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ODP.OQ - Q2 2002 Office Depot Earnings Conference Call

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OVERVIEW:

Office Depot reports 2Q02 revenues up 4% and total operating profits up 15% to $92.7m, despite flat comparable worldwide sales. Worldwide e-commerce sales increased 38%, with company on track to exceed $2b in FY02. Technology sales were down 12% in quarter. Q&A Focus: Share repurchase; Store closures; Options policy; Internet business.

CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Good morning. We would like to welcome you to the Office Depot second quarter 2002 earnings conference call. All lines will be in a listen-only mode until after today's presentation. At which point, instructions will be given in order to ask a question. At the request of Office Depot, today's conference is being recorded. I would like to introduce Ms. Eileen Dunn, Vice President of Investor Relations and Public Relations, who will make a few opening comments. Ms. Dunn, you may begin.

Eileen Dunn - *Office Depot, Inc. - Vice President Invetor Relations, Public Relations*

Good morning. And thanks for joining us for today's second quarter 2002 earnings conference call. Before we begin today's presentation, I'd like to remind you that except for historical data, comments on this call should be considered forward-looking within the meaning of the Private Securities Litigations Reform Act Forward-looking statements, including projections as to revenues or earnings and other statements related to expected future performance by Office Depot, involve risks and uncertainties which may cause actual results to differ materially from those discussed on this call. Please refer to our filings with the SEC for further information. Now, I'd like to turn today's call over to Office Depot's Chairman and Chief Executive Officer, Bruce Nelson.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Thank you, Eileen. And good morning to all of you Thanks again for joining us. I hope you had an opportunity to read our press release this morning on our earnings. I will take you through a summary highlights of the performance we had during the second quarter, and then, obviously, at the end of the call, give you a chance to ask us any questions you'd like to ask. Overall, before I make my summary comments, I would say in spite of soft revenue, as you've all seen, our second quarter performance from our standings was outstanding. We met or exceeded all of our internal targets, our objectives are in line, our costs are in line, and we achieved our earnings forecast both internal and external. On a consolidated sales basis, for the quarter, our second quarter revenues was 4%. Comparable worldwide sales were flat for the second quarter, and declined 1% for the first half of the year.

Our worldwide E-commerce sales, our leading position worldwide, drew 38%, and on a year-to-date, and we are, in fact, to exceed more than $2 billion in E-commerce this year. No one sells more over the Internet than Office Depot does. Business to business office supplies,we are the biggest. Our results continue to believe that we expand that leadership. On a company-wide basis, our customer complaints dropped 32% from last year. This is in spite of an improvement in the second quarter last year. We are reaching all-time high indices in satisfying our customers. Our indexes across all channels increased. The weakening U.S. dollar which primarily impacted us in the month of June, favorably impacted in total quarter two sales by $15 million. But on a year to date basis, we are still $5 million negative compared to last year as a result of currency in the first five months of the year. On a total sales growth perspective, our retail comps negative 1% for the second quarter, representing our fifth consecutive quarter of improving comp trends. Our North America comp transactions were up 3%. A very encouraging sign in our North America retail stores. The cost decline was driven primarily by continuing declines in hardware sales, with desk tops and laptops, comping down 16%, and the category overall, which then includes monitors, printers, all-in-one machines and digital cameras, was down 12% in the quarter.

Our total technology sales, which two years ago were about 22% of our sales, have now dropped to be 14% of our sales, reflecting the last two years of difficult comps in this technology sector. BSG sales grew 4% during the quarter. Sales improved for our contract division across all regions quarter to quarter, but was offset by some continued softness in our Office Depot and our Viking catalog domestic business. The average order value in our business BSG business improved for the first time in six quarters, another encouraging sign of a small recovery in the large and medium customer segment. And our domestic E-commerce business, here in North America, grew 37%. International comp sales were 4% in local currencies. Japan and Viking catalog both had negative comps during the quarter. Excluding those two countries, international comps were 7% for the second quarter. And we had improved trends in Germany, the U.K., Netherlands, Italy and Ireland. On a consolidated operating basis, our operating profit increased 15% to $92.7 million, versus $80 million in 2001. Our quarter two North America retail operating profits grew 35% and achieved its highest return on sales since the first quarter of 2000. That does exclude the $12 million estimated charge we took for the settlement of the California wage litigation suit that was outlined in our press release. Our BSG operating profit was up 10% to 8.1% of sales.

International division operating profit was flat reflecting the entry of two new countries, Spain and Switzerland. Four new Office Depot BSG startups in Europe, and continuing losses in Japan. And in spite of that, this division still achieved 12.5% of sales of operating profit. Our consolidated gross margin grew 27 basis points overall, primarily all in North America retail. I'll talk about the gross profit in each of the business segments. Our BSG and international gross margins had both slight decreases. BSG down 192 basis points. That's the inclusion of 4Sure.com, not in the numbers last year, improved inventory management, meaning our purchasing from key suppliers is less than planned, which affects our vendor rebate programs. And international was down slightly as a result of higher retail sales mix and a growing BSG mix in Europe, and an increase in prospecting, which are lower margins in some key countries as we ramped up our efforts to grow new customers successfully. The key operating drivers of operating expansion and retail were margin improvements and our -- and, again, another quarter of improvement in BSG selling and operating costs, which in the quarter improved 234 basis points. On a consolidated EPS basis, on a fully diluted GAAP reporting basis, EPS grew 29% to 18% for the second quarter, compared to 14 in the second quarter of last year.

