THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

ODP.OQ - Office Depot Inc. at Sanford C. Bernstein & Co. 20th Annual Strategic Decisions Conference 2004

EVENT DATE/TIME: JUNE 03, 2004 / 1:00PM GMT

CORPORATE PARTICIPANTS

Bruce Nelson *Office Depot - Chairman & CEO*

Charlie Brown *Office Depot - EVP & CFO*

CONFERENCE CALL PARTICIPANTS

Colin McGranahan *Sanford C. Bernstein & Co. - Retail Hardlines Analyst*

PRESENTATION

Colin McGranahan - *Sanford C. Bernstein & Co. - Retail Hardlines Analyst*

Good morning. We're going to go ahead and get started to try and keep on schedule here.

A couple housekeeping items to get going. You should have cards on your seats. Those are for questions. They will be collected at the end for the Q&A period. And if you could please also turn your cellphones to vibrate or off, I would appreciate that.

My name is Colin McGranahan. I am the retail hardlines analyst here at Bernstein. It's my pleasure this morning to introduce Office Depot. And Bruce Nelson, who is the Chairman and CEO, will be presenting this morning.

Bruce has a lifetime of experience in the office products sector. He began his career in I believe 1968 at Boise Cascade and spent 22 years with that company, but also served as the President and CEO of BT Office Products and the President and COO of Viking Office Products. And Bruce joined Office Depot in 1998 through the acquisition of Viking and was named the CEO in July of 2000 and Chairman of the Board in December 2001. It's a pleasure to have Office Depot back here at the SDC again this year. And also this year we have the pleasure of having Charlie Brown, the CFO, with us, as well as Chuck Rubin, who is Office Depot's new Chief Merchandising Officer, and of course Sean McHugh for investor relations. Bruce?

Bruce Nelson - *Office Depot - Chairman & CEO*

Thank you Colin. Good morning. A lifetime experience is a polite way to say I'm old. I have been in the industry all my life, some 35 or 36 years. I should by telling you I do like this business a lot (indiscernible) I will talk about that in the second. The business model that we have and some others seem at the surface to be simple, but it's really quite complex -- different customers, different sizes, different channels and different brands in different countries.

So let me tell you briefly a little bit about the company. I am not going to spend a lot of time on who we are and what we do. I'm going to give you some insight into the four or five things we think really drive future shareholder value, and I'll spend most time on those. And I will do my best to do this in a timeframe that gives you a chance to ask me questions before we conclude.

The Safe Harbor statement, I won't read it to you. You have seen it 100 times. I endorse it and I want you to know you've all looked at it. So I don't want to make light of it, but I won't go through the process of reading it word by word.

Who are we? Most of you know us well. We are over $12 billion, we are of global; we are multi-channel so we sell through retail stores, through e-commerce, through catalogs, through a virtual seller called 4Sure.com, and through large customers through an outside sales force, and through seats on seats (ph) where we sell outbound telemarketing. We sell customers of all sizes. It is predominantly B2B. Business is highly based on small, medium and large businesses around the world. This is a diversified portfolio which I will show you in a second, and we do have and continue to have the leadership in worldwide e-commerce, an important part of our business. I will share more insights with that. And the reality is no one sells more office products to more customers in more countries than does Office Depot.

Three key segments we talk about a lot -- our international group, about $2.7 billion in revenue. It is contract, catalog, e-commerce and some retail. Retail is the least part of our international business. We go to market with Office Depot, Viking direct, as it's called, and our acquisition of a year ago called Guilbert. And we do that in 21 countries around the world. Our North American business services group consists of our contract operations. That's our outside sales force; about 13, 1400 people in the US that call on Fortune 100 companies through an outside managed sales force. We go to market with catalogs -- Office Depot brand and Viking brand -- and a company called 4Sure.com, and that's our business services group. And again, the core customer is a business customer, in this case from the small, medium to the very large national and growing global accounts. And finally, we have North American retail stores, a little over 900 of those; 5.7 billion of those 2002 revenue. We are in 46 states, heavily concentrated in three areas -- California, Texas and Florida is where the heart of most of our stores are. I will speak to what that means in a minute and some of our future direction.

This portfolio balances us both in terms of revenue and sales. Strategically since the acquisition of Viking, which I was a part of in 1998, it's been our objective to balance our portfolio so that we have a more equal balance between retail, BSG here in North America and international. And we've done that extremely well. On your right hand side, the sales mix, 46 percent of our business is retail, 29 percent of our operating profits come from retail, 32 BSG, 36 percent and 22 percent of our revenue comes outside United States, 35 percent of our operating income. You will get some insight to that. Our international business has always been admired by most competitors. We are best in class in most of the business we are in and we continue to grow that business well.

