mindful of the significant work that still must be accomplished to drive continuous improvements in those operating results.

We still have much to do to drive top-line growth as well as achieve the results from various cost management activities in each of our divisions. These growth and cost management activities will take some time to complete. In addition competition in the office supply market both domestically and abroad is steadily increasing and we anticipate increased gross margin pressure in many categories in the years to come. Globally we have a significant percentage of our sales where margins are contractually linked. So our fourth quarter and fiscal 2005 results do appear to be promising but we just want to remind everybody that we still have a lot to do. I believe our clear direction along with improved execution and sharp focus on profitable growth are the keys to achieving our industry leadership goals over time. Now I would like to open up the call for questions.

QUESTIONS AND ANSWERS

Operator

Thank you. [OPERATOR INSTRUCTIONS] Our first question comes from Colin McGranahan with Bernstein. Your line is open.

Colin McGranahan - *Bernstein - Analyst*

Thank you. A couple questions. First, looking at the international sales can you comment on -- I know you said it was geographically fairly representative, but can you comment on the performance in the contract business and Guilbert relative to the catalog business and what impact the store closures and retail had? Just so we get a sense of where that negative 3% came from? That's question one. Secondly, Steve, could give us any insight into capital expenditures in 2006 and should we expect any increase in CapEx to remodeling? And if you could, just a sense of how many remodels you think you would be willing to undertake in the coming year. Then third and final question would be on BSG, obviously a very impressive performance in that category. Is there any additional clarity you can provide to us in terms of what's driving that margin improvement.

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

Okay. Thank you, Colin. In international sales we experienced declines across all the key markets in Europe and it was a little tougher in the contract business as we completed the Guilbert integration. Mail order was a little more stable than that. There was a decline from some of the retail store closures that we had in Spain and in France. I don't have the exact number, Colin, but that's not the majority of our business. The majority of our businesses are in the other two segments. In terms of CapEx for the year we can expect somewhere in the order of 300 and 400 million and we've said in the 10-K that we hope to remodel at least 60 stores during the year which is a big chunk of that in crease in CapEx for next year.

In BSG the question was good margin expansion. In BSG we were pleased with that margin expansion. Remember, that contract, when you have margin pressure across categories, our business in contracts guarantees pricing. That's what the contract is all about. And so as that business has grown and as we've experienced from the price pressure we've been able to manage that very well. I would say that our expansion in private brand is helping that business as well to -- helping not only to -- on the margin side but also helping on our point of differentiation with competition.

Colin McGranahan - *Bernstein - Analyst*

If I could just follow-up on the international, the Guilbert business I think when it was purchased in 2003, it was roughly $1 billion U.S. equivalent and whatever that was the euro-dollar exchange rate. What size is that business today after obviously what's been a very difficult environment and some competitive pressures?

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

I don't have the exact number on the size of the Guilbert business per se because we have integrated it with the pre-existing contract business so we don't call it out, Colin. But Pat, you've got a couple of comments on the--.

Pat Mckay - *Office Depot Inc. - EVP, CFO*

Yes, Colin, as a follow-on in terms of the business solutions division performance one of the other things that was a key contributor during the quarter and you'll remember that that division has been doing a number of things in terms of improving its operational efficiency's. One of the things was to -- some call center consolidations and closures and some outforcing there as well as the integration of the Viking brand with the Office Depot brand has enabled us to have some cost savings opportunity there. So we're beginning to see the fruits of that effort that's been expended drive to the bottom line performance of that division.

Colin McGranahan - *Bernstein - Analyst*

Okay, that's helpful.

Operator

Our next question comes from Daniel Binder with Buckingham Research.

Daniel Binder - *Buckingham Research - Analyst*

Hi. Good afternoon. A couple of questions. With regard to, and I know you don't provide guidance, but just directionally, the way we should be thinking about gross margin. If retail on BSE is sort of flattish and Europe continues to struggle, what are the things that you think you can do, particularly on the international side to help kind of arrest that decline? And then the second question that I had was with regard to the pricing environment, I was wondering maybe if you could give us a little more detail on what's going on in the delivery business, and then the last question was with regard to acquisitions. Obviously you made one here today, or announced one today. Is there any chance of looking at further consolidation in the delivery business in the U.S. through acquisition?

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

Let me take one at a time, Dan. Directionally, in terms of gross margin you've got countervailing factors going on here. First of all, the move towards private brand, everything we're doing in private brand, category management, and so forth is constructive to gross margin. On the flip side the contract business pressures gross margin and in Europe that has been exacerbated by the economic environment. If that environment stabilizes, of course that takes a little bit of pressure off of that situation. Also impacting gross are some of the costs programs, and we're working very hard on that. We hope that the pricing environment which also as you know contributes to gross is constructive in the coming year, but we don't really know what is going to be held in that environment, either in retail or in the delivery business.