As you know from the release, included in the operating income this quarter, is a one-time charge of approximately $12 million or two cents per share for the anticipated settlement of a class action lawsuit in the state of California alleging that Office Depot incorrectly classified its retail store managers and assistance store managers as exempt from the payment of overtime hours worked in California. As you've seen in news recently, this is not unique to Office Depot. Excluding these one-time litigation charges, EPS grew 25% to 20 cents, versus 16 cents for the second quarter, and on a year-to-date basis, EPS has now grown 52%, to 50 cents versus 33 cents in 2001, reflecting the improvements we've made in the operating performance at Office Depot.

Now I'll speak briefly about performance in each of the key segments. The North America retail sales, as I said earlier, we had another consecutive quarter of comp sales improvement. Our supply sales, our core office supply sales, continue to show improvement with positive comps during the quarter. Our second quarter product mix furniture was down 1%, overall, as I said, technology/hardware was down 12% versus 13% in Q1, a small improvement, and software was slightly up in quarter two. Our average ticket size, in spite of the increased transactions in the stores, and increased traffic actually declined, reflecting the impact of lower furniture sales and lower technology sales. We in the quarter, we converted our 12 Canadian Ontario Providence stores to Office Depot, and we experienced a lift in revenue since that conversion. We now have the right for the first time in our history for the Office Depot name throughout Canada.

We are converting more of our customers who come in to our stores to buyers than ever before and a result in the second quarter, in that regard, were quite encouraging. As I said earlier, our customer service index is measured by our customers. Our customers today are giving us feedback in two primary ways. One at the register and one when they walk out of the store, was up substantially from year-ago levels. North America retail operating profit was up 180 basis points in the second quarter, a 35% increase, excluding the litigation charge. As I said earlier, that's the highest operating profit performance in our North America retail stores since the first quarter of 2000, in spite of negative comp sales of 1%. Our retail margins continue to improve our gross margins this quarter, by 185 basis points over last year. That's primarily a shift away from technology, the continuing benefits of our remerchandising which we've talked about numerously, better SKU management and quicker sale-through of our clearance merchandise which results in less markdowns.

Our store operating costs, excluding the California litigation costs, improved slightly from last year. That's a result of better controls on merit increases and the nonanniversarying of some of the merchandising initiatives we implemented during the second quarter of 2001. On the BSG side, our total sales, was, as I said earlier, increased 4% for the second quarter. Our contract division has positive growth in the second quarter, showing some signs of recovery in the economy in all of our regions. Our western region still has negative sales growth where we've been most impacted by the slowdown as a result of the dot-com blowups but it improved over the first quarter. We still expect this division to continue to improve throughout this year as we focus on this segment to grow.

Our second quarter revenue per order was higher this quarter than in any quarter during the past five quarters. Our average order size is improving, another small sign of an improvement in this sector. As I said earlier, our domestic E-commerce sales, which are in this business segment, grew 37% for the quarter and continue to grow our industry leadership position. Our warehouse customer service indexes were up across all categories. Our service level up, our on-time delivery up, our customer complaints were down, our call centers performed better than ever as a result of our consolidation last year from 24 to 7, and our customer complaints in the second quarter dropped 45% in the second quarter a year ago in the business segment. Our operating profit basis in this segment, our second quarter operating profit improved by 42 basis points from 7.7% last year to 8.1% in this quarter.

Our second quarter gross margins declined in this segment 192 basis points. As I mentioned earlier, that is primarily the result of the inclusion of 4Sure.com, which wasn't included in the these numbers a year ago, some short-term pressure on vendor rebate in key suppliers in this segment, as we've improved our inventory turn in this channel to the highest in the industry. Our second quarter selling and operating expenses were down 234 basis points in this quarter. Again, reflecting the improvement in quality that we've now had consistent in this segment for well over a year. Our DSO in this segment improved again from 51 days to 46 days, and you can see these improvements in turns and our DSO as reflected in our strong cash position at the end of the second quarter, and our growing free cash flow position as we focus on managing our business more effectively and more efficiently.

From an international perspective, based on first quarter trends, we saw some improvement internationally during the second quarter. Second quarter sales internationally in U.S. dollars grew 12%, again, a little bit from the benefiting of the currency in June in particular. Second quarter comp sales and local currency were 4% and 9% in U.S. dollars. As I said earlier, foreign currency translation benefited us in this quarter by a positive impact of about $15 million in sales and positively impacted operating profit in this segment by about $2 million in the quarter.

On a year-to-date basis, however, foreign currency translation still negatively impact sales by about $5 million, and now are about neutral on an operating profit basis. Our contract sales startups in our new countries are all still meeting or exceeding our initial plans, and each of the four countries we have these new divisions. As I said earlier, we had two countries, internationally, Viking Catalog France, and Office Depot Catalog in Japan, both comp negative in the quarter, and overshadowed somewhat the improvement we saw in the rest of the countries.

Our retail comps in France where we decided to make a major position in retail grew 5% in local currency and 11% in U.S. dollars. Our Office Depot business in France, which includes retail, catalog and the launch of a new BSG division grew 19% in local currencies against the very difficult economic environment in France.

Our retail comps in Japan were negative 10% in local currency and negative 14 in the U.S., continuing to reflect the softness in the overall economic condition of Japan. And in Japan, during the quarter, we opened two new stores, closed one store, bringing a total of twelve stores in Japan. On an operating profit basis, operating profits in this quarter were flat as planned year over year, but still 12.5% of sales. And as I said earlier, this reflects our commitment to continue to invest in this high return on sales, high RONA business, as we grow this business for the future.