As I said earlier, we have a global leadership in e-commerce. Some data on that -- about two-thirds of our North American business services group business comes through the net. The advantage of that is our customers get timely response, they get rich information, customized Web sites. We build purchasing decisions into the Web sites. It takes cost out of our business because it means we have less people in call centers and less customer service help, and it's really self-service. It is about two-thirds of our business. We think that can grow to about 80 percent of our business.

In Europe only about 20 our 25 percent of our business comes through e-commerce -- huge opportunity to grow. Guilbert, the company we acquired a year ago, they had less than 10 or 15 percent of this business through e-commerce. We believe we can leverage our e-commerce platform, drive business through the net, provide customers a better experience, more information and at the same time reduce costs. We have been the leader in this business. We continue to invest. We continue to be the leader. This business segment has always been profitable -- always, for the last four or five years, been profitable. It is a key part of how we go to market.

We have seven key strategies. I'm not going to go through all of these. I just want you to understand that these seven key strategies are known worldwide by our 50,000 associates. Each one of them I believe could articulate pretty clearly what they are and what they mean, and hopefully each one of them could articulate how they fit into one of the seven strategies and what activities and functions and focus they have that drives these. We measures these, we set goals down the level (ph). We're just committed to execute these seven things -- reposition North American real estate; control costs while enhancing quality; customer centric experience; differentiated product; Excel in Europe; high-performance organization through leadership and training; and build or acquire new businesses.

I'm not going to talk about all seven. Instead what I would like to talk about are the four I think -- or elements of the four -- that really make a difference and where our focus really is. These four things I'm going to spend some time on in-depth. They're not quite in priority order, but they're pretty close -- reposition our North American real estate portfolio; enhance the customer and product profitability; develop differentiated product assortments -- that's challenging in an industry in which there's not a lot of product differentiation; and finally, Excel in Europe.

Let me speak a little bit about our North American real estate portfolio. Remember, it's 46 percent of our business worldwide. It is a bigger percent of our business than that here in North America. But it's what we are known for - it is our brand, it is our image and it's 900 stores.

Three key elements to this strategy -- ramp up or increase the number of new store openings -- I will give you some data in a minute; remodel our older stores to accelerate comp growth and utilize our acquisition of the Kids-R-Us site to enter unsaturated northeastern markets, which have about one-third of the US GDP in which we feel today we compete in a very, very small way.

Let's talk about store portfolio and age and a little insight into our portfolio. First of all, you all know this -- older stores comp less. Generally speaking today an Office Depot store on average reaches comp maturity at five years. On a generalized basis then when a store is five years old it tends not to comp positive any longer. Its operating profit sometimes continues to rise, but it doesn't have comp growth for a lot of reasons. One (indiscernible) and it might be older; it might be a little out of position in the market. And two, it might have been cannibalized either by ourselves and/or a competitor. And three, the market has moved. The small-business market has relocated itself and the store may or may not be in exactly the right position. Over 70 percent of Office Depot stores are older than five years. Roughly speaking, generally speaking, that means that almost 70 percent of our 900 stores do not comp positive. You can then get some insight as to why then it's really challenging with an older store base to drive comps.

The other piece of that which could mitigate that over time is retailers like ourselves reinvest capital in remodeling. In the past three years because we have tested different formats and up until now have been uncomfortable with the returns, we've only remodeled less than 30 stores at Office Depot in the last three years. We've done that strategically. We've tested and tried different formats, but couldn't satisfy ourselves that we could get adequate return on capital, and therefore we were slow in remodeling stores through North America.

The second part of our portfolio is interesting. This is a the competitive overlap. The take away from this slide is you focus on the red, just to give you comparison. To compare us against the market cap leader entry (ph) Staples, Staples has about twice as many store percentages (ph) -- almost 40 percent of their stores do not have an office store competitor within five miles, almost 40 percent. That's twice as many as Office Depot.

I can tell you a lot about our stores that are in markets in which we don't have another office supply superstore within five miles. They are more profitable, they comp greater, they are better penetration, customer loyalty is stronger. They're just better stores and that make sense because you don't face a direct competitor. So this is part of our real estate portfolio that we work hard to overcome and why it speaks to repositioning the portfolio. As I said earlier, -- that third piece, I would add, is that we have also lagged opening new stores here in North America for the same reason. We have for the past three years slowed down the opening of new stores. We've opened 101 new stores in the last three years in North America, closed almost as many, so on a net basis we really have 22 more stores at the end of 2003 than we had at the end of 2000. You can't and don't grow a retail business unless you grow store base.

