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ODP.OQ - Q2 2007 Office Depot Inc. Earnings Conference Call

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OVERVIEW:

Co. reported 2Q07 revenues of $3.6b, net income of $109m, and diluted EPS of $0.40.

CORPORATE PARTICIPANTS

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

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

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

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

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

CONFERENCE CALL PARTICIPANTS

Matthew Fassler *Goldman Sachs - Analyst*

Mike Baker *Deutsche Bank - Analyst*

Gary Balter *Credit Suisse - Analyst*

Mitch Kaiser *Piper Jaffray - Analyst*

Bill Sims *Citigroup - Analyst*

Armando Lopez *Morgan Stanley - Analyst*

Colin McGranahan *Sanford C. Bernstein - Analyst*

Danielle Fox *Merrill Lynch - Analyst*

Chris Horvers *Bear Stearns - Analyst*

Dan Binder *Buckingham Research - Analyst*

PRESENTATION

Operator

Good morning and welcome to the second-quarter 2007 earnings conference call. All lines will be on a listen-only mode for today's presentation, after which instructions will be given in order to ask a question. At the request of Office Depot, today's conference is being recorded.

I would like to introduce Mr. Ray Tharpe, Director of Investor Relations, who will make a few opening comments. Mr. Tharpe, you may now begin.

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

Thank you and good morning, everyone. Before beginning today's conference call, I would remind you that certain statements made during this call are forward-looking statements under the Private Securities Litigation Reform Act. Except for historical, financial, and business performance information, comments made during this call should be considered forward-looking. Actual future results may differ materially from those discussed on this call due to risks and uncertainties both foreseen and unforeseen.

Certain risks and uncertainties are described in detail in our report on Form 10-K filed with the SEC on February 14, 2007, and in our Form 10-Q filed this morning. During portions of this call, we may refer to results which are not GAAP numbers. A reconciliation of non-GAAP numbers to GAAP results is available on the investor relations area of our website at officedepot.com.

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

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

Thank you, and thank you for joining us for Office Depot's fiscal 2007 second-quarter conference call. With me today are Pat McKay, Executive Vice President and Chief Financial Officer; Chuck Rubin, President, North American Retail Division; Charlie Brown, President of International Division; and Ray Tharpe, from Investor Relations.

I hope you have had an opportunity to read our press release and learn about the second-quarter results. If not, the press release along with the accompanying webcast slides are available on our website at www.officedepot.com. Just click on the Company information and then on investor relations.

For eight straight quarters now, we have executed the initiatives in our strategic plan to consistently deliver double-digit earnings per share growth to our shareholders, averaging 32% growth in earnings per share as adjusted over the period. Unfortunately, the streak came to a halt this quarter. As we have previously disclosed, we knew that we were facing significant headwinds as we entered the second quarter this year, a quarter which is also our seasonally lowest point for sales.

While we are frustrated that we were not able to grow earnings at the same rate as in the previous two years, we are pleased that in this challenging sales environment we delivered earnings per share consistent with the prior year, and we were able to invest in our global business for the future.

In North America, we maintained our focus on pursuing only those sales which would yield profitable growth. This approach allowed us to somewhat mitigate the effects of a softening economy in the United States, while continuing to position us for margin expansion when economic conditions improve. We remain positive on the long-term growth in margin expansion opportunities for Office Depot.

Second-quarter sales grew 4% to $3.6 billion compared to the second quarter of 2006. Sales growth in North America was flat in the second quarter, down from 3% in the first quarter, reflecting a continuation of the macroeconomic conditions that we began to experience in the first quarter, particularly in our small-business customer sector.

Sales in our North American Retail Division grew 1% with comparable store sales down 5% for the quarter. International Division sales increased 14% in US dollars and 7% in local currencies.

Our US businesses were depressed by a continuation of the slowdown in housing sales and a softening economy. Particularly affected were our small business customers in both our North American Retail Division as well as our North American Business Solutions division. Despite these soft market conditions, data from the NPD Group indicates that Office Depot's revenue share among office supply stores increased sequentially in the quarter.

We recorded charges in the second quarter of both years, associated with the implementation of plans announced in 2005 and disclosed in our previous SEC filings. Excluding certain items in both periods from second-quarter charges, net earnings as adjusted were $118 million in the second quarter of 2007 versus $125 million in 2006. Diluted earnings per share were $0.43, unchanged versus the same period last year.