Two new countries so far this year, Spain and Switzerland. Startups in four new countries in DSD and plans to open another additional country late this year and probably one next year as well. Gross margins slightly declined by 91 basis points in the quarter, mostly the result of a higher mix of DSD and retail business, and a higher prospecting percentage of our business in our key European countries to grow our business. Store and warehouse operating costs only increased by 51 basis points in spite of the startup costs of Spain, Switzerland and the DSD units, all of which lose money in their initial startup period of time. Our Japan losses improved on a year over year basis to 1.5%, $1.5 million operating loss during the second quarter, compared to $2.5 million operating loss in the first six months of last year in spite of negative growth. As we get our arms around Japan and drive that country for efficiency and profitability. Our operating margins have been impacted, as I said, by the addition of new countries, and in the second quarter, for example, we absorbed more than $6 million of operating losses as we grow our business for the future. We have, as you all know, the most successful international business of anyone in our segment.

We have been overseas since 1990. We know how to make money. We're investing this business, and these losses that we absorb today will, we believe, turn into substantial profits in the future, and in spite of some of the issues and the concerns about the economy, we're optimistic about our position in Europe. In summary, looking towards the remainder of 2002, based on all we know today, we remain comfortable with consensus earnings of $1.02. That implies that our second half EPS will grow close to 15%, and for the full year, close to 30%. The slower half, second half of EPS growth, is now anniversarying the substantial improvements we made in the second half of last year. We expect retail -- North America retail sales in the low single digits for the remainder of the year with some improvement or higher in the fourth quarter. We believe there'll be some improvement in both technology as a result of the HP Big Band launch, which is HP's largest launch ever of new printers, technology and ink, and we have and remain to be a destination store for HP products, and we believe we can grow in that segment. We also anticipate a back-to-school season that is slightly better than last year in our forecasts.

In the BSG group, we expect mid to single-digit growth rates in quarter three, with higher growth in quarter four as we focus our growth in the higher-business segment, and we've successfully proven so far this year that we're able to do that. Internationally, we expect double-digit currency growth, low double-digit currency growth, in the second half in local currencies. Reflecting on the quarter, as I said in the beginning, in spite of the negative comps in North American retail, we continue to make substantial improvements in our business. Our margins overall are strong, sustainable. Our operating costs have trended positively now for some period of time, we're executing better than ever in our history, and today, we believe we have a solid foundation to grow this business in the future.

If you allow me to reflect for a moment, tomorrow is my second anniversary as the CEO of this Company. I celebrate my two years. Our Company during that period of time has dramatically changed. Together with the leadership team we've built, we've transformed this Company's culture to one of focusing on customers, employees and shareholders. Two years ago, I said our primary goal was to gain the trust and confidence of the people who work with this Company, to improve the retention and the quality we provide service to our customers, and to gain the trust and the confidence of shareholders. This is our eighth consecutive quarter of meeting or exceeding consensus estimates. I said two years ago that we would build an executive leadership team that we could be proud of, that could help grow our business. We're primarily done with that. Most of them in the room are with me today, and I'm proud of what they've accomplished. We established a solid foundation. We have integrity, trust, and confidence in our balance sheets, our numbers, our cash flow, our balance sheet has never been in better condition, now in particularly in light of our decision to call the alliance.

All of you saw Greenspan's speech yesterday, and he talked about a crisis of confidence. I can assure you there's no crisis of confidence at Office Depot and the integrity of our numbers, the soundness of our balance sheet. We've accomplished a lot in two years, we've closed underperforming retail stores, we've improved our warehouse quality and efficiency. We were the first to rationalize new store growth, and we continue to invest in Europe. We now have a platform to grow here in North America. We believe we've identified ways in which we can grow, that are not impulsive, but are well planned and we believe with our confidence, we can execute those plans, albeit in a difficult economic environment. We've identified new customer product verticals across all channels here in North America.

In retail, we have new formats being tested, new in-store small business services and we're using and introducing technology to deliver on our promise, what you need, what you need to know. We continue to invest, to grow our large customer DSD segments. We think there's an opportunity to gain share in that segment by focusing the improvements we've made in our warehouses, our costs to acquire, our customer profitability, and we are confident we can grow in this segment. Internationally, we continue to stay the course. We invest not only for the future but at the same time we deliver industry-leading impressive results on return on net assets, return on working capital and return on sales.

We believe there is not a crisis of confidence at Office Depot. We're focused on the things to make this a better company, our employees have told us it's a better place to work. Our customer indices have never been higher. We face a difficult economic environment, the last four or five weeks, certainly of the stock market and the capital markets, bringing the question, "what's the economy going to be like both domestically and internationally?" We're confident of our ability to execute. I don't think there's ever been a better time to invest in Office Depot. Kind of a summary of the results of the quarter and my comments, what we'd like to do now is open up the call for your questions.

QUESTIONS AND ANSWERS

Operator

Thank you. At this time, if you'd like to ask a question, please press star one on your touch-tone phone. You will be announced prior to asking your question. To withdraw your question, press star two. Once again, to ask a question, please press star one.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Operator, are you still there?

Operator

Yes, one moment. We're waiting for questions to register in our queue.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Thank you.

Eileen Dunn - *Office Depot, Inc. - Vice President Invetor Relations, Public Relations*

Operator?

Operator

One moment, ma'am. Your first question comes from Matt Kassler.