Our reluctance to grow store base has been based on really three things. One is a model that we were comfortable with that we could roll with that would get return on capital. Two is some systems capability to ensure that if we did accelerate openings we can effectively handle it. And three is understanding the store format and size that we think gives the highest returns and gives us the most amount of flexibility for stocking the SKUs we think customers want to buy, which leads us to the confidence we now have about our retail portfolio called Millennium.

Millennium is our new store format. Our latest version of that is called M2. It now incorporates all of the customer and operational feedback from our earlier tests. It's more open, it has it adjacencies that customers like, its shopability by all the customer measurements is significantly higher, it has an improved operational design and too is less CapEx to build or remodel than other models we have tested. It requires less selling square feet. We are now confident that we can take an average Depot store, roughly about a 6 or $7 million store because on average that what that's what our stores do, and we can operate that store effectively today out of 17,500 square feet versus the average 27,000 square feet we have in the chain, so a substantial reduction of square feet. That means lower real estate costs, lower occupancy costs, lower operating costs and lower payroll costs. We confident this model will work.

We ran (ph) two things. The M2 remodel we are confident has substantially or will substantially reduce in-store replenishment costs. The big costs in stores is the replenishment -- get units in the back room where it was delivered onto the shelf so the customer can see it. We have some significantly redesigns in M2 which we will unveil, if you will, for the first time at the end of June that will, we believe, take significant labor costs out of the North American stores.

And we have done some things with signage which we think will drive customers (indiscernible) store. You say, that doesn't sound very important. Let me give you a statistic. Almost 60 percent of the customers who shop at an Office Depot superstore, and we believe our competitors, have to ask where the merchandise is. They can't easily find it. If you think about that in the aggregate, that's an awful lot of time and store hours that are not helping the customer other than to find their way to a section. We believe we have a store design that is intuitive and that will make it more clear and easy for customers to shop and understand the store. The store design itself is significantly different than any superstore here in North America, and this will be the model of store we use to open all of our new stores going forward. We now expected to open between 70 and 80 new stores in the second half of this year with this model. And we're remodeling North America at 50 or 60 of those stores in the second half of this year as well.

One other questions that always come up is well that's a lot of capital and are you going to get a return; and are you just going to put a lot of capital to try and save (ph) comps without understanding its return on capital. We've looked at an M2 remodel program and we look at store volume and investment, and we've calculated the lift on average, the incremental lift it will take to get -- earn our cost of capital that back. So if you look at the highlighted box, we now believe that on average we can remodel a store in North America for about $250,000. That on average is about $150,000 less than our M1 format. We think that remodel substantially then changes the store to the design we have conceptualized and talked about. And to get return on that we basically have to get between a 2 and a 2.5 or 3 percent lift. We're confident we can do that to earn back our cost of capital. We will look at investing by store, by store volume, and by how much capital -- some stores by definition will take more than 250. We also think there's an awful lot of stores in Office Depot that will take far less than 250, but the focus here in we're confident we can earn back the cost of capital by reinvesting in this portfolio.

Finally, the last piece of this is to use our Toys-R-Us acquisition of sites to enter the Northeast. This is the least saturated office superstore market in the US. By any way you calculate saturation, it's the least saturated market. It contains roughly one-third of the GDP of the United States. If you take from Baltimore north to Massachusetts and not quite to Detroit, it's almost a third of the US GDP. It's an area where Office Depot stores are under penetrated. It has the highest concentration of business customers than in any other geography, and we believe we have a new store format called M2 that's highly differentiated in store layout, design and costs, and that we now are confident we can use this new store design to enter the rich northeastern markets.

Now, I know that makes investors nervous. Number one, it brings the question is there going to be a competitive war. I should remind all of you that for the past five or six years our two primary office superstore competitors have significantly entered Office Depot territory. So if you go back to the origin of the superstore (ph) chain, I said Texas, California and Florida are the strongholds of Office Depot. For the past three or four years we have faced significant entry of new competitors into those markets where we were, and continue to be in some cases, dominant. So this has been going on in the industry for years. The difference is we're going into the least saturated, highest density, one of the highest cost markets to do business, but we're doing that with a differentiated store format, with a lower operating cost model, and one we're confident can return to the shareholder value and accelerate our growth in retail.