Gross margin declined 50 basis points, principally due to a shift in mix and increased property costs associated with new stores, partially offset by higher private brand sales.

Operating expenses increased as a percentage of sales by approximately 10 basis points, reflecting investments made which more than offset benefits from cost management initiatives.

EBIT as adjusted was $176 million for the quarter, or 4.9% as a percentage of sales, versus an adjusted EBIT margin of 5.3% in the prior year period.

Our as-adjusted effective tax rate for the second quarter was 26%, and for the first half it was 28%. We expect the rate for the remainder of the year to be between 28.5% and 29%.

Net earnings for the quarter on a GAAP basis were $109 million compared to earnings of $118 million in the same period of 2006. GAAP earnings per share on a diluted basis were $0.40 for the quarter versus $0.41 in quarter two of 2006.

Second-quarter charges had a negative effect on EPS in both years -- $0.03 per share in 2007 and $0.02 per share in 2006. We recognized $12 million dollars of charges during the second quarter and anticipate charges of approximately $30 million for the remainder of 2007 and $65 million in 2008. However, future charges may change as plans are implemented.

We have provided a reconciliation of GAAP to non-GAAP results that you can access on our website, officedepot.com, under Company information and investor relations. Now, Chuck Rubin will take you through the second-quarter results of the North American Retail Division. Chuck?

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

Thanks, Steve. Second-quarter sales increased 1% to $1.5 billion, down from 3% growth in the first quarter. Comparable store sales in the 1,063 stores in the US and Canada that have been open for more than one year decreased 5% for the second quarter. Comps were negatively impacted during the quarter by the continued softness in the economy. You will recall that our retail customers are predominantly small and home office businesses as well as nonbusiness consumers. We experienced softer sales in furniture and supplies and, to a lesser extent, technology during the quarter, as our customers adjusted their spending in reaction to macroeconomic conditions such as changes in the housing market and higher fuel costs.

Despite these soft market conditions, data from the NPD Group indicates that Office Depot's retail revenue share among office supply stores increased sequentially in the second quarter. As US new home construction continued to decline during the second quarter, the pace slowed to a rate of 24% below that of a year ago, underlying a persistent slump in the broader housing market. This trend significantly impacted our furniture business, which continued to experience soft sales and accounted for approximately 160 basis points of impact to our overall comp sales decrease.

In addition, we believe that the impact of this housing slump has adversely affected a broad range of small businesses and resulted in a reduction in our customers' overall spending patterns. Combined with rising fuel prices, these macroeconomic conditions have negatively impacted our sales.

Other drivers of the negative comps include new store buildout of about 70 basis points; increases in private brand penetration, impacting about 10 basis points; and changes in our mail-in rebate programs, which impacted about 40 basis points.

Although comparable store sales were disappointing, the North American Retail Division successfully delivered a 7% increase in operating profit to $104 million for the second quarter of 2007 compared to $96 million in the same period of the prior year. Higher product margins and cost management initiatives more than offset the impact of the negative comps and increased property costs associated with new stores.

Operating profit margins expanded to 6.8%, an increase of 40 basis points from 6.4% in the prior year period.

However, looking ahead to the third quarter, we are seeing early indications of a tough retail environment from a consumer slowdown in spending that could resulted a more competitive and promotional environment for the back-to-school season. In this challenging macroenvironment, we have pursued a number of initiatives to stimulate sales. Some examples include increased small package sizing to appeal to very small business customers; new customer service programs, which resulted in improved customer service scores; continued enhanced productivity of our advertising, particularly in print media; the introduction of buy-more save-more offers that offer even greater value to our customers; and furniture floor sets that are new and allow more take-with products for our customers.

At the same time, we chose not to repeat certain promotions that generated increased sales in the second quarter of 2006 because they did not generate an acceptable profit margin. The discontinuation of these promotions negatively impacted comps by approximately 70 basis points in the second quarter.

Average ticket size increased slightly. The comp decline was entirely driven by a reduction in the number of transactions. Comparable average sales per square foot were $219 for the quarter.

We remain pleased with the results of our overall remodel efforts, completing 54 remodels in the quarter. As previously communicated, our goal is to remodel substantially all remaining North American Retail stores within the next few years. We exclude a brief remodel period from our comps to account partially for some of the disruption.

These remodeling activities do create a short-term negative impact on our retail results, but represent an important part of our longer-term retail profitable growth strategy. We believe our new M2 format provides a clearly differentiated shopping experience to our customers with intuitive signage, clearer sight lines, and better product adjacencies all contributing to a more pleasant shopping experience for our customers.