Matt Kassler

Thanks a lot, good morning. A couple of questions if I could. First of all, given that you now have some clarity as to your financial situation, do you know what you're planning to do with the [INAUDIBLE] and you have a very substantial cash position and continue to generate substantial cash, and given that the stock has come under some pressure, are you contemplating, or would you contemplate any kind of share purchase activity?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Thanks, Matt, good morning to you. The good news in the sense that's it's good, I say the good news, it's certainly mixed news. We're not the only stock that's been substantially revalued in the last couple of months. We do have an authorized buy-back of stock that was authorized by our Board some time ago, and that authorized buy-back was $50 million. We have been on a planned gradual buy-back of that stock, and we're about 2/3 through with that buy-back. I think, we've said all along, and I continue to say all along, that our goal is to drive RONA. We've demonstrated in the last two years, we've done that in spite of very low growth world wide. And one way or another we'll increase the RONA. Ideally, what we'd like to do with that cash is to grow our business. And as I said earlier, we've spent the better part of a year and a half or two years, building a foundation which I'm confident we can grow on, including selectively look at opportunities to acquire.

The LYONS redemption that we just announced, has the impact of acquiring basically 13.9 million shares. And so in some respects, it's a buy-back of shares by the redemption of LYONS that we've called. Our Board, myself and our management team, are focused on driving RONA. And having said that, cash has to generate returns. We have, we think, some exciting opportunities that could require some cash in the future. They're retail formats that I spoke earlier about. Customer product category segments. But we clearly identify opportunities to grow. We've got plans to grow, we're not prepared to talk about how we're going to do that. But we believe we can identify uses of our cash that grow this Company's top line, grow its bottom line and grow RONA, and that's what this management team is committed to do. And I might add, a year ago, this management team with shareholder approval, took a very different view about stock and options and how we get paid as executives. And the conclusion is as follows: if we outperform a selected group, a large selected group of companies, we do well, as a management group. If we don't outperform, and that's on shareholder value, we don't do so well. So we're driven per shareholder value, and that means we have to clearly always look at how we use cash.

Matt Kassler

So not to put words in your mouth, but to kind of summarize, it sounds like -- it sounds like you want to keep your powder dry for strategic uses of cash?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

I think the summary I want to keep my powder dry. There are growing opportunities to look, frankly, I think the readjustment of the capital markets, readjust valuations of opportunities. I've said all along, I believe there are opportunities, particularly in Europe, where we have an incredibly strong base, a very strong management team and a strong platform and we continue to look and evaluate those. And I'd like to be in a position always of, if opportunities come forward, we're in a position to compete, and on that basis, I want to keep my powder dry, if you look at it from that perspective.

Matt Kassler

Gotcha. Second question, if I may. Just looking at the income statement, one line that was different from my expectations was corporate GNA, where as a percent of sales, I believe, you rose from about 4.2% to 4.8% and you had risen in the first quarter as well. There's also sequential dollar increase. Can you talk a bit about what's happening on that line item and whether we should expect continued year-to-year increases in the corporate GNA numbers?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

From our perspective, we look at GNA two different ways, Matt. We first of all, look at our core GNA, what's happening with the core employment base in GNA, what's happening to that growing, and I can tell you that without question, that's well under control. The GNA is influenced by the startups in particular, because that's where we put the, that's where we put a lot of the costs, and we've opened two new countries so far this year. We've got DSD starting up in four countries, we've announced a new one. Actually, Italy starts up in a month or two, and we're also starting to occur some costs as we announced the German startup of DSD.

We've got part of our, part of our, corporate-wide bonus system is based on our ability to achieve EPS objectives. We are on track to achieve a higher bonus payout corporate-wide. I'm not just talking to executives, I'm talking about for the people on bonus systems around the world. We're on track to achieve higher levels of bonus payout than a year ago, based on the fact that at $1.02, we'll have grown EPS this year, somewhere near 30%. That implies higher bonus payout, that's in the GNA cost. And, third, without quantifying, I'll tell you that we've invested in some strategic projects. We've taken a look at customer product growth opportunities, we think we've identified some very interesting things, and that's got a short term impact on GNA growth.

We will continue our investment internationally. Part of the GNA is a percentage [INAUDIBLE]. When revenue does not grow as planned. overall, then the GNA looks higher as a percentage. But I can assure you, that we're not wasting our GNA dollars. On our core processes, I think we've been a leader in the use of the Internet to take costs out of our business in routine, more routine jobs, and then we turn around, invest for growth in the future. I can't emphasize this well enough. We don't have an environment where we demonstrate our ability to grow. I want you to know we've invested an enormous amount of time, and we believe we have a platform now to grow, and that leads to future shareholder value. So I hope I answered your question, Matt. I hope I wasn't too defensive about it. But I believe the investments we've made will have payouts in a huge way in the future to our shareholder value and our ability to grow the Company top line.

Matt Kassler

Okay, thank you.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

You're welcome.

Operator

Your next question comes from Daniel Bender.

Daniel Bender

Good morning.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Hey, Dan.

Daniel Bender

A couple of questions for you. First off, on just store closures, how many more should we expect this year, if any?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

I don't anticipate any more than we've announced. I've said all along with a portfolio of stores of 860-plus in North America, we'll always have openings, closings, but in terms of material closings, we said that we would close 14 more this year. We're on track to do that. I don't anticipate any major change in that direction. Albeit, at any one point in time, when a store comes up for remodel, and we are for renewal, and we have some later this year, we could make a decision on a store due to close, but materially, we're not closing any more stores than we've announced.