One other fact that's interesting is where there is an Office Depot store, every other part of our business performs better -- our contact business performs better, our delivery business or catalogs performs better, our e-commerce business is better, our loyalty is better, our retention is higher, and our cost to acquire new customers is less. And therefore, it's an important part of our strategy that we have worked on for well over three years and now feel confident that we can roll (ph). So over the next six months we will take the Kids-R-Us sites (indiscernible) we acquired 124 Kids-R-Us sites, of which we felt we could use 50 or 60 of those for Office Depot sites. Of those 50 or 60, about 30 of those, 30 or 35 of those, are here in the Northeast. That will become the basis of our entry into three significant markets in the Northeast. The rest of the stores or the Kids-R-Us sites will convert to Office Depot stores predominantly already in existing territories and the rest of the real estate portfolio we will offload to somebody else. We have sold 20 of those sites to Petsmart -- Petco -- forgive me, I get them mixed up -- Petco and we're in the process of contacting other retailers for the remainder of those sites.

What does all this mean? We're going to restore growth to our retail base. At the end of 2000 we had 888 (ph) stores in North America. We're going to add in the neighborhood of 80 to 100 stores per year for the next three years. A substantial number of those will be here in the Northeast but we will also fill in the markets in which we have already a very strong presence. A good example of that is South Florida. In three counties in South Florida we have about 33 or 34 stores. We are the dominant player. We are in the process of increasing that store count by 50 percent. We are about half way there, and so a good number of these stores go into the heart of an area where we have high branded image, high brand identity, and strong operating performance, and continue to add retail capacity, and that capacity does extremely well.

Let me change now to customer profitability, and first I want to talk about again identifying retail customers and how important it is to manage customer profitability across all channels and brands.

First, let's talk about retail and I will go into some depth in this. Four things we've done. We've redeployed our North American sales force. Last fall and the early part of this year we took some 1300 reps here in North America, basically focused their efforts on those reps that are good to acquire accounts and those reps that are better at penetrating accounts. We aligned our sales management and our sales force. We're beginning to see the early signs that that will accelerate new account acquisition in our contract business. We have not had difficulty retaining accounts. We have had some challenge in growing the revenue of our existing accounts through the economic cycle we have been in. That too looks like it's changing. But with the redeployment of our sales force we are confident we will accelerate new account acquisition in the medium and large accounts here in North America.

We have ramped up substantially a program called TAM, telephone account management. Now we're taking smaller and medium-sized accounts instead of calling on them with a human being outside sales reps we call on them from the inside. It is more cost efficient. We better coordinate the contact points between catalog and contract. We are also seeing some significant growth in those accounts in territories we have converted to TAM, and we are rolling that program out.

I am going to talk about the Advantage program in a second, and marketing spend (ph) is key elements of this. Let me talk about Advantage. We launched a customer identity program in February called Advantage. We have now 1.5 million customers. Advantage customers buy two to three times more. It improves our ability to focus. It's self funding. It differentiates and when we know a retail customer -- up until Advantage we've only known about 20 percent of our retail customers. It allows us to know more of our customers, better target market to them, direct advertising spend to them in a more meaningful way, and understand their profitability, the retail customer profitability, across all channels.

We're optimizing marketing spend. We're looking at the right mix, as you always have to do. Chuck Rubin not only is our chief merchant but he is also our chief marketing officer. And he has adopted the age-old phrase which you heard many times, "only half of our marketing money is spent effectively. The problem is we don't always know which half it is." There are some sophisticated tools today in place that are helping us understand that half, and Advantage will help us focus our direct marketing efforts to those accounts that we know when they buy, how often they buy, how frequently they buy and what they buy, and that leads to better retention, better response rates and more baskets. As part of one-to-one marketing we use our data marketing skills that we have from the legacy of Viking to do this effectively.

Our Magellan merchandising system, some of you heard about this. It's the largest single digit (ph) system program we have ever undertaken at Office Depot. It's a 32 month project, 31 month project. Here's the top line. We are about halfway through; not quite. It is on time, it is on budget delivering the benefits as planned. Four key areas -- store and space planning, merchandise and discrete assortment, merchandise planning, and replenishment and forecasting. Let me speak a little bit to each one of those.

Store and space planning, that module is in and operating. We simply could not add hundreds of new stores and remodel hundreds of stores without a more effective space planning tool. That piece (indiscernible) Magellan has been delivered on time, on budget and is performing well. Magellan better aligns our merchandising system capabilities with our strategy. You need capability to go with strategy. It enables processes, tools and technology. Four planned outcomes -- improve sales and margin through a more effective store utilization called space planning, stronger assortment of merchandise plans, discrete assortments. We've been a chain that what is good for 1 store is good for 900. Magellan gives us the capability to discrete assort by store through some sophisticated tools. Better pricing, better decision-making and data, and improving stock. And here's some of the highlights of the benefits. We think it's a 1.5 to 2.5 percent sales lift. That means 100 to $150 million of incremental sales when Magellan is fully implemented in about 15 months from now. We think it's a 35 to 65 margin basis point improvement. That too is incremental. That is 20 to $30 million of incremental gross margin. We think we can improve our already industry-leading supply chain; seven to an eight percent improvement in inventory turns. That means 60 to $75 million reduction one time in inventory. Our project is complex, but to date is on time, on budget, delivering the benefits as they have been scaled to deliver.