In terms of acquisitions, yes, we have made a small acquisition in Korea that we're announcing today. And we have an intent to grow our businesses in international, expand geographically there. Your question was related to the North American business services group specifically. We do believe that there's room for consolidation in that area. I think the top players have a market share that's under 10% and so the vast majority of the market share is still completely fragmented, so we do see a promise of further consolidation it's anybody's guess as to how soon that will happen and how material that will be.

Daniel Binder - *Buckingham Research - Analyst*

just more of a housekeeping question as a follow-up here. Is the -- I guess I was just curious, with $0.09 of charges in the quarter, it would seem that the earnings should have been $0.43 but you're saying that the extra week was -- would get to $0.38. So I'm just kind of wondering why, there seems to be like $0.05 that's attributed to that extra week. Just trying to understand why that would be.

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

Well, that's exactly right. That extra week, it's very hard to determine exactly what the impact on EPS is, so we did our best to try to characterize that, obviously it's a non-GAAP measure, but we know the 53rd -- we know the number with the 53rd week in it which is the 43 which would give you a 48% EPS growth versus year ago. We just tried to characterize that. Obviously the fixed costs are still in regardless of the extra week, but there's variable costs in the sales and we went with it. It's hard to parse out globally. That was our best effort at it was the $0.05 which then gives you a comparable growth of 31% in our earnings per share in the quarter.

Daniel Binder - *Buckingham Research - Analyst*

Thank you.

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

Thanks, Dan.

Operator

Our next question comes from Matt Fassler with Goldman Sachs.

Matt Fassler - *Goldman Sachs - Analyst*

Thanks a lot. Good afternoon. If you could start out by talking a bit about mix trends that you might have seen in retail, talking about the growth that you saw in core supplies versus technology, versus furniture. Chuck, why don't you comment on mix trends?

Chuck Rubin - *Office Depot Inc. - EVP, President, North American Retail*

Yes, hi, Matt. We saw some positive movement in each of the businesses. In technology, certainly the notebook business continues to be strong, networking, mobility, all the accessories that support the technology business which is also helpful for our overall margin. Our supplies business also shows pockets of some good strength. It really goes back to innovation and trying to stay in touch with the customer, so we saw growth in writing instruments, a variety of our -- what we categorize as business essential businesses, with a lot of strength on newness whether it's new features, new colors, things along those lines. Then our furniture business as well we saw strength in our collections business, our Christopher Lowell business continued to be strong. Again, back to innovation in some of the novelty that you saw in seating, in lighting, as well as, as I say, the collections themselves with new looks, new finishes for the furniture.

Matt Fassler - *Goldman Sachs - Analyst*

Got you. If you think about the impact or was there an impact from mix shifts in one direction or the other on the gross margin rate in U.S. retail, or North American retail?

Chuck Rubin - *Office Depot Inc. - EVP, President, North American Retail*

Technology business continued to be strong. Our strongest growth was in that product division, so that has an impact overall but we think we managed it well during the fourth quarter and as I mentioned, we're pleased with the outcome of the basket that's sold with those technology items.

Matt Fassler - *Goldman Sachs - Analyst*

Got you. The second question I have, if you would, related to accounts receivable, those had been up year to year earlier in the year. They seem to be down year to year in the fourth quarter which was a real nice improvement. If you could just shed some light as to whether that was domestic, I guess BSD, or international where you saw those improvements.

Pat Mckay - *Office Depot Inc. - EVP, CFO*

Sure, Matt this is Pat. As we looked at the receivable levels at the end of the year, certainly sales, international sales were down so that does have some impact on the overall receivables this year over last year and over the prior quarters as well. But we did have some improvements in DSO as it relates to our domestic business and collectability areas, collection areas over the past quarter, so we had some key areas we kind of focused in on and were able to drive down DSOs in the fourth quarter for those domestic accounts.

Matt Fassler - *Goldman Sachs - Analyst*

Is it safe to say that the quality of the receivables you have out there versus last quarter given the decline is probably a bit better?

Pat Mckay - *Office Depot Inc. - EVP, CFO*

Oh, yes.

Matt Fassler - *Goldman Sachs - Analyst*

And the final question, you made reference to the payables ratio, which was down a bit year to year, obviously the inventory came down so overall working capital is looking good but if you could just shed some light on timing and anything in particular that you have in mind that might enable you to reaccelerate leveraging that inventory.

