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ODP.OQ - Q3 2005 Office Depot Inc. Earnings Conference Call

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OVERVIEW:

The Co. reported sales of $3.5b and pro forma net earnings of $115m or $0.36 per share for 3Q05. 3Q05 GAAP net loss was $48m or $0.15 per share vs. earnings of $89m or $0.28 per share in 3Q04. For the full year of 2005, ODP anticipates CapEx to be in the range of $260-270m (Phonetic).

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PRESENTATION

Operator

Good morning. We would like to welcome you to the Office Depot third-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 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 - Director of IR*

Good morning. Before beginning today's conference, 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 this call due to risks and uncertainties both foreseen and unforeseen. Certain risks and uncertainties are described in detail in our report on Form 10-K filed with the SEC on March 10, 2005 and in our 10-Q filed with the SEC this morning.

During portions of this call Office Depot executives may refer to results of our third-quarter 2005 which are not GAAP numbers. The providing of non-GAAP figures is not intended to reflect that we believe such non-GAAP information to be in any way superior to GAAP information. It is intended, rather, to clarify certain issues pertaining to our financial performance and to make it easier for listeners to compare results against comparable periods in the prior year. 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 - Chairman & CEO*

Good morning and thank you for joining us today for Office Depot's fiscal 2005 third-quarter conference call. With me today are Pat McKay, our Chief Financial Officer; Chuck Rubin, our Chief Merchandising and Marketing Officer; Charlie Brown, our President of International; and Ray Tharpe from 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 on the Investor Relations tab.

Net results for the quarter on a GAAP basis show a loss of $48 million or $0.15 per share compared to earnings of $89 million or $0.28 per share in the same period of the prior year. The third-quarter results for 2005 include the effect of charges related to asset impairments, exit costs and other operating items previously announced on September 12, 2005 in our filing on Form 8-K as well as the incremental effect on compensation expense of our early adoption of FAS 123R. The third-quarter charges had a $0.50 per share negative impact on the results and option expensing negatively impacted the results by a penny per share.

Without the third-quarter charges in option expensing our net earnings on a pro forma or non-GAAP basis were $115 million or $0.36 per share. This is an increase of 24% compared to an adjusted earnings per share for the third quarter of last year of $0.29 when that earnings per share number is adjusted up by a penny per share to reflect the charges of a comparable nature that were recorded in that period.

For the third quarter of this year we reported sales of $3.5 billion, a 5% increase over fiscal third quarter 2004. Sales for the trailing four quarters were over $14 billion. These results were driven by strong performances from our North American retail and our business services divisions. Our international division continued to experience a decline in sales driven primarily by a challenging economy and competitive pressures in Europe.

We understand the possible difficulty of sorting out the impacts of our third-quarter charges. So we've provided a reconciliation of GAAP to non-GAAP results that you can access on our website, again www.OfficeDepot.com under the category of Investor Relations.

Company gross margins were 30% for the quarter as compared to 31.3% in the prior year. The third-quarter charges, however, negatively affected company gross margins by approximately 50 basis points. Other negative gross margin impact was primarily attributed to the decline in the international division which more than offset improvements experienced in North American retail.

Total operating expenses as a percentage of sales were 32.7% for the quarter, up from 27.3% for the same period in 2004. The third-quarter charge as an option expensing negatively impacted operating expenses by approximately 640 basis points, somewhat offset by improvements realized in both general and administrative expenses as well as store and warehouse operating and selling expenses driven by advertising cost efficiencies, increased sales leverage and lower warehouse costs.

The effective annual tax rate for the Company is projected to be 32.8%. In the quarter, however, we realized tax benefits due to closure of various worldwide audits that were somewhat offset by tax expense on the additional repatriation of foreign earnings. EBIT for the quarter was a negative $91 million compared to $139 million in the prior year. But the third-quarter charges and option expensing included in EBIT in the quarter totaled $242 million.

Return on net assets was 7.2% versus 9.2% in the same period the prior year. Third-quarter charges and option expensing negatively impacted that calculation by 280 basis points. So we continue to make progress on a sequential basis and we remain committed to improving this metric going forward as we focus on improving shareholder value.

Now I would like to take a moment to briefly discuss the charges that we announced on September 12, 2005. As I noted earlier, on September 12th we announced a number of charges related to asset impairments, exit costs and other operating items that followed a companywide assessment which began in the second quarter of 2005. The pretax charge relating to current and future periods is expected to be $320 million, of which $237 million was recorded in the third quarter of 2005. The balance of the charge we announced on September 12th will be recognized as incurred during the fourth quarter of 2005, as well as in future fiscal periods. This effort -- the effort underlying these charges are intended to rationalize our balance sheet.

We separately have launched an initiative to drive our overall cost structure lower. This effort naturally complements the positive results and continuing programs that we have underway to drive our top line and increase shareholder value. In addition, we incurred incremental costs associated with the effect of early adopting the FAS 123(R), which brings the total of these two items for the third quarter to $242 million. For ease of your analysis, we have provided a summary of the third-quarter charges on the slide.

Now let's discuss our division results beginning with North American retail. Third-quarter sales in North American retail were $1.6 billion, a 10% increase compared to the same period last year. Comparable store sales in the 885 stores in the U.S. and Canada that have been open for more than a year increased 4% for the third quarter. This represents our seventh consecutive quarter of positive comparable sales led by continued strength in technology sales. We were happy with the positive results achieved in the important back-to-school period as well. During the quarter, comparable average ticket size increased and comparable transaction counts decreased slightly. A significant portion of the transaction count decline is attributable to low ticket purchases we believe from the nonbusiness customer.