And finally, our supply chain, just a brief comment about our supply chain. As I said, it's industry-leading. We have the highest inventory turns in our industry, and frankly have had that for some time. We intend to continue to grow that leading supply chain, and we do it in differentiated way. We're the only superstore retailer in North America that uses a combination of large warehouses which fulfill customer orders and cross docks (ph), North American cross docks which replenish stores. We basically go to every one of our stores every day from a cross dock. That means a couple of things. We replenish more frequently which means higher inventory turns, our in stock position is better, and it answers one of the concerns people have when you invest more in technology. The fact is we can feel comfortable about managing the lifecycle of technology products of desktops and laptops by utilizing our best in class supply chain and manage their lifecycle by deliver every day. Other office supply superstores don't have that capability that allows you to manage that inventory as well as we do. We intend to expand on that lead.

Private-label. Private-label today is about 12 percent of our business. Worldwide directionally we're headed to 25. It's an enormous opportunity for lots of different reasons. Yesterday we announced a significant redesign of the packaging of our private-label paper. The reason paper is so important is it is a big part of our category -- it is 15 to 20 percent of our revenue -- it occupies a significant part of the space of our retail store and it is enormously confusing to buy. The reality is what we want to do is to drive the paper to the customer requirement. What's the customer requirement? So we package and we identify features, benefits and attributes, and we drive the customer to the product they need, and often that is the product that has higher margins and higher value than commodity kind of paper. There's an enormous opportunity at Office Depot to add value to private-label, and as I said directionally it is our goal in the next couple of years to double our penetration. What does that mean? It means improved margins, it means improved buying and leverage, and it's a better value to the customer.

That's been in conjunction with a concept we call global content management. We've invested significant amount of effort in this over the past two or three years. This means that we can describe a product one time -- attributes, benefits and futures -- put it in a sophisticated database, and deliver that information to the point-of-sale -- signs in retail stores that drive the customer to the right product they want at the right time. How do you explain the difference between 20 and 24 and 26 pound paper (indiscernible)? We can do it in in-store signage. We can do it over the Internet, we can do it through catalogs, and we can do it through e-commerce. So global content management gives features, benefits and attributes that the customer cares about most, describes the product that way which we think helps the customer make decision about products. The net return is we get more of their wallet and we get higher margins.

Developed proprietary brands. Christopher Lowell, some of you may or may not be familiar with his name, but this is a private brand expansion to an otherwise destination category that was highly fragmented. This is exclusive to Office Depot. It's features and benefits were designed by us and Christopher Lowell to hit both price and value points and quality that were not addressed within our industry. It has higher gross margins than average and its sales are well ahead of plan. We think there are opportunities beyond this category to do the same thing, and this, as I said, is exclusive to Office Depot. You simply can't buy it anyplace else.

Let me talk a little bit about our international group for a minute. One of the things you heard me talk about, Excel in Europe. We are the leader in Europe by a significant factor. If you look on your left, you see our pro forma versus our four major competitors. Basically we're twice their size. Size counts, size matters, leverage counts. This is an enormously profitable business and has huge opportunity to grow, and we intend to grow and continue our European market leadership.

Here's a little bit of what our international business looks like as a part of our revenue. About 45 percent of it is contract international, about 49 percent of it is mail-order, and as you can see only 6 percent is retail. Retail is not our primary strategy outside the United States. Delivery is, and this takes the two elements -- mail-order which is basically the legacy of the Viking acquisition of 1998 and enormously profitable, cash flow, high return on investment, growing business, although it's smaller growth rates, and our contract business, which we entered both a startup starting in 2001 and then in the acquisition of Guilbert last year gave us the lead in Europe and we intend to expand and grow that lead. This group is enormously profitable. It is high sales growth in local currencies. It is high profit growth in local currencies. It does have the currency risk with it to translate results outside the United States to US currency. Today that's benefiting us slightly if you look of the value of the euro to the dollar. But this is an enormous business. This is an important part of our business segment that is incredibly profitable, generates high return on capital and high amounts of free cash flow, and we intend to continue and invest and grow this business.