Daniel Bender

Okay. Great. Other question related to -- I guess the sensitivity of your EPS to, let's say, a percentage point in comp store sales, your margins have been obviously moving up, and it's been probably a little bit tougher for some of us to determine what a deviation in comps, up or down, would have on it as an impact on your EPS. I was wondering if could you give us any sense of that?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

I think directionally, you can still make a broad assumption that a 1% change in the North America retail comps equates pretty close to a penny. One of the things that we've been able to demonstrate, your point, Dan, is that we have been able to adjust a lot of our variable costs to track more in line with comp sales growth. And should we experience some pressure on comp sales growth in the second half, I think there's some ability we still have in our variable cost structure, but I think we've been pretty good now demonstrating two years, but directionally, you have to assume that a 1% change in North America retail costs is about a penny a share. Per quarter.

Daniel Bender

Okay. And in the back half of this year, it sounds like you're continuing to look for sequential improvement in the rate of comp store sales gained at retail, although those are against, I guess, slightly more difficult comparisons last year in the back half versus the front half, and I guess with all that said, it sounds like most of the pressure has been in technology and furniture, and I'm just curious, do the comparisons in technology and furniture get easier as we move through the remaining part of this year?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

It's somewhat easier, but I think our optimism, and I would say our cautious optimism for a moment, in our North American retail business, is really focused on a couple of areas. One, is we do think that we'll see some lift in technology in our retail stores, and by technology, I mean basically laptops, desk tops and all-in-one machines and printers. I think all of you've seen that HP is launching their biggest launch in their history. Some 50 different SKUs over the second half of the year, both new technology, better technology at lower price, and we believe we've always been an HP destination. Frankly, HP has always been our largest single supplier worldwide by quite some margin. We believe that these products will sell. We've got some early signs they are. And we think that's going to give us some lift in the second half of the year.

I think second of all, we anticipate a slightly bit of back-to-school season this year, not dramatically better, but still an improvement over last year. We did pretty well last year, we think we've got some specific plans in place, both for products and promotion, if you will, that we believe, we remain confident today that will have a little uptick in our back-to-school. To the extent that there's an indication of that, our contract business, which has a clearer segment in back-to-school this time of year, has got a good order booking. This is stuff that's in the house that will shift this quarter to next quarter. That's part of the lift we're getting in BSG. So it's those two assumptions that we think we're going to get, we're going to turn the chain on comps to positive in the third quarter, and a little more positive in the fourth quarter. We're also putting a lot of emphasis on the holiday season. We've always been a destination for holiday purchases of businesses, and we've got some exciting things we're planning for that, and I appreciate in light of the overall economic concern of both the U.S. and the world, you say what does all of that mean, and frankly, Dan, at this point, I don't know. I just know what we're doing. And I remain confident that we'll execute it well, and I think there's some uptick here.

Daniel Bender

Okay, just a last question, in your press release, you do cite that you're testing multiple new retail formats, so obviously you wanted us to know that. I'm just curious if you can give us any more detail on what that involves?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

No, I won't.

Daniel Bender

Okay.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

This is the age-old issue in retail. I guess one day I'd like to -- I'd like to have the culture and the history of Southwest Airlines. Where they'll tell you a year in advance where they're going to go, how they're going to do it, when they're going to do it, at what price they're going to do it, and not a competitor in the world can seem to match it with that kind of advanced knowledge. We're not at that point yet at Office Depot in our retail business. I think similar tests some work, some don't. Frankly, we're excited about some aspects of it, but we're not ready to extend specifics to it, because the minute we do that, it turns into well, how much cost is that going to that be, and when's that going to be, and how many are you going to add? I just want to leave all of you with this is a business that we, in North America retail that we do not consider dead. While you might argue there is saturation of some stores in some markets, and I wouldn't argue against that, this is a business segment that's $285 billion big, and our share of it's very small, and there are customer product categories in which we enjoy a decent share of the customers we target. We believe there's a whole growing share of customers that we don't. And we think we've identified some ways to reach them. I think the proof's in the pudding, and I'll wait until we can report increased comps, increased growth and then tell you more specifically how we did it. I just want to leave you with the solid foundation that this is a company that's spent a couple years now building a foundation, and I think it's in place. And I think now we can start to do better things to grow our North America retail business.

Daniel Bender

Great, thanks.

Operator

Your next question comes from Aaron Robinson.

Aaron Robinson

Hey, I think that's me. Bruce, I hope the next two years is as prosperous as the first two. I had a quick question. The BSG number looked like it ticked up a little bit and the gross margin ticked down a little bit. I'm not sure if you explained it, but are those two related? In other words, is pricing down, therefore, some elasticity is getting increased market share, and then I had one follow-up.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Okay, thanks for your wishes for the next two year term as well. I hope it is as well. This has been the most exciting thing I've ever done, frankly the most rewarding thing I've ever done. It's something I'm most proud of, the team that's helped build it, so if you'll allow me those personal comments in the midst of a "crisis in confidence in America".

Your second comment is, are those things related, growth in BSG and margin, and the answer is, no. Our core BSG margins actually grew slightly in the quarter. There is an impact with the vendor programs, inventory turns are well ahead of what we thought. What that means without going into enormous amount of detail, is that we now face the risk of some key vendors of not hitting their maximum rebate levels as a result of total volume purchases. And good, conservative accounting says that you recognize that at this point in time. And so, there is pressure short term on supplier rebates, and that's impacted in the totals. Second, as I said earlier, there's a mix issue, 4Sure.com was not in our numbers last year. This is a lower margin business model that we believe speaks to how people buy technology when they bought their second or third piece of it. They don't go to a store. They want specific help, and we invested in this business by acquiring it a year ago. We are optimistic about where it goes, and we're encouraged by its -- by its new direction or its uplift. So, no, this is not related. I do think if we get more successful in the larger segment, and I believe we will, I think that's a mix issue, and I think you'll see then on a mixed basis our margins come down a bit, because the reality is, larger accounts have lower margins. That is true. But that's not the case in this quarter.