Average sales per square foot increased 3.7% in the third quarter as compared to prior year. So we made good progress on store productivity in the quarter. Our operations in a U.S. Gulf Coast states were negatively impacted by Hurricanes Katrina and Rita. The disruption of sales from temporary closures experienced throughout the end of the third quarter as well as the increased costs are embedded in the division results. At various points in time through the quarter, we had up to 50 stores closed for some period of time. At the end of the quarter, seven stores were closed and have been excluded from the comp store calculation, and as of today, six stores remain closed.

We reported a division operating loss of $30 million in the third quarter with the third-quarter charges in option expensing negatively impacting operating results by $156 million. As a percentage of sales, the operating loss was 1.8% compared to an operating profit of 7.2% in the same period last year, with the third-quarter charge in option expensing impacting margin by 950 basis points. Cost efficiencies and improved gross margins were realized despite the negative effects of the two hurricanes and higher fuel costs. Broad based product category management improvement, higher levels of private brand sales, and increased vendor support were the main contributors to the gross margin increases that were realized in North American retail.

Effective advertising and expense control delivered cost efficiencies this quarter and more than absorbed the incremental costs associated with adding stores during the period. Now I'd like to highlight a few of our ongoing initiatives to drive profitable growth in North American retail. In the third quarter we continued our successful taking care of business campaign that we had launched during the first quarter. This campaign continues to be very well-received by our business customers. Also our back-to-school programs drove increased sales in the quarter as we integrated the program messaging across all media vehicles.

In July, we announced the expansion of our partnership with NASCAR and the Roush racing team. So beginning in 2006 Office Depot will become the primary sponsor of Carl Edwards and the Roush '99 Ford Taurus and we'll continue our exclusive office products NASCAR sponsorship. We're very 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.

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 vehicles. The Advantage loyalty program continued to grow at a healthy pace during the third quarter. Our Advantage members continue to demonstrate a higher purchase frequency compared to non Advantage members. We continue to observe strong double-digit sales lift among measurable customers.

In merchandising our ongoing initiatives continued to deliver results as well. Private brand sales penetration continued to increase during the quarter and we remain on track to reach our yearly goal. We also expanded the number of private brand products that we offer to customers. Global bids were conducted in several product categories during the third quarter resulting in lower cost of goods for those selected items. Additional product categories are scheduled for bid during the fourth quarter of 2005.

Our category management initiatives, which began in 2004, continued to deliver results in the third quarter as we continue to refine our product and pricing strategy to meet the needs of our retail and business services customers while delivering returns for our shareholders.

The North American retail team has done a good job in delivering operational cost savings over the past year. In the past couple quarters we've mentioned many examples of cost-saving programs. Those include retrofitting of energy efficient light fixtures in our stores; upgrading energy monitoring systems that allow us to adjust store electricity usage in real-time; executing more favorable lease agreements for store technology hardware, for instance cash registers and copy center equipment; shifting store broadband communications from frame relay to the less-expensive DSL mode; reviewing and adjusting shopping bag specs, saving over $0.5 million annually. Also my favorite, shortening the customer register receipt text printout resulting in register tape savings across the chain.

But here are some additional examples of cost-saving programs that are currently underway. Optimizing utilization of printing equipment in our copy, print and ship operations by digitally moving print jobs to the most cost-effective resources, saving over $1 million annually. Next, consolidating the number of vendors who supply our finishing equipment for our copy, print and ship operations which resulted in a cost reduction of 23%. Next, rationalizing the amount of inserts that we ship directly to our stores. Amount of inserts now is based on the store volume and will result in savings of $125,000 this year and $245,000 each year moving forward.

Once again, while none of these examples may appear individually significant, taken together with continued focus we are confident that our cost-saving efforts will have a substantial impact going forward.

During the third quarter the Company opened 13 stores and closed 15 office supply stores. At the end of the third quarter Office Depot operated a total of 1009 office products super stores throughout the U.S. and Canada. We also had seven stores that were closed, as I mentioned before, at the end of the quarter due to the effects of the hurricanes.

Now I'd like to just take a moment and clarify a point regarding the closure of 16 stores that we disclosed in the 8-K filed on September 12th of this year. These store closures are not related to the asset write-down of the Kids-R-Us stores that was disclosed in that same 8-K.

As a normal course of business we monitor the performance of our stores and, where appropriate, we may decide to close certain locations. Additionally, we have announced these decisions in the fourth quarter of each fiscal year. But this year we completed it early and decided to include it with the 8-K filed on September 12th. So of the 16 stores closed or scheduled to be closed in 2005, only one is a Kids-R-Us store.

We continue to make progress in improving the performance of our KRU stores and we remain committed to profitably expanding our presence in the Northeast where many of these stores are located. We've experienced good results in the past quarter in the Northeast where our sales have grown at a double-digit rate. Also, because we get a lot of questions on it, in the Chicago market we once again recorded a double-digit growth rate over the same period last year.

We're very pleased with our North American retail results this quarter. We continue to benefit from our new store openings in existing and new markets along with improved performance from our existing stores. And we will continue to execute against our strategic priorities in an effort to drive future profitable growth.