Pat Mckay - *Office Depot Inc. - EVP, CFO*

Yes. Actually as we look at 2004,I think that was a bit of an anomaly for certain timing et cetera. I think we talked about that in prior conference calls as well as in any of our filings. This year end as we looked at the 97% accounts payable inventory ratio, one of the things that we have continued to focus on and the opportunities we're trying to match up are payable cycles with the cycles of inventory turns, if you will, in our stores and in our chain. So we're continuing to work with our vendors to make sure that there is kind of a rational basis in terms of that payment cycle and as we work through any kind of new programs with vendors, the merchants and all of us are really working through to make sure that we're working towards a correct balance.

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

Matt, as you know we're very focused on cash, the generation of cash and this is one piece of it. So this has our attention.

Matt Fassler - *Goldman Sachs - Analyst*

Understood. Thanks a lot.

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

Yes.

Operator

Our next question comes from Bill Sims with Citigroup.

Bill Sims - *Citigroup - Analyst*

Thank you and good afternoon. Can you give us some performance metrics on your M2 stores such as comps or returns on store relative to your non M2 store and then tied to that have you looked beyond the M2 format yet or is that still your latest and greatest?

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

We haven't disclosed exactly what the performance metrics are but suffice it to say that we're pleased with the performance and we intend for this to be our prototype going forward. We have nearly 200 stores in that prototype today which we will -- which we are slightly modifying, small stuff, but this is settled. We're not looking at further format changes. Our intent is to carry this forward across the remodels this year and also, as we said before, to remodel the majority of our chain over the coming handful of years.

Bill Sims - *Citigroup - Analyst*

Okay. And then from -- have you finished the review of all your businesses now or should we expect potential for further charges outside of what you've already outlined in your release down the road?

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

No, we've completed the business review. Last quarter we talked about North America being complete and international being only partially complete so international now is complete and so we've taken obviously the 2005 charges and in our Form 10-K you will note that we've outlined the charges as predicted for 2006, 7, and 8, so we're trying to full disclosure, give everybody the ability to look out and see the impact of the changes in the coming years.

Bill Sims - *Citigroup - Analyst*

Thank you very much. Good luck.

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

Thanks, Bill.

Operator

Our next question comes from Danielle Fox with Merrill Lynch.

Danielle Fox - *Merrill Lynch - Analyst*

Thanks. Good afternoon. I have two questions. First, you touched on intensified price competition in contract but I'm wondering what you're seeing at the retail and the international divisions? In terms of price competition.

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

Well, I didn't say it was intensified. It just simply -- the nature of contract, the contract business is that -- the way it works, is we're dealing with larger companies who are trying always to run RFPs and bid the pricing, and so they're always looking for better pricing. That's what I meant. It's not intensified from--.

Danielle Fox - *Merrill Lynch - Analyst*

Not a change.

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

No, no, it's not a change at all. We anticipate and are seeing a rational pricing environment both internationally as well as in North America. I don't see that changing over time. I think -- so I think if you're thinking about pricing, it's only the contract business, so as our mix changes, if that business grows faster than other businesses, well, you've got that natural kind of a mix change, and then also if technology continues to grow at a faster rate you've got a natural down draft on gross margin. So those are the two -- Danielle, those are the two natural down drafts, but then there are a lot of offsets to that, which we're working on, which are all the category management opportunities, strategic pricing opportunities, and private brand, of course.

Danielle Fox - *Merrill Lynch - Analyst*

It sounds like the macro environment is improving somewhat in Europe. Are you actually seeing any sequential improvement in demand or is it still early to see it translate at the office supply level?

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

It's -- what we saw at the very end of 2005 was what we hoped to be a light at the end of the tunnel here. So we see some firming up and we're not going to comment or give guidance into 2006, but we do see things firming up and we hope that continues.

Danielle Fox - *Merrill Lynch - Analyst*

Thanks very much.

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

Okay, Danielle, thank you.

Operator

Our next question comes from Michael Baker Deutsche Bank.

Michael Baker - *Deutsche Bank - Analyst*

Hi. Can you hear me okay?

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

Sure. Go ahead, Michael.

Michael Baker - *Deutsche Bank - Analyst*

Good, thanks. I'm out of the office. Real quick, three questions, so did you discuss or could you discuss regionally on the North American retail business were some regions like the northeast or Midwest better or worse than others? Second question is, paper pricing I believe has been falling. Can you discuss how that impacts your business maybe at the retail comp level and also I think it would be a benefit at your contract. Can you discuss that? And then finally, I think you had spoken about on the mix pockets of strength in the supply business. Can we assume that the supply business did comp positively in North American retail, perhaps though not as much as the 5% that the total division did? Thanks.