We need to accelerate and will accelerate the Guilbert growth. We bought Guilbert a year ago, doubled our size. Our challenging work today is growing that piece of our business. Guilbert had not grown on a top line for the past three years. We need return a culture of growth through some sophisticated tools. We're confident we will do that.

Our catalog businesses in Europe are doing fine; a little softness in Germany, a little softness in France, but they're doing fine. And we're going to focus on our retail profitability in the three countries outside the United States where we have 100 percent owned (indiscernible) -- France, Spain, and Japan. And we will continue to acquire or build our presence in new countries. An example of that is a couple weeks ago we announced the acquisition of our franchisee in Hungary. it is not a lot of capital. He gives us access to 10 new European countries with a very strong management team and a presence and a business that's already profitable, albeit small, that fits into our culture extremely well that gives us more opportunities to grow that business in the future. And we've been outside the United States since 1990 so we know how to run and manage this business.

Let me talk about in summary what all this means. A balanced portfolio, three basic businesses, seven key strategies driving our business, and we are confident that these initiatives will deliver value. Let me give you some examples.

By improving our international retail business three countries - Japan, Spain, and France -- when we get those to EBIT brake even that would result in six to seven percent share accretion. Put another way, our start-ups in those three business is jointly (ph) costing the company six, seven cents a share. We are on our way to profitability in France with comps this past quarter of plus 18 percent, our Japan operations are basically today at break even prior to G&A costs, and our Spain operation -- five (ph) retail stores -- are now progressing nicely. We believe within the next 24 months we will get those to at least EBIT brake even. That's six or seven percent of share. Doubling our private-label penetration from 2003 levels could add another four to five cents per share -- higher margins, higher values, better perceived value for the customer. And returning our North American retail stores to the profitable probability level they had in 2002 -- that's two years ago -- would add 15 to 20 cents per share of earnings. We are confident we have a store model that will help us do that. We are confident with our global sourcing, leveraging our private-label, focus on payroll costs, focus on CapEx that we can and will return our retail business in North America to 2002 profitability level (ph). And the point of all that is we have an enormous room to grow.

Talked about strategies for a moment; let me talk (indiscernible) about high level 2004 and take you from the strategic to the tactical and just reaffirm what we think this year is going to be like. We believe we will have quarterly sequential improvement in North American comps. We view the first quarter plus three percent. We think our overall sales growth in North American retail this year will be six to eight percent. It will be the first year we have had retail sales growth in almost four years. And our gross margins compared to 2003, excluding the mix of technology, will be slightly higher. We're seeing margin improvement across our retail businesses in all categories except technology, and technology is a higher percent of our mix and that would cause the consolidated margin mix to look lower. Our North American business services group, we see sales from the mid to the high single digits as the quarters and the year continues; slightly lower gross margins predominately because of the mix to larger customers, the fastest-growing segment of our North American delivery business; and a continued decline in North American warehouse costs.

To remind you (indiscernible) North American warehouse costs, over the past three years we've probably invested about $75 million roughly in North American warehouses. That investment, a capital investment, plus other focus has taken out $150 million of cost in our North American warehouses over the past three years, and there's still more opportunity to do that, and we continue to see that in the first quarter throughout this year.

Our international group sales growth in local currencies in low to single mid digits, that may be at short-term risk with the impact of Guilbert and our struggle to grow that in two countries at the moment, France and the UK. Although I will add we are not losing share in either of those countries. We have a large position in those countries. We have a Guilbert organization not used to growth. We are confident we can restore it to growth.

Stable gross margins, except the impact of Guilbert in the mix. And we have and will continue to achieve (indiscernible) synergies. Our CapEx for the year -- 3 to 350, excluding the impact of the toy stores. We offered to pay $197 million for those sites. We now think by the time we get done with that, not taking some of the sites as planned, off-loading some of the sites, that that will be more like 125 million when we're done with that. At this stage, by the way, we've only been able to close on 10 stores. Kids and Toys are slow delivering us the closings, and we don't pay for those until we close them. So we've got about 10 closed. And we think free cash flow, ex out the Kids will be up 4 to $450 million. And we remain comfortable with the EPS guidance this year of $1.20 to $1.25.

So that kind of sums up first an awful lot about the three or four things we're spending most of our time on that we drive value and then a little of insight into the current year. Hope that's given you a feel an a flavor for Office Depot. And Colin at this time we will open it up to questions.

QUESTIONS AND ANSWERS

Colin McGranahan - *Sanford C. Bernstein & Co. - Retail Hardlines Analyst*

If you could please pass your cards to the assistant walking through the aisle.