Aaron Robinson

Follow-up, as far as the retail business is concerned, how are you going about merchandising back-to-school given the mix shift from consumer to business? How do you get your merchants, I guess, into a consumer mode and make sure they come out of that consumer mode once this thing is done and to what degree are you working back-to-school versus last year?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Those are complex questions, some of which are answers, but I'll wait to see unfold when you walk into the store and see our back-to-school set. First of all, I would say -- I don't know, I think that back-to-school in North America retail both for us and our competitors has an awful lot to do with consumers and not as much to do with business. I mean, if you look and profile the customer, I think we get an awful lot of consumers in our store, for back-to-school, at least we do. I know by demographics we do. Frankly, our goal is to bring them into the store this year, delight them with the product selection, delight them with the complete school list for their school, delight them by giving back 5% of their purchases to their school of choice, which has been an enormously successful promotion, and delight them with service so they say, "Hey, I'll come back to Office Depot in the future for some of my quote consumer home office individual needs." So that's one thing.

Two, is I think our merchandise selection this year for back-to-school, it's assortment and it's display, from my perspective and my eyes, and appreciate those are the eyes of the self-serving, CO of the Company, are better than last year. I've seen the back-to-school set in our store, it's out earlier, and I like it better. I think the product selection is better, I think the graphics are better, the signage is better, the flow is better. And, three, we're going to selectively -- back-to-school is always a competitive period. You're already seeing signs of it being competitive in terms of early advertising of it. But we think our in-stock position, our product breadth and assortment, our 5% back is going to drive traffic into our stores and our hope is that traffic gets impressed so much, they come back later. So there is some optimism we have in back-to-school in that regard. It's not huge, but we're saying it's going to be better than last year.

Aaron Robinson

Thank you very much.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Thank you, Aaron.

Operator

Your next question comes from Peter McMullen.

Peter McMullen

Good morning. Two quick questions. One, with all of this talk about options, I just wondered what your philosophy going forward might be, and, two, as you sit today and look at '03, what major factors would you have us focus on in determining, you know, some sort of hurdle rate for next year? Thank you.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Your first question on options, Peter, is one I think, we have an upcoming Board meeting. I intend to have this discussion, we've had it. We've broken out, according to the guidance of the regulations, if our options were expensed last year using the methodology that we put in our annual report, that would have the 12-cent EPS impact. I think the whole issue of options, who gets them, how many they get, in light of the current economic environment means we have to take a look at it. I can tell you that this Company has not abused that. It's not given mega-grants to executives. None of us that are here today have gotten enormously rich on options. Our option program is clearly in line with industry. Our total options in terms of total dilution are well below the upper-third core tile, we're more in the middle of what companies do. We go deep with our options. That I'd like not to avoid. We give options to store managers.

I know that's sometimes contrary to shareholders viewpoints, but to a store manager that works in North America, option grant's a big deal, and I'd like to be able to keep something like that in place. We put a new option program in place last year with new performance standards that are clearly performance-based, and they're based on this management dream driving shareholder value. One of the issues I have with all of the legislation, is an over reaction to some companies that have had excessive greed and have violated both the integrity and trust of the investors, and we deal with that. This Company's done neither of those things. We've not restated, we don't have to restate. We don't have mega-option grants. I think the whole issue of what we do is a good discussion for a Board to have. I'm not prepared to talk about what that might be, because I think it's dialogue and discussion. And second, I think you have to look at the environment that's external. And whatever the law is, we'll comply not only to the letter of the law, we will comply to the spirit of the law. And that's been our objective all along, as it relates to all three, I think as you look at all three, I think the overall issue is what's the forecast for the overall health of both the North American and the global economy. We're still a business that has impact by economic benefits.

We'll continue to make into '03, I think, smaller, gradual improvements in our cost structure. We've gotten huge costs out of this Company in two year, we've gotten efficiency. It's harder to continue to get it. We find ways to drive processes better, faster and more efficiently, we'll continue to do that. But I think when you look at '03, you've got to make large assumptions about how the Company grows. Because if the world economic environment or the North American one deteriorates and gets worse, then I think this Company, along with most others I know, will have difficulty growing EPS and growing shareholder value in the next year given the economy. So I think you say our margins are sustainable? I know there's always been questions about, is the gross margin we've got sustainable? Well, we've got five, six quarters at it, so I hope you believe they're sustainable.

We've said that we'll get gradual improvements in our cost structure. Are they sustainable? We've got five, six quarters of it? I think soon we'll get some more. We've said we'll invest for growth in the international that will pay. Some of our investment growths a year and a half ago are paying handsomely today, so I think that's kind of the outlook for '03. I think it's overshadowed, if you will, not by what this Company can do and execute, because it will, but the external environment, which right now seems uncertain at least for most people who look at it. I'm not an economist, but what happens globally in the next year and a half, will have an impact on our next year's results, obviously.

Peter McMullen

Thank you.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Thanks, Peter.

Operator

Your next question comes from David Young.