Now turning to the North American business services division. Business services sales increased by 5% to almost $1.1 billion in the third quarter compared to the same period last year. Increased sales in the contract channel, particularly in large customer and national account segments, as well as in the Office Depot catalog contributed to the overall revenue growth.

We continue to see benefit from our recent investment in our sales force. The division customer transaction counts and average order values both increased compared to the third quarter of last year. Division operating profit was $60 million for the quarter as compared to 102 million in the prior year as a percentage of sales was 5.5% during the third quarter versus 9.9% in the same period last year.

The third-quarter charges and option expensing negatively impacted profit by a total of $56 million or approximately 510 basis points. Although this division was also negatively impacted by the effects of hurricanes Katrina and Rita, including the closure of a distribution center for approximately one month during the quarter, other improvements in operating cost efficiencies more than compensated for their impact on the business results for the quarter.

The division experienced some gross margin rate decreases due to higher penetration of slightly lower margin contract business coupled with increases in transportation cost, but partially offset by higher vendor support in the quarter. Significant selling and warehouse expense leverage also contributed to the overall operating margin improvement.

North American business services 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 to provide differentiation in the eyes of our customers.

Second, direct marketing. We've refined our circulation plans and expanded the use of telephone account management. These actions have led to third-quarter growth in both the number of transactions and the average order value.

Third is the Viking brand. We have begun a deliberately paced effort to integrate our Viking and Office Depot catalogs. The migration plan associated with this effort is designed to make the transition really effortless for our customers. Our goal is to create an unparalleled shopping experience for all of our direct marketing customers whether or not they shop at the Office Depot or the Viking catalog. This migration has been taking place over time and will not be completed until mid 2006.

Fourth, the customer segment growth. The additions we made to our sales force late last year and early this year are starting to contribute in a significant way as we experienced growth in our medium and large customer segments as well in national accounts during the quarter. So good results in business services.

Now turning to the international division. International's third-quarter sales decreased 4% in U.S. dollars to $770 million, or decreased 3% in local currencies compared to the same period 2004. Our international division continues to operate in a very challenging economic and business environment. Sales declined in most major geographic markets. The U.S. dollar continued to strengthen in the third quarter resulting in negative foreign exchange impacts.

Division operating profit was $59 million or 7.6% as a percentage of sales as compared to $97 million or 12% as a percentage of sales in the prior year's third quarter. The third-quarter charges and option expensing negatively impacted operating profit by a total of $10 million or 130 basis points. Gross margins in international experienced substantial declines and is the result of the continued -- as the result of continued pricing pressure in key product categories and increased competitive activity.

The international division's operating profit was negatively impacted by approximately $1 million from the movement in foreign exchange rates during the third quarter. As I stated last quarter, these operating results are not up to our expectations and it may take us a few quarters to stabilize the situation. Meanwhile we are taking action to improve the performance of the international division.

First, we currently have a search out for a new leader for our European operations. Next, we are continuing our rollout of telephone account management to deliver more effective customer relationship management and demand generation. Third, we are in the process of rationalizing our supply chain and other assets as part of the Guilbert post merger the integration process. Fourth, we are streamlining our overall processes and cost structure to ensure that we remain competitive in the marketplace. And finally, we announced the consolidation of our support functions which will improve our operating efficiencies and cost-effectiveness.

Despite these short-term results we remain optimistic on the long-term potential of our international business. We see great potential for our business outside of North America and we believe that we can grow this business at a more rapid rate and deliver higher profitability over time. Now I'll turn it over to Pat McKay to take us through cash flow and the balance sheet. Pat?

Pat McKay - *Office Depot - CFO*

Thanks, Steve. Let me start with cash flow. During the first three quarters of 2005 cash provided by operating activities was $414 million, down from 577 million in the same period last year. This year-over-year working capital change primarily reflects the timing of settlement of trade accounts payable and the settlement of certain tax payments that were deferred by the government for businesses affected by hurricanes in 2004.

Depreciation and amortization totaled 205 million for the first three quarters of 2005, up over last year largely due to increased store openings in North America. EBITDA adjusted for third-quarter charges was 676 million for the period, up 5% versus the same period in 2004. Capital expenditures amounted to 201 million in the first three quarters of 2005. North American retail new store openings represented the biggest capital investment area.

For the full year of 2005 we anticipate CapEx to be in the range of $260 to $270 million. We continue to identify and execute on investment opportunities that drive returns above our cost of capital. We accumulated 213 million of free cash flow during the first three quarters of 2005 as compared to 325 million in the same period of 2004. This year-over-year change, again, is affected by the reduction in cash flow provided by operating activity, primarily the timing of vendor and tax payments.

Last fall we announced a $500 million share repurchase program authorization to be conducted over a two-year period. During the third quarter we repurchased $394 million worth of stock completing the share repurchase activities associated with this announcement. We expect our Board to be in support of our plans to continue with a share repurchase program.

Now let me move on to the balance sheet. We ended the third quarter with 833 million in cash and short-term investments. Our investment in merchandise inventory totaled 1.2 billion and for the third quarter inventory per retail store was 921,000 lower than the prior quarter level of 1.06 million. Our third-quarter inventory balance includes the year-over-year impact of opening 88 net new stores in the past year and expanding the assortment in key categories in North American retail as well as improving in-stock positions across all channels. Working capital increased as compared to the third quarter the prior year.