At the end of the second quarter, Office Depot operated a total of 1,186 office product stores throughout the US and Canada, approximately half of which are operating under the M2 format.

Our current plans are to open approximately 125 stores this year, down from our previous estimate of 150. We anticipate opening approximately 150 stores in 2008, down from our previous estimate of 200. We believe that we continue to have significant opportunity to expand our store count, but have moderated our rollout strategy in response to current economic conditions. Most of these stores will be opened as fill-ins in markets in which we currently operate, enabling us to leverage regional advertising spend and supply chain costs.

We continue to be very disciplined in evaluating both individual new store openings and our overall execution strategy, based on our internal hurdle rate. Our financial model also recognizes that the opening of new stores as fill-ins is likely to negatively impact sales of existing stores. In the second quarter of 2007, comp sales were negatively impacted by approximately 70 basis points in the quarter due to the effect of these fill-ins.

Despite this, the impact of new store openings on the total market is positive, and the net effect exceeds our 13% IRR hurdle. We feel it is important to maintain and strengthen our market position in core market areas, and remain committed to doing so as long as these actions result in profitable growth.

I also would like to highlight that the overall retail store expansion has been rational; and in fact, the impact of new store growth by competitors has had less than a 50 basis point effect on our comps.

In the second quarter, our design, print, and ship business experienced double-digit growth, contributing 40 basis points in comp growth to the division as we increased customer awareness and expanded our service offerings. During the second quarter, our design, print, and ship associates became Xerox certified print specialists by completing a comprehensive training program developed in conjunction with Xerox, our strategic partner in copy and print. This program is exclusive to Office Depot and will further position Office Depot as the destination for printing solutions for small businesses.

We continued to broaden our scope of services also, with the introduction of logo design and other graphic design services, digital passport photos, and the rollout of additional large-format printing and finishing equipment. We also enhanced our online digital print offering, Print on Demand, making it even simpler for customers to use.

Private brand penetration continued to expand in the second quarter as furniture, supplies, and technology all realized increased penetration. A private brand customer service program rollout was completed during the second quarter, with development of a call center and website. Private brand penetration -- percent penetration from North American Retail is in the mid-20s, and we believe there continues to be substantial opportunity for further private brand penetration as we continue to expand our assortment in each of our proprietary brands.

While improving product margins, increasing private brand penetration negatively impacted comp sales by 10 basis points in the second quarter due to their lower average selling prices.

During the quarter, we continued to shift numerous mail-in rebates to instant rebates. This was part of our efforts to optimize the overall value proposition and buying experience for our customers. However, this shift negatively impacted sales comps by 40 basis points in Q2.

We remain committed to profitably expanding our presence in existing markets as well as selectively targeting new markets where we see opportunities for profitable growth. We believe that the deployment of capital to new stores and remodeling of our existing stores, coupled with our other marketing and merchandising growth initiatives, should enable our North American Retail Division to continue to deliver profitable sales growth and build shareholder value into the future.

We believe that we are doing the right things for the long-term health of business, while not pursuing unprofitable short-term comp growth. Now, I would like to turn the call over to Pat McKay.

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

Thanks, Chuck. North American Business Solutions Division sales were unchanged compared to the second quarter of last year, down 3% from the growth that we experienced in the first quarter. Second-quarter 2007 revenue reflects growth in the contract channel of 4%, which was offset by expected declines in our direct channel from the continued effects of our brand consolidation in the prior year. As we have discussed with you previously, this was a deliberate action geared toward reducing unprofitable business from our portfolio.

As with retail, sales in this division re being impacted by a soft macroeconomic environment, particularly in small-sized businesses. However, offsetting softer sales in small-sized businesses is strong momentum in large and national segments, especially in the government and education customer verticals. These are profitable customers for the division but carry higher average total sales albeit at lower margins.

The North American Business Solutions Division had an operating profit of $80 million for the second quarter of 2007 compared to $105 million for the same period of the prior year. On a sequential basis, operating margins improved 80 basis points from Q1 despite the lower sales volume.

On a comparable basis, however, operating margins declined as expected versus the second quarter of 2006, reflecting a continuation of the temporarily higher expense levels associated with the investments that we have made in the expansion of both the contract sales force as well as the implementation costs associated with the new furniture delivery program, coupled with the impact of changes in sales mix. We anticipate that our operating margins will continue to improve sequentially during the second half of the year.