David Young - *Bernstein*

Hi, David Young at Bernstein. A couple of questions. Can you comment on, given that your Internet sales now make up over 50% of the BSG group sales, can you just comment on the relative profitability of your Internet business versus the other BSG businesses?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Yeah, first of all, the Internet business, it comes from multiple channels. It's in the BSG. It's our total Internet business, in that, as officedepot.com, which is the public site and BSG Net, which are the private sites for our contract, commercial customers. By definition, all Internet transactions of Office Depot cost us less than any other transaction, period. And that number's approximately 1%, 2%, depends on how you calculate it, from a call center costs, from a fax cost, from a phone cost. Two is, our Internet business has always been profitable at Office Depot on a fully allocated cost basis it is fully integrated. It has never been a separate business. We've always looked at it as an enabler. An order in a North American warehouse, which we have 24, for an Internet, for a fax, for a phone, for a contract sales rep order, for an order placed in retail for delivery is all of the same to a North American warehouse. They can't tell the difference.

So it has all the metrics of every other order, and so we continue to say it's an enabler. Our objective is to make it the best site of sites in the land, to make it easier on the contract commercial side to convert. We have more third party conversions in our contract business than anybody else, bar none. We're easy to convert for private side and commercial contract business. Our officedepot.com site has always been profitable. We have never chased customer acquisition at insidious rates. We do it smart, we do it wisely, we use E-mail wisely, but it is not a separate business, it's an enabling part of our business, and it continues to grow, and we believe it will become an even higher percent. On the BSD side, the contract side, over half our transactions today come through the Internet, and we think that will continue to grow.

David Young - *Bernstein*

I see. So you don't measure separately from profitability standpoint?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

No, we don't. Because that's -- that's a channel conflict inside the Company.

David Young - *Bernstein*

I understand.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

There's no reason to do that, because we share the platform, the technology, the skill base, the analytical base, the front-page, back-page, middle-page, software interface across all channels, across all companies, and we do it worldwide. Our engines are the same on the back end of these things. Our front ends are customized.

David Young - *Bernstein*

Are the 4Sure.com numbers included in the Internet numbers that you quoted, that growth number? And if so, how much did it impact the growth?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

The answer is, I don't know the answer to that, David. We'll get that answer for you. Off the top of my head, I don't know that.

David Young - *Bernstein*

Okay.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

We'll come back to you on that regard.

David Young - *Bernstein*

A couple of minor questions, housekeeping questions, what are the planned store openings for the year?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

23 to 25 new stores.

David Young - *Bernstein*

Okay.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

We're on track to do that.

David Young - *Bernstein*

Okay. And the last thing is, then, you might have commented on this in the first quarter, and I apologize if I didn't catch it, what was the reason for the share count increase?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

I'm going to let Charlie Brown, Charlie, the CFO, is by my side. I'm pretty sure I know the answer, but I want to make sure it's the right answer, so I know Charlie knows the right answer, so, Charlie?

Charles Brown - *Office Depot, Inc. - Chief Financial Officer*

The number of shares that was really influenced by option exercises, we had, as a stock, increased during the first and second quarters, we had a large number of employees who exercised their stock options.

David Young - *Bernstein*

I see. OK. That's the increase in the basic share count?

Charles Brown - *Office Depot, Inc. - Chief Financial Officer*

The second basis, remember when the stock does go up and more options are in the money quote unquote, higher numbers of shares outstanding go in the share outstanding calculation, and we had a rising stock price, substantially rising stock price through the first quarter of this year.

David Young - *Bernstein*

Okay. Thank you very much.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Thank you.

Operator

Your next question comes from David Asasio.

David Asasio

Hi. I jumped on the call a little bit late, and I may have missed this earlier. I was hoping you could discuss a little bit your motivations behind calling your LYONS.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

I'd be delighted, David, to discuss the motivation behind calling the LYONS. And I'm going to turn that one over to Charlie as well, Charlie Brown, the CFO of Office Depot, Charlie?

Charles Brown - *Office Depot, Inc. - Chief Financial Officer*

Well, the, probably the origin of thinking of calling our options, really had to do with constantly looking at our debt structure. As we go out and look at potential acquisitions, the LYONS really become cumbersome, because, you know, there's the uncertainty of will they or will they not convert? That's probably the first consideration. The second, is that where our share price is currently, and, you know, depends on what our outlook is for the full year, there's a highly likelihood that these options will be [INAUDIBLE] to us in December. But at some extent, what we've done is really accelerate that and cleaned up our debt structure a little bit to give us a little more flexibility, and that's really the reason behind it.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

I would add to that that given our dramatic improvement in free cash flow, our growing cash balance, which this quarter approached $1 billion, our continued belief we can continue to manage the balance sheet well, we think that it is a good use of cash at this particular point in time given the price of the stock and the strike put price of the option which can be put to us late this year. And as I said, then it adds to the other things about balance sheet, reduce debt, and so we look at it as saying it's a good use of corporate funds at this point to do that, based on what happened in the capital markets, and particularly within the last month or two.

David Asasio

Okay. Thank you.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

You're welcome.

Operator

Your next question comes from Brian James.

Brian James

When the LYONS get called, what does that do to interest expense and what does it do to number of shares outstanding? In fully diluted?

Charles Brown - *Office Depot, Inc. - Chief Financial Officer*

The number of shares, I think as we mentioned in the press release is about 13 - 14 million shares that will essentially come out of the EPS calculation. In terms of interest rate, these are 5% convertibles, so essentially, what we're getting a little bit of a negative arbitrage between what we're paying versus the interest income that we're earning, which is just under 5%. But given where interest rates are currently, it's essentially a break-even.

Brian James

Okay. Thank you very much.

Operator

Your next question comes from Whitney Pilson.