We've already experienced improvements on our recent initiatives around improving the inventory to payables relationship and we ended the third quarter with an accounts payable to inventory ratio of 101%. Our long-term debt declined substantially compared to the same quarter last year as we redeemed 240 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 quarter our debt to total cap ratio was 16%; 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 for the trailing four quarters was 6.9% compared to 11.6% for the comparative period ended in fiscal 2004. Our return on equity was affected by 510 basis points due to the third-quarter charges and option expensing. Return on net assets was 7.2% versus 9.2% in the prior year's third quarter. This year third quarter is affected by 280 basis points, again due to third-quarter items.

Finally, as we announced last year, we have been reviewing the composition of our G&A expenses in assessing the appropriateness of additional allocation to the operating units. The Company may allocate G&A and other operating expenses to the operating segments and redistribute certain other amounts based on refined allocation methodology. This methodology is being refined and may be used in 2006. That concludes the cash flow and balance sheet discussion and I'd like to turn the call back over to Steve for some final remarks before we open the call up to questions. Steve?

Steve Odland - *Office Depot - Chairman & CEO*

Thanks, Pat. Before we conclude our remarks today I again want to remind everyone of our three key strategic growth priorities. First of all is North American retail. We hope to continue to improve store productivity and implement our store expansion plan over time. Second is our North American business services group. We plan on profitably growing our market share through new customer acquisitions and new product and service offerings. And finally, international. We need to reignite profitable growth in Europe and over time increase our geographic reach.

I also want to remind everyone that we don't issue formal business performance and earnings guidance. Rather we remain committed to making decisions and taking actions consistent with the long-term interests of our shareholders. We have a business that generates substantial cash flow year in and year out. We can use our cash flow to profitably grow our business in a number of ways. First, by opening new stores in new geographic markets. Second, by making necessary investments in our core business. Third, by acquiring assets or businesses in our key priority areas. And forth, repurchasing stock as long as we believe that it's accreted.

This company is clearly headed in the right strategic direction. I believe our clear direction along with our improved execution and sharp focus on costs are the keys to achieving our industry leadership role. Now I'd like to open up the call for questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS). Matt Fassler, Goldman Sachs.

Matt Fassler - *Goldman Sachs - Analyst*

Good morning. I'd like to focus on two points, Steve. First, on the international front. You spoke kind of in one sentence number one about the search for a new leader and also talked about taking a few quarters to stabilize the business. So I guess question one, does that mean that Charlie's role there is more of an interim role? And then around that international issue, you say a few quarters to stabilize. I know you're not issuing guidance, but given that you did make that segment would you anticipate that that profitability could come under further pressure here?

Steve Odland - *Office Depot - Chairman & CEO*

First of all Charlie Brown, who is with us today, is our President of international including operations in Europe, Latin America and Asia. Charlie is, on an interim basis, directly leading Europe while we search for a successor to our leader there and that search is underway where we will have somebody resident in Europe and on the ground and leading that business.

I mentioned that the business is under pressure and probably will be for a few quarters. It's the same comment that I've made the past couple of quarters. The situation is dominated by a difficult economic situation over there. I think everybody knows that our key businesses are in the UK, France, Germany, the big countries there which have seen some tough economic times -- high unemployment, low business formation and so forth.

So we're in this period of time. Those aren't excuses, that's just the situation that we're in. So those kinds of larger macroeconomic circumstances are not likely to change radically overnight. Meanwhile, we need to make the kind of business restructuring and sharpen our strategies to deal in a tougher economic environment frankly and that's what we're doing right now.

Matt Fassler - *Goldman Sachs - Analyst*

Gotcha. And if I could just follow up with a second one. As we think about the way the quarter has progressed -- and I know we're all taking a long-term view -- the Company has had some I guess volatility in the magnitude of increases. The fourth quarter last year prior to your arrival was a very strong quarter with sharp domestic profit increases, particularly driven by gross margin. The first quarter the pace of growth faded; the second quarter we saw once again very strong growth.

I guess, how do you feel about the predictability of the business and particularly focusing on the gross margin line? Are the vendor dollars, which seem to be one of the drivers of the delta, in your view sort of at a steady-state rate? Or do you still feel like we're going to see kind of spikes, if you will, in vendor dollars that could drive some of that volatility?

Steve Odland - *Office Depot - Chairman & CEO*

I think that the business has experienced now seven straight quarters of comp store growth in the North American retail business which I think is to what you were referring. The gross margins have been impacted by -- favorably by our vendor dollars and we did see some spikes in vendor funding late last year. Also remember we had some charges in the fourth quarter of last year which was the beginning of some of our restructuring.

But nevertheless, setting that aside I think that the business is pretty stable. And listen, I hope that we have great big spikes in our (multiple speakers) going forward, but we're not projecting that of course. but I think what we see here is the rollout of a category management effort that began in 2004, it's been very successful leading to seven straight quarters of results. And I think we see our vendors participating at a higher level now than before.

We also are expanding our private brand; our penetration is up again this quarter which favorably impacts our gross margin as we go forward. So our strategies are working in North American retail and we're very pleased by the results.

Matt Fassler - *Goldman Sachs - Analyst*

Okay. Thank you very much.

Operator

Michael Baker, Deutsche Bank.

Michael Baker - *Deutsche Bank - Analyst*

Just in the North American retail business, I'm wondering if you could discuss the pace of sales throughout the quarter. Did you see any kind of big drop-off in September around the big gas price increases? And then second question in North American retail, just what you're seeing competitively -- some of our competitors. Is there any change in the pricing structure in the business? Thanks.