First, why don't we start with one just on the overall environment. If you can comment on what you're seeing in terms of business demand, trends in office products demand; what your outlook is for the economy or the trends going forward as well?

Bruce Nelson - *Office Depot - Chairman & CEO*

I think from our perspective there are signs that the overall environment is positive. A couple things that we look at -- spending in technology. Remember, technology spending for a small business is a PC, a laptop, a new all-in-one printer, a new laser printer. These are not huge CapEx items; these are 3, 400, $900 each. That's increasing the across the board. We think that's a good sign. Small businesses have under-invested in those categories in the past three years, and they want to shop those at Office Depot. Our average order value in both retail, commercial and our contract businesses is creeping upwards. That means customers are buying more on an average transaction. That's always been an indication of confidence. The average number of items on an order is increasing slightly. That too has been always a leading indicator about customer confidence. And overall spending is up, so we're pretty confident we do have, at least at the moment, an environment in which there is growth in spending.

The worry we all have is the political environment as all that (ph) means to it, and certainly the issues outside the United States. But basically all the signs we see tell us that we've got an improved environment for spending at the retail level and at the large account level. Our large account business is growing nicely -- that's corporate America. They are starting to add some payroll in the aggregate and we're winning some share. So we are optimistic (indiscernible). Our forecast for the outlook is basically business is the same. We don't see it -- it doesn't have to get better for us to perform better. If it got worse that would be another issue, but we think that is going to hold throughout this year.

Europe, a little different. I think Europe's economy is not as in good shape as the US, particularly in the large countries. France, Germany in particular are struggling for growth; high unemployment, you all know about it. France and Germany represent a significant part of our present (ph). I don't think we're getting economic tail wind in Europe at the moment. In fact, I would say we have economic head wind today in some bigger countries in Europe.

Colin McGranahan - *Sanford C. Bernstein & Co. - Retail Hardlines Analyst*

Question here on the longer-term operating margins. First, what is the North American retail margin difference between Office Depot and Staples today apples-to-apples, I guess asking about G&A (ph) allocation? And what is the long-term consolidated operating margin targets?

Bruce Nelson - *Office Depot - Chairman & CEO*

Let me go to the first one. Apples-to-apples as we talk about before allocation it would appear that Staples' retail business is probably in the neighborhood of directionally 150 to 200 basis points more profitable than our North American business. I think that's a function of a couple of things, not the least of which is their presence in Canada which is 220 some odd stores (indiscernible). I happen to believe that that's an enormously profitable segment of Staples' business.

I also would add that I think where we compete side-by-side given a Staples in three to five miles there is no evidence that we're less profitable, nor is there any evidence that we lose share. So I think part of it is a real estate portfolio, and that's why I'm really confident about our ability to raise our store operating margins to 2002 levels.

The second question, Colin, was what?

Colin McGranahan - *Sanford C. Bernstein & Co. - Retail Hardlines Analyst*

Consolidated operating margin target long-term.

Bruce Nelson - *Office Depot - Chairman & CEO*

As you talk about operating margins, certainly five to six percent consolidated. I don't think it gets much higher than that. I don't think the competitive environment lets you get much higher. I think that creates umbrellas (ph). Certainly five to six percent operating margins is an attainable target and not that much of a stretch for us.

Colin McGranahan - *Sanford C. Bernstein & Co. - Retail Hardlines Analyst*

A question here on comps and leverage. Within the North American retail division when do you begin to see leverage from delivering positive comps given that you didn't see that in Q1, and does it require greater than a three percent comp to leverage SG&A (inaudible)?

Bruce Nelson - *Office Depot - Chairman & CEO*

I think -- and this is just an insight into Q1 for a minute -- the lack of leverage in Q1 was intentional. If that makes you nervous I'm sorry, but we increased our advertising spend in Q1 deliberately for a variety of reasons, and I won't go into all of them. And two, as we have said all along, an early ramp up of comps would come with technology. That with the confidence we have of (indiscernible) technology and now with the addition of Chuck that our early in 2004 comps would ramp up quickly in technology (indiscernible). Technology contributes less to the bottom line; it is probable, it's just less profitable. So I think we will start to see leverage in comps, particularly in the second half of the year, as our supply comps increase.