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

Yes. We haven't talked about regional results, but we were pleased on the balance throughout North America. Didn't see anything that was material. We don't see paper prices falling. If it would it would impact our sales of course but we don't see that happening. We think that the paper pricing is relatively stable. And pockets of strength in the supply business, yes, I mean, in the fourth quarter we reported a 5 comp in North American retail. The big news there was the holiday season and technology, and I just want to call that out, because I would urge that you not straight-line that 5% because we were benefited from a more consumer driven holiday business, the benefit of additional shopping days, and, look, Tech was on fire here during the holidays, and so to predict that that's going to continue would just simply not be the right thing to do. But we were pleased with a positive comp in some of our other areas as well.

Michael Baker - *Deutsche Bank - Analyst*

Okay. Well, thank you very much. Appreciate it.

Operator

[OPERATOR INSTRUCTIONS] Our next question comes from Chris Horvers with Bear Stearns.

Chris Horvers - *Bear Stearns - Analyst*

Good evening. On the category management program, could you just give kind of a quick description on exactly what that entails and then as a follow-up, what -- where are you in the program, how much more is there to go? Is there a way that we can look at it and say, let's say we've been through 50% of our assortment and we have 50% to go?

Chuck Rubin - *Office Depot Inc. - EVP, President, North American Retail*

Yes, on the account management issue, Chris, this is Chuck, it really gets down to a couple of components. It's the mix of the product that we offer, the assortment of it, the pricing of it, also how we advertise it, and how we present it in our stores and various marketing vehicles. So it's really trying to manage our product as a portfolio, recognizing that customers have different expectations in terms of the mix, the features, the pricing attributes of different products. It is -- we're only partway through our category management approach. We're pleased with how it's gone so far. We've been executing well so far, but we think that there's much room for improvement as well.

Chris Horvers - *Bear Stearns - Analyst*

Okay. And then with that, has there been a change in, let's say, the average basket, or the average ticket in the past year?

Chuck Rubin - *Office Depot Inc. - EVP, President, North American Retail*

Yes, I think we had in our release, our average order has gone up, as a result of a number of the efforts that we've talked about today.

Chris Horvers - *Bear Stearns - Analyst*

So the average order price, that's kind of like an average price increase overall?

Chuck Rubin - *Office Depot Inc. - EVP, President, North American Retail*

It's an average order values. So it's the basket that the customer purchases at any given time.

Chris Horvers - *Bear Stearns - Analyst*

Okay. And you don't have any details on, I guess, units versus price component of that?

Chuck Rubin - *Office Depot Inc. - EVP, President, North American Retail*

No, I think what we released is just the AOV having gone up.

Chris Horvers - *Bear Stearns - Analyst*

Then on the private label side, where are you as a percentage of sales? I think your goal is 20%, and is it something where you're looking at expanding SKUs in 2006?

Chuck Rubin - *Office Depot Inc. - EVP, President, North American Retail*

We're very pleased with the level that we achieved in 2005. We know we have much more progress in 2006, and you will see it through an expansion of SKU counts, an expansion of categories, what private brand we'll reach into that they haven't been in before, and also the benefit of SKUs for the full year of 2006 that came into the assortment later in 2005.

Chris Horvers - *Bear Stearns - Analyst*

Thank you. That's very helpful.

Operator

Our next question comes from the Daniel Binder with Buckingham Research.

Daniel Binder - *Buckingham Research - Analyst*

Hi. I just had a couple more questions to throw in. I guess maybe just sort of touching on that last question, is there a way you can quantify how much of your comp store sales retail came from price inflation?

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

Most of our comp store sales was unit volume. We had very little price inflation.

Daniel Binder - *Buckingham Research - Analyst*

Then if we were to just sort of look out over the next few months Office Max I guess will be closing a lot of stores. Is there anything that you're able to do from sort of a store level perspective in terms of getting these managers out there and prospecting the small businesses and sort of preparing for those stores to close and picking up that business?

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

Well, clearly, Office Max has been very public about the 100 or so stores that are being closed, and we'll take a look at those stores as everybody will, but I think there have been estimates made in the marketplace of these great possible growth results that could accrue to us because of those closures and I just want to point out that the three largest players, the so-called superstore players, have over 3500 stores in North America, and -- or in the U.S., and 100 stores which are arguably the worst 100 stores, or they wouldn't be closing them, just taking out that small amount of the lowest performing stores really has a very, very tiny impact, and it's going to be spread around the entire industry. So I think the potential impact on Office Depot is de minimus just on paper, and we'll see what happens to the people and the real estate as those stores are closed.