Steve Odland - *Office Depot - Chairman & CEO*

The quarter was fairly typical in terms of the flow of the sales. Clearly while we had 50 stores closed there were some difficulties there. But I think from a direct standpoint, cause and effect on fuel prices, no, we don't see a specific hit there. Competitively we haven't seen anything unusual there as well.

We have had a great back to school season. Our focus of course is on the business customer, but the one time a year where we have a great consumer focus is back to school. We started the execution earlier than normal and I think our stores executed that extremely well. And so that period of time in August and September were quite strong for us.

Michael Baker - *Deutsche Bank - Analyst*

Great, thanks.

Operator

Colin McGranahan, Sanford Bernstein.

Colin McGranahan - *Sanford Bernstein & Co. - Analyst*

Continuing to focus here on North American retail. Excluding the charges margins were up about 50 basis points. Can you just compare and contrast the improvement in third quarter versus what we saw in the second quarter where margins were up about 160 basis points. And what were some of the deltas in that difference maybe in terms of mix, maybe in terms of impact from the hurricanes, fuel, etc.? How can we think about how that changed quarter-to-quarter sequentially?

Steve Odland - *Office Depot - Chairman & CEO*

Remember that the business sees margin ebb and flow seasonally through the quarters anyway. But I think what we're seeing contribute positively to North American retail of course is our private brand impact. And as the penetration increases in private brand the margins are clearly higher there than in other categories. On the flip side, technology sales are -- technology just in general are lower margin kinds of products and we did have fairly substantial growth in technology this quarter.

We were able to see some pretty good gains in labor productivity this past quarter and we'll continue to look at that. We're not cutting labor -- in fact we have increased our labor but that has been productive in our increase in expenses. We have also mentioned before that we are focused on all of our marketing expenditures and the ROI on those expenditures. So some of the margin increases of the blocks last year were driven by our early category management efforts, but those continue as well.

Colin McGranahan - *Sanford Bernstein & Co. - Analyst*

Okay.

Steve Odland - *Office Depot - Chairman & CEO*

So it's a collection of all those things.

Colin McGranahan - *Sanford Bernstein & Co. - Analyst*

Okay. And then just a follow up. You talked about use of free cash flow and listed four things -- opening new stores, investing in initiatives, acquisitions of assets or businesses and repurchase stock. Clearly number four there was the big use in the third quarter here. Any changes to your view in terms of those first three uses looking forward in terms of number of store openings, how you're thinking about that for next year and then any cash use investments or acquisitions on the radar?

Steve Odland - *Office Depot - Chairman & CEO*

No, I think the reason that I stated the four in that order is because that is the order of our priority. We want and we need to use our cash flow primarily to profitably grow our business and that includes new stores and geographic markets. But we do have quite a bit of excess cash flow and you saw this quarter we were able to deliver that cash flow and use it to complete our share buyback plan. And so our Board is supportive of continuing that plan going forward as well as we have excess cash flow and as repurchasing stock is accretive to our business.

Colin McGranahan - *Sanford Bernstein & Co. - Analyst*

Thank you.

Operator

(OPERATOR INSTRUCTIONS). Michael Cox, Piper Jaffray.

Michael Cox - *Piper Jaffray - Analyst*

Good morning. My first question relates -- or probably best for Steve. As you talk about vendor support, I was hoping you could discuss or contrast of the vendor base in office supply versus your previous experience in the auto parts space?

Steve Odland - *Office Depot - Chairman & CEO*

Well, they're different vendors. I think that the vendor base in office products has been at this a very long period of time as were the vendors in the auto parts industry. I think that the capital intensity in this arena is a little bit different but you've got -- and you've got different commodity impacts. In the auto parts of course you've got steel and you've got the labor impacts here, you've got paper and some other things.

I think the point is, though, that category management works in our Company and in our industry just as it has in the past. And my experience in grocery, drugstores, C stores, auto parts and now here is that category management, a focus on segmentation of customers, a focus on category by category delivery of good, better, best ranges, development of private brands in order to distinguish ourselves versus our competition, sharp merchandising in the stores -- all of those things matter and work extremely well and I would say that we're still in early stages of development of category management with our vendors and we look forward to further development over the coming years.

Michael Cox - *Piper Jaffray - Analyst*

Okay. And as we look at the store growth for 2005, the number of new stores seemed a little light at least of our forecast. I was wondering if you could give us some type of indication what you're expecting for net new stores in 2005 and then perhaps some type of indication for '06?

Steve Odland - *Office Depot - Chairman & CEO*

No, no. We're on track with what we said before that we were going to open up gross about 100 new stores. And what we did, though, announce on September 12th in our Form 8-K is that we were going to close 16 stores. We had never announced or predicted a number of store closures, but those store closures usually are reviewed, as I said, in the fourth quarter, we just did it a quarter early. Next year we've also said in 2006 that we are targeting to open about 100 new stores in North America as well. So there have been no changes to that plan.

Michael Cox - *Piper Jaffray - Analyst*

Okay, great. Thank you very much.

Operator

Dana Mullins (ph), Buckingham Research.

Dana Mullins - *Buckingham Research - Analyst*

Good morning. Can you talk to us a little bit about the progress you're making on fine-tuning your M2 prototype? When do you think you could roll out a more significant remodel program? And my second question is who do you believe your major competitive -- where do you think your competitive pressure is coming from in Europe? How do the recent combinations in Europe affect your competitive position?