And one of the initiatives we have that is more short-terms is in the next eight weeks we will reset almost two-thirds of our stores in the middle of the period -- the technology section of the store. That's not a reallocation of space to technology; that's putting adjacencies, supply adjacencies, computer supply adjacencies near the hardware. And we believe that will drive higher basket, higher margins, higher growth, and we've got some evidence on the test data to point that out. We will have those resets done in two-thirds of the chain by the second week of July. The third of the chain we're not resetting are the stories we have designated for remodels in the next 12 to 18 months. So we're confident that as we get to the second half our comps will ramp, they will be supply driven and there will be leverage on the cost base, and therefore deliver incremental EPS.

Colin McGranahan - *Sanford C. Bernstein & Co. - Retail Hardlines Analyst*

Speaking of remodeling, can you discuss the M2 rollout in stores per year and the corresponding CapEx and free cash flow for '04 to '06?

Bruce Nelson - *Office Depot - Chairman & CEO*

You can do the cash, if you would Charlie. The roll out -- I said earlier we will open about 80 to 100 stores. The variability will be the Kids sites that gets delivered to us in the second half of this year, and virtually all of those will be M2. And our current plans are to remodel 50 to 60 existing stores to M2, and we will hopefully have all of those done before the holiday season, some before back-to-school.

Assuming that the M2 model generates what we think it will, then we would accelerate remodeling of our existing chain in 2005 and beyond into the 100 per year as opposed to less than 100 per year. And if we get the kind of return that we would like, we will accelerate those as fast as our capabilities will let us.

On the free cash flow, I will give that question to Charlie and let him expound.

Charlie Brown - *Office Depot - EVP & CFO*

Our current guidance on free cash flow for the year is 400 to 450 million. That obviously doesn't include a significant acceleration in the remodels. At a 200, $250,000 remodel to so 100 a year you would have to knock about a couple hundred million off of that number as we accelerate that program. There probably also would be a slight dip for the acceleration of openings, but as we start to lap that the cash will come back. So through '06 you are probably looking at with an accelerated remodel program free cash flow in the, I want to say 300 million to 350 range.

Bruce Nelson - *Office Depot - Chairman & CEO*

And that's with accelerated remodels and accelerated new openings.

Charlie Brown - *Office Depot - EVP & CFO*

Certainly better than 250.

Colin McGranahan - *Sanford C. Bernstein & Co. - Retail Hardlines Analyst*

There was a nice follow-up question here, if I can find it. You talk a lot about free cash flow. What's the view on allocation of that free cash flow in view on dividend?

Bruce Nelson - *Office Depot - Chairman & CEO*

The most frequently asked question on the face of the earth. I said (indiscernible) We are driven to increase return on capital. You can't sit with a lot of cash and do that. We have continued to discuss ways to give back shareholder value, and we will continue to discuss. Our commitment to this is to deliver value to you one way or another, either grow the value by reinvesting the business as we did with Guilbert and/or give that cash back to you directly in the form of either dividends or stock repurchase. That's our fundamental perspective of how we run that business. We've done that in the four years I've been here and we will continue to do that. So I think you will continue to see us drive our cash per shareholder value.

Colin McGranahan - *Sanford C. Bernstein & Co. - Retail Hardlines Analyst*

Time for one last question here. There's obviously been a lot of organizational changes over the course of the last 12 months. Can you just comment generally on how the organization is settling in, and then any update on the search for a President, North American position?

Bruce Nelson - *Office Depot - Chairman & CEO*

I think this is probably one of the most talked about events at Office Depot, and I can understand your concern and nervousness. From my chair, I think if you ask my two colleagues here, one of which is new, they would say to you that the changes we've made in the last 12 months have been enormously positive. I'm confident we have an executive team that is working more in harmony with each other in a more coordinated fashion than ever before, and delivering (indiscernible) better than before. In spite of what (indiscernible) it is not unstable inside the company. In fact it's quite stable.

On the search for a North American President, that's not a position that's been open for use, so it's not something that has to be filled. Unlike some other positions that we had where we had to find somebody, a la marketing with Chuck and merchandising because both are now his responsibility, I continue the search for that position. It is to add bench strength. It's a new position at Office Depot. I'm optimistic we can find the right person. The search continues. It's not an easy search for a lot of reasons. It's a complex business model. And we've got a team of people that the individual has to be still a part of as opposed to change the team.

So I'm confident about leadership today and our stability, and I'm not nearly as nervous about it as some of you who write about it and try to understand it from the outside. I could go into lots of detail about it, but it wouldn't serve any useful purpose. What I would say to you is I'm highly confident about the team we have in place today, more than I've been in the four years I've been CEO. You'll only believe that when you see the results. I am confident to deliver results.

Colin McGranahan - *Sanford C. Bernstein & Co. - Retail Hardlines Analyst*

Bruce, thank you and thanks Chuck and Charlie for your (multiple speakers).