Whitney Pilson

Hi, two questions. You referred earlier to the competitive environment and the back-to-school season. I was wondering if you could just speak more broadly about what the economic slowdown is so forth, are you seeing a worsening of the competitive environment for you? And second question is, can you give a little background on why your primary internal evaluation metric is RONA as opposed to return on equity or return on invested capital?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

I'm going to answer the first question. I'm going to have Charlie answer the second question on RONA. Yes, we will tell you. No, I dont' think we've not seen a worsening of back-to-school at this point. We've not seen a degration of pricing at this point in time. We've just seen early on, earlier advertising of back-to-school. Back-to-school really doesn't start the first flight from our perspective, starts the last week of July. We realize the country goes back-to-school at very different times, and it starts the last week of July and flows through almost into September. It's a complicated system, by the way, to figure out when you advertise back-to-school and what region or locality.

What we're seeing right now from the competitive arena, is that early advertising of back-to-school, which, in our perspective, is two, three weeks early. But it isn't focused on price. It appears to be focused on, we've got to come in and see it, get your back-to-school early. So I don't know what the price environment's going to be. I can always, there's always three or four, five items, particular items that mass retailers decide to highlight and drive traffic in. I mean, that's just always the way it is. We would anticipate that would occur this year, and have anticipated that. But, no, I don't think we've seen a change in the environment, just a little surprise that we've seen advertising, and I would say the form of the advertising, if it's in ROP, that won't mean much to some of you, but that's more expensive than inserts, and it's means you've reacted quicker. So it looks to me like it's going to be an advertising early game on pricing, it's hard to say what it's going to be like. Charlie, on the RONA versus the return on equity?

Charles Brown - *Office Depot, Inc. - Chief Financial Officer*

Mathematically, those two metrics work out to be essentially the same, it's just a question of how you compute them. We like RONA, because what we're able to do, we can't do with return on investment capital, is break down the drivers on RONA to think that are meaningful to our operators. These are things like DSO, these are things like inventory turns, and by breaking it down to that level of granularity, what we can do is engage the entire Company in driving returns as opposed to just the executive groups sitting around and talking about return on invested capital. So for us, RONA is really, it's a living, it's a breathing, a concept, and, again, we can take it down to the store level or into our call centers or into our warehouses, and that's why we like it.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

We can take RONA to a store manager level, which we do, because there's some things a store manager has control of, and there's some things they don't. And when you get return on equity, there's an awful lot of things a retail store manager has nothing to do with return on equity.

Charles Brown - *Office Depot, Inc. - Chief Financial Officer*

They really can't relate to it.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

They can't relate to it, but they can relate to RONA and over time these two things track pretty closely, anyway depends on how you calculate them. So we've chosen RONA as a way internally to align 45,000 people to what you really have to do, when it's all said and done, to drive shareholder value. And you have then some impact clearly. Bob Keller, who runs our North America delivery business, has a huge impact on RONA on how much capital he wants to put in warehouses and how many -- what his receivables are. He doesn't have a huge impact on whether we choose to finance it, that equity, you know, with interest to it, but it's not in his level. RONA and investment is, and that's true for other business unit operators as well. So we've gone through this argument a lot in our Company and we've settled on we think it's easily -- more easily communicated, more easily understood and people, like store managers, can clearly understand their role in it. So that's our perspective on RONA.

Whitney Pilson

Thank you.

Operator

And your last question comes from Derek Weiner.

Derek Weiner

Yes, hi. There seems to be some confusion on the call price for the converged for the LYONS that you're calling. I believe it's in the press a couple of different ways. Could you clarify what the call price is, is it an accreted value since the 74,355 that would have been in December?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Yes, it is at the accreted price and would be 1,753.

Derek Weiner

74,355 was the December price. What would the price be of the call?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

$17.53. Okay. It's actually the accreted value as of August 19th, I think, which is the end of the window.

Derek Weiner

But it would be something greater than $74? Something greater than $74.355? I don't understand the --

Charles Brown - *Office Depot, Inc. - Chief Financial Officer*

Yeah, I don't have that calculation.

Eileen Dunn - *Office Depot, Inc. - Vice President Invetor Relations, Public Relations*

If you'll call us back after the call, we'll go through that calculation with you.

Derek Weiner

Okay. Simplistically speaking, to account for interest between August 19th, from the 74,355 on December 11th, is that correct?

Charles Brown - *Office Depot, Inc. - Chief Financial Officer*

Yes, it would be with the accrued interest at that point in time.

Derek Weiner

Right. I think you needed to clarify that in the press.

Charles Brown - *Office Depot, Inc. - Chief Financial Officer*

Okay. Thank you. That's a good suggestion.

Derek Weiner

Thank you.

Operator

At this time, there are no further questions.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Okay, thanks again for taking your valuable time to listen to Office Depot. I hope we've clearly articulated and summarized both our confidence in our ability to execute, eight continuous quarters of meeting or exceeding what we outlined we would do. Saying what we do and then doing it, is how you gain trust and credibility, having pristine financial statements, financial reporting and a balance sheet is about what we're about, and then growing our business is where this group is focused. We spent two years refining, improving, getting a solid platform. We believe we're in better shape today than ever, both from an executive leadership team and knowledge of our customer and product segments that we think we can wisely invest for growth in the future. Thanks for listening. Thanks for your confidence in Office Depot. We look forward to talking to you on our mid quarter update, which we'll do towards the end of August, which will then give you more insight into the current trends of quarter three. Thanks very much.

Operator

You may disconnect your line. Your conference call has concluded.