Steve Odland - *Office Depot - Chairman & CEO*

We have may great progress on M2. For people who may not be familiar with that, we have been searching for the past couple years in developing different prototypes which are variations on our superstore concept. And M2 is short for Millennium 2 and is the second version of a concept that we've been testing for a couple of years. We think we're very close to having this prototype where we need it to be. We realize, however, that to undertake a major remodel program throughout North America will require a lot of capital and so we don't want to do that lightly. We want to make sure that all those expenditures are well spent and that they pay out.

And so we're putting the final touches on that prototype and we'll continue to test those over the coming quarter or so. But over the next few years we believe that M2 in some form or another will be the prototype that we use to remodel our stores. Just a reminder, we have been building all of our new stores in the M2 prototype over the past year and remodels, of course, have been to the -- as we've remodeled stores they've been to the M2 prototype.

We do have -- regarding your question on Europe, we do have our President of International, Charlie Brown, here. Charlie, do you want to make any comments on Europe?

Charlie Brown - *Office Depot - President Intl. & CFO*

Sure. The competition in Europe varies by country and it varies by channel. Pretty well known players; if it's on the contract side it's going to be Lirico (ph) and Corporate Express. And in the mail-order side, again it varies by country, but Staples, as you know, acquired the Guilbert mail-order business a couple years ago and so they're a strong competitor in several countries.

As for the recent announcement, the acquisition of Aarons (ph) by Lirico -- I mean, clearly that gives them additional size and scope and improves their position in a couple of key countries, Germany and the Netherlands. But this competitive landscape -- it is a very competitive market and it hasn't really changed that much in the past few years -- those are the key players.

Dana Mullins - *Buckingham Research - Analyst*

Okay, thank you.

Operator

Thank you. I'm showing no further questions.

Ray Tharpe - *Office Depot - Director of IR*

Are there any other questions. We have none in the queue, but we want to make sure that everybody on the phone does have a chance to ask any questions. The message this quarter is a little bit more complex than normal with the involvement of our charge which we announced on September 12th. That charge was largely non-cash. And as you can see, when you look beyond the effects of the $0.50 per share charge in the quarter, we delivered earnings of $0.36 which is a 24% increase compared to an adjusted earnings per share over the prior year. So we're very pleased with the results but this can be a complex message. We'll take the next question then.

Operator

Michael Baker, Deutsche Bank.

Michael Baker - *Deutsche Bank - Analyst*

One more quick follow-up. The growth in the contract and the BSG, is that mostly taking share -- in other words adding existing or adding new customers or is that growth in existing customers?

Steve Odland - *Office Depot - Chairman & CEO*

We've been successful in our North American BSG in all of our segments and in attracting new customers as well as deepening our growth in current customers. This has been a big success story for us over the past couple of quarters as we have received the benefit of our investment in the salesforce as well as sharpening our focus on our marketing tools. The direct business of course is a very small market share in the whole scheme of things. We probably have around a 3.5% marketshare here.

So, while we don't believe that this is zero sum gain -- because it is a growing industry and a growing market -- we believe that we're doing quite well in developing the medium to large customer base to complement what has historically been our strength in our small customer base. So, good results this quarter.

Michael Baker - *Deutsche Bank - Analyst*

So really, it sounds like you're seeing the growth on both new and existing?

Steve Odland - *Office Depot - Chairman & CEO*

New and existing and in virtually every segment as well.

Michael Baker - *Deutsche Bank - Analyst*

Great, thank you very much.

Operator

Mark Rowen, Prudential.

Mark Rowen - *Prudential - Analyst*

I joined the call a little late so I apologize if this is redundant, but I came in where you were talking about the closures in the Northeast. I heard you say that only one of the 16 was a Kids-R-Us store. So can you just give us a sense of how long this retrenchment period is going to last? You talked about wanting to expand your North American retail base into new markets. Can you give us a sense of timing for how long the retrenchment is going to take and then when you think you'll expand, what markets that might be in?

Steve Odland - *Office Depot - Chairman & CEO*

First of all, what I was saying is I was clarifying that of the 16 stores that we announced the closure of in North America in our September 12th announcement, that only one of those was a former KRU store. We did not actually say where in the country that KRU store was. I remind you that there were stores throughout the country (indiscernible). And I did say that we are pleased with the results in the Northeast. They're developing well, they're developing consistent with our forecast there and we've seen double-digit growth again in the past quarter.

Clearly we have opportunities to grow our store base throughout North America even in our historical strength, the Southeast and the Sunbelt states, we're finding an incredible amount of growth just to keep up with the population growth in those areas. And so the fill in stores and so forth are paying off quite nicely in those areas as we develop our franchise there. The Northeast of course is an opportunity for us to continue growing further as is throughout the West Coast, Chicago and so forth.

So virtually every market of the country, and certainly in the populated areas of Canada, provide an opportunity for expansion or us. We are not focusing on any one specific area solely. We are expanding at a moderate pace where we can find reasonable deals over time. And once again, we are on track to open gross about 100 new stores this year and gross 100 new stores next year. And just as a reminder, we did announce the closings a quarter early, but we have closings every single year as we optimize our store base, so this is nothing new.