Daniel Binder - *Buckingham Research - Analyst*

Sure. You had mentioned how holiday and the strength in technology which is typically lower margin had a nice impact on the comp store sales at retail. I was wondering, is there any way you can maybe just give us what kind of impact that may have had on gross margin?

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

Well, the technology business is the lowest of our gross margin so the fact that we were fairly flat in our gross margin during the quarter with that big surge in technology was actually great news. It's masking really some terrific underlying strength in our grosses in North American retail. I do want to point out once again that at that five comp, was at least a couple hundred basis points, if not more, that surge in technology, and shouldn't be straight lined going forward.

Daniel Binder - *Buckingham Research - Analyst*

I guess just out stores recently learned that your product return policy is going to be changing a bit on technology hardware. We're going to see something more similar to what the CE guys do with technology hardware and restocking fees. I'm just curious, is that worth a lot to the gross margin given your average return rate in technology hardware or is that just sort of a small piece of the total?

Chuck Rubin - *Office Depot Inc. - EVP, President, North American Retail*

Daniel this is Chuck. I think it is a small piece of the total. I think I'd characterize it as our return policy is adjusting. It will be very competitive with what's happening in the marketplace and first and foremost we stay very focused on serving customers and being sure that we're there to support them in their needs and develop a long-term relationship with those customers.

Daniel Binder - *Buckingham Research - Analyst*

Great. Thank you.

Operator

Our next question comes from Matt Fassler with Goldman Sachs.

Matt Fassler - *Goldman Sachs - Analyst*

Hi. Just a follow-up question. On the technology front you talked about the Christmas surge being in essence a one-time issue. I'm kind of wondering your early read on the impact of Microsoft's Vista operating system, Chuck, as you think about the second half of the year and what that might do for technology and how you think you'll be positioned because it seems like that could be another catalyst, if you will for the industry overall and I just wonder if -- what your view is on that?

Chuck Rubin - *Office Depot Inc. - EVP, President, North American Retail*

Matt, I think there's a lot of things that we're excited about in all the products that we're going to carry this year. Vista is a new product, and has lots of innovation to it and we're all about offering that to our customers, and as I mentioned, so many of the new things we're going to offer, we're excited about all of them. Vista would be one.

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

I think you see over time new operating systems tend to be the way that drives growth over a multiyear period. I don't think everybody runs out and changes operating system upon issue, but it tends to trickle out into the market. So I know Microsoft, as a partner of ours, is very excited about that system but I don't think you're going see any rapid surge in the marketplace as a result.

Matt Fassler - *Goldman Sachs - Analyst*

Got you. Thank you.

Operator

Our next question comes from Maurice Diane with Janice Capital.

Maurice Diane - *Janice Capital - Analyst*

Thanks. I had two quick questions, guys. One, I jumped on the call just a little late so could you repeat if you said the breakdown of comps between traffic and number of transactions? And the second question is the variance that you gave in CapEx for this year, does that depend strictly -- mostly on the number of M2 remodels or anything else, and could you tell us what the high/low range might be on the number of those remodels?

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

The comps, I don't know, Chuck, do you want to talk about the breakdown in comps?

Chuck Rubin - *Office Depot Inc. - EVP, President, North American Retail*

Comps, we were pleased with -- I think you said traffic and transaction count?

Maurice Diane - *Janice Capital - Analyst*

Yes.

Chuck Rubin - *Office Depot Inc. - EVP, President, North American Retail*

We were pleased with both our traffic count as well as our transaction, our conversion rate of our traffic and our AOBs.

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

So it was a good balance in how the comps were driven, Maurice. Secondly, on the variance on the CapEx, we quoted a number that's roughly 300 to 400 million which is an increase over this year, a good portion of that is due to remodels. We've said that we want to do at least 60 remodels this year. We will have replacement stores in that as well as over 100 new stores, we'll have work that we do in our distribution systems and also we're working on our technology systems. So that's kind of the range we're saying. It's still early in the year. We'll probably be able to tight than range as we get closer to the back half of the year.

Maurice Diane - *Janice Capital - Analyst*

So besides that range, it just doesn't relate to the number of M2s that you may or may not do?

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

No, there's a number of things. Most of the CapEx is new stores and there's the remodels and tech and then supply chain, yes.

Maurice Diane - *Janice Capital - Analyst*

Thank you very much.

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

Thank you to everybody for joining us today for the call. Since there are no more questions we'd like to wrap things up and look forward to talking to you in the future. Thanks.

Operator

Thank you for participating in today's conference call. You may disconnect at this time.