Mark Rowen - *Prudential - Analyst*

So just to clarify, the 16 stores that you're closing, only one was a former KRU store. But most of those, to my understanding, were in the Northeast, is that right or that not necessarily accurate?

Steve Odland - *Office Depot - Chairman & CEO*

No, that's not necessarily accurate.

Mark Rowen - *Prudential - Analyst*

So they were across the country?

Steve Odland - *Office Depot - Chairman & CEO*

They were dispersed in geography, correct.

Mark Rowen - *Prudential - Analyst*

Okay. Thank you very much.

Operator

Dana Mullins.

Dana Mullins - *Buckingham Research - Analyst*

What changes have you made in your real estate team to ensure that the new sites in the Northeast will be higher quality sites than what we've seen in the past year?

Steve Odland - *Office Depot - Chairman & CEO*

That supposes that we didn't see high-quality sites in the Northeast over the past year which I'm not sure is the case. We have added talent to our real estate team over the past year and we also have focused on the development of a new forecasting model which we believe does a better job of capturing all the factors that lead to a profitable site for us. That model has been in place now for about the past six to nine months and the research is quite strong. So I'm very pleased now with the level of analysis that's being done and the people that are focusing on our real estate sites. We're also working of course with external developers in various geographies of the country as well.

Dana Mullins - *Buckingham Research - Analyst*

Okay. Thank you very much. What about the Kids-R-Us stores write down? What should we expect that to look like?

Steve Odland - *Office Depot - Chairman & CEO*

As you may remember, on September 12th in our filing and Form 8-K we did announce a charge to write down the KRU premium that we paid for that business. If you recall, what we had to do when we made the acquisition was pay a premium in order to get those sites over and above what we thought was the stores themselves could handle and we carried that until we could account for that. We don't expect further KRU write downs in the future. We acted on September 12th with the best knowledge that we have and the best projections we have related to that premium.

Dana Mullins - *Buckingham Research - Analyst*

Okay, thank you.

Operator

Frank Henson (ph), Bear Stearns.

Frank Henson - *Bear Stearns - Analyst*

Frank Henson here from Bear Stearns. I joined the call a little late so I apologize if this question has already been answered, but I was wondering if you could just talk about the capital structure at Office Depot, whether or not you think the Company has the appropriate capital structure. I know you only have a little less than $600 million worth of debt on the balance sheet and I was hoping that you might be able to just provide a little more clarity with respect to the capital structure for this business?

Steve Odland - *Office Depot - Chairman & CEO*

I think that Office Depot is blessed with very strong operating cash flow. We also have an intense effort on making sure that we manage our working capital and our cash very strongly. We are an investment-grade rating by the rating agencies, BBB+ rating on -- from S&P and I think it's BAA2 from Moody's.

Our view is that that allows us to conservatively manage our business. We have tremendous excess cash as we talked before that we can use to profitably grow our business which is our number one priority. We also have the ability to take the excess cash and invest it in repurchasing our shares. And if you joined late you may not have caught that we did complete the outstanding $500 million authorization that we had on our shares. We completed that during the quarter.

So the business -- you point out accurately that the business has the ability to increase leverage if we had an opportunity that exceeded our current capital structure and that's one of the great things about this business. But we don't have plans to use that at the moment and we'd use that if necessary for acquisitions or other large opportunities that come along. Did that answer your question, Frank?

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Frank Henson - *Bear Stearns - Analyst*

Yes, it does. Thank you very much.

Operator

Bruce Crystal, Armstrong Shaw.

Bruce Crystal - *Armstrong Shaw - Analyst*

I was wondering if you could help me on a couple of items. The first is on North American retail there with the progress. Specifically were you north of 20% on the private-label business? Secondly, were your same-store sales positive in the supply category? And then thirdly, could you help us understand a little bit more on the international side -- I know you've got Charlie with you, but specifically the margin erosion even if you add back the charges continues to be let's just say challenging from the investor standpoint.

You're down 400 bips from a year ago or so and again down sequentially here. And I was wondering -- there wasn't any real meat put on the table here with respect to the number of DCs we're going to close, how to really rationalize this cost structure, the call centers, etc. And while I know you have a heck of a lot on our plate here, I kind of thought maybe at this call we'd get a little bit more clarification on how Europe is going to get rationalized so that -- I'm hopeful that we can get back to low double-digit margins? Thank you.

Steve Odland - *Office Depot - Chairman & CEO*

Let's start with your first question which relates to the penetration of the private brand in North American retail. We deliberately didn't share a specific percentage number and I don't think we should going forward as we believe that this is becoming a big competitive advantage for us. But suffice it to say that we achieved our goal on the penetration levels of our private brand. We're very pleased with how that is performing and we think that this can become a material part of our mix going forward into the future.

Also, we really don't share same-store sales numbers on any specific category, but I think that it's safe to say that we did have a good quarter across our businesses. The international margin erosion, we did point out, is concerning to all of us as we face the increased competition as well as the economic environment. Clearly pricing is tough in Europe today as people are doing the e-auctions and those kinds of things. So we have experienced margin erosion, we have experienced it sequentially, that is correct. And we're working very hard to make sure that we add value and differentiate ourselves in our catalog and mail-order businesses in Europe so that we can staunch that.

The other thing we're doing, though, at the same time is we're working on the cost of goods side in the cost structure. From a cost of goods standpoint we are doing far more global tenders and working between the North American and the international segments so that we can lower our cost of goods while at the same time meeting our customers needs on a pricing standpoint and this is a fairly new effort for us which we have just begun and we hope that we will be able to equilibrate over time. We have not made any announcements related to specifics around call centers or distribution centers or anything like that in Europe. What we did say in our September 12, 8-K filing is that we have plans to take future charges in Europe and we articulated what we could. There are obviously legal reasons why we can't going into specifics on works counsel issues but suffice it to say that the restructuring program in Europe will look at all of those elements over time and that we will make sure that we have got a very competitive cost structure on the ground in Europe. Charlie, I don't know whether you what do add anything to that?

Charlie Brown - *Office Depot - President Intl. & CFO*

I think you said it well. I don't think I can add a lot to it.

Bruce Crystal - *Armstrong Shaw - Analyst*

When you get further into this program would you anticipate that you can get back to the 12% operating profit level in Europe?

Steve Odland - *Office Depot - Chairman & CEO*

I don't think that we can make projections about specific margin levels. We are not giving guidance, Bruce, as you know.

Bruce Crystal - *Armstrong Shaw - Analyst*

No, no, I'm not asking for when. I am just saying as a structural issue is there any reason to think that you can't get back to those levels?

Steve Odland - *Office Depot - Chairman & CEO*

That is typically not something that I would forecast and I do consider that part of guidance and so we wouldn't go there. I think that it is important to note that the situation in Europe is changing and that we need to change with it. We haven't changed rapidly enough but we need to do that now. Looking for new on the ground leadership over there and it is receiving quite a bit of support from our North American group here. That is why I say I think it will take a couple of more quarters to completely stabilize but again we have high hopes to profitably grow our European business into the future.

Bruce Crystal - *Armstrong Shaw - Analyst*

Thank you.

Operator

John Barrett, Columbia Management Group.

John Barrett - *Columbia Management Group - Analyst*

Steve, a couple of questions on business services. What do you see as organic growth in that business?

Steve Odland - *Office Depot - Chairman & CEO*

It is tough to know exactly because the numbers are not quite as reliable as any of us would like but if you look at industry kinds of figures you are seeing anywhere from low to mid single digit kind of industry growth numbers. It is hard to know what is valid and what is real in that and what is inflation and so forth. But clearly this is a developing industry. It is growing as small businesses develop over time and I will remind everybody that is the core of our business service targeted customer.

John Barrett - *Columbia Management Group - Analyst*

Okay.

Steve Odland - *Office Depot - Chairman & CEO*

Is that where you were going, John?

John Barrett - *Columbia Management Group - Analyst*

Yes, so basically growing in line with the industry. The reason I asked is your competitors has had faster organic growth and they have also mentioned strength in the contract business as well. What is going there? Do you expect to grow faster through from smaller players or from taking share from them in that space?

Steve Odland - *Office Depot - Chairman & CEO*

Remember this is a highly fragmented industry and I think that the top key (ph) players have only 10 to 15% of the market share combined. The vast majority of the market share is in smaller players as well as in wholesalers and multichannel kinds of players. I believe that the top players are picking up market share and that we have the opportunity to do so in the future. But I think that the industry is probably a low single digit kind of growth industry.

John Barrett - *Columbia Management Group - Analyst*

Okay. Pricing in that industry, is it more rational today than when you first came onboard?

Steve Odland - *Office Depot - Chairman & CEO*

I've only been on board now for a couple of quarters --.

John Barrett - *Columbia Management Group - Analyst*

But it seems the improvement, you have seen also -- commensurate with that you've seen an improvement in business services delivery.

Steve Odland - *Office Depot - Chairman & CEO*

I don't think it is anyone's intent to price irrationally. Volume without profitability is not worth a lot is it? I think that we need to focus our business and we will, on profitably growing over time.

John Barrett - *Columbia Management Group - Analyst*

Okay. One last question on that business. The termination of the Viking catalog business, that decision, do you expect any sales disruption from that because in looking at Office Depot in the past, Viking was sort of a crown jewel and I question whether that decision -- you run the risk of losing some of your customers there because I know there is a number of employee terminations as well. I think the estimates I have seen were up to like 800 employees being terminated. So I just want -- do you expect any business disruption there?

Steve Odland - *Office Depot - Chairman & CEO*

Your numbers are wrong. I don't know what you are hearing or where it is coming from. Viking was an acquisition that was made in 1996. Over the past many years the proposition has been merged behind the scenes. The distribution system, value proposition, pricing, the items and so forth the salespeople, the support and the call centers that is all seamless and it is all the same people supporting both Office Depot and Viking catalog. The only thing that is really left is the name, catalog. Anytime you change anything in the world as you know, John, there is risk. There is risk to opening the store in the morning, too. But we think that this transition is actually well behind us and that now the name change is all that is functionally left and we are essentially completing the integration of an acquisition that happened not nearly nine years ago and should have been completed sometime ago. We are not particularly concerned about a high-level of business risk going forward.

John Barrett - *Columbia Management Group - Analyst*

What are the number of employees in that business being terminated?

Steve Odland - *Office Depot - Chairman & CEO*

We haven't said any numbers but we have largely moved the businesses together over the course of time and there were very few discrete employees assigned to Viking left.

John Barrett - *Columbia Management Group - Analyst*

Okay, thanks.

Steve Odland - *Office Depot - Chairman & CEO*

I would like to think everybody for joining us on today's conference call and we are out of time so thanks very much and we will talk to you next quarter.