The additions that we made to our sales force in the fourth quarter of 2006 continue to produce encouraging results, with our prospecting sales personnel performing at levels better than anticipated. Our new hires have been with us for nearly six months; and historically we have seen them reach breakeven returns after being with the Company for nine to 12 months.

As you know, our telephone account management service was outsourced at the end of 2006, and we currently have two service providers in the continental US up and running. Our management team will continue to seek new approaches to optimize our telephone account management service.

While our run rate in the former Allied Office Products business remains down versus peak preacquisition rates, as we have outlined before, this is a normal and anticipated part of the acquisition process. We are seeing positive sequential trends in this part of our business as we reacquire Allied customers through focused recovery efforts following our period of initial service issues.

We're gaining momentum because of our total solution sell-in and our customer satisfaction focus. We have successfully recaptured a significant portion of targeted lost customers and are increasing our sales per order metric, with the goal of returning them to preacquisition spend levels. As of now, the trends in this business suggest we will meet or exceed our IRR hurdle rate.

During the second quarter, we acquired Axidata, a small Canadian-based office products delivery company with approximately $60 million in annual sales. The internal and external reaction to our Axidata acquisition, while only one month old is very encouraging. Our new employees are excited about the opportunity to partner with our Business Solutions Division team to grow the Canadian business, an underdeveloped market for us; and the integration process has gone well to date.

Our Internet sales continued to grow in the second quarter, with sales in the previous 12 months totaling $4.7 billion globally compared to $4.5 billion a year ago.

While the past two quarters have been challenging for the North American Business Solutions Division, we've taken the appropriate steps to improve our results in the second half of 2007. As our new sales personnel reach their full productivity potential, our enhanced furniture delivery service is fully implemented, and our new solutions-based initiatives are deployed beyond our already-improved service results we are positioned for continuing margin recovery during 2007.

Now Charlie will review the results of our International Division. Charlie?

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

Thanks, Pat. At almost $1 billion, the International Division reported increased revenues of $124 million on an increase of 14% compared to the prior year. Sales in local currency increased 7% over the prior year. This marks the sixth consecutive quarter of sales growth in local currency.

In particular, our focus on expanding the contract sales force and new account acquisition continues to drive the top line, with sales in the contract channel growing by double digits in local currency versus the same period last year.

Division operating profit of $42 million for the quarter compares to $48 million in the same period of 2006. Operating profit margin of 4.3% is 130 basis points lower when compared to the same period last year.

During the quarter, the division made a number of investments that resulted in short-term operating margin compression of approximately 100 basis points, but positioned us to deliver long-term operating margin expansion. For example, we added almost 200 sales reps in Europe and Asia. We expanded our global sourcing office in China and expanded our regional offices in Asia and Latin America. We also rebranded our Korean business from Best Office to Office Depot, which introduces the benefits of a global brand to that market. We completed a similar rebranding in China last year.

These investments during the quarter more than offset the benefits from our continued focus on reducing ongoing operating costs. Our efforts here are focused on investing in strategies that provide long-term growth potential.

Acquisitions in the second half of 2006 also resulted in approximately 30 basis points of operating margin compression compared to the second quarter last year. However, collectively, the companies acquired in the prior year have grown revenues by over 50% on an annualized basis. We see these smaller acquisitions as opportunities to seed emerging market growth. It is expected that these investments will begin to expand operating margin beginning next year.

During the second quarter, the International Division continued to execute against several strategic initiatives aimed at driving profitable growth in all regions. In Europe, we had sales growth in all channels, which are driven by an expanded contract sales force and a redesigned contract selling model that improves effectiveness and delivers more targeted value propositions. We also expanded the use of telephone account management across Europe and increased retail penetration with five new stores year-to-date in France, Hungary, and Israel.

Over the next few years, we also contained to migrate our Viking brand to Office Depot and grow the portfolio of private brands to expand our growing brand equity with our customers globally. We will do this through a measured and thoughtful dual branding approach. Unlike the transition in North America, we do not have an owned brand that competes with Viking in Europe. Importantly, we will not change the customer value proposition.

In Asia, we doubled our contract sales force in China, and we have expanded our retail presence with eight new stores opened year-to-date including two new stores opening in Japan in the second quarter. We continued the ramp up of our global sourcing office in Shenzhen, China, with Office Depot associates working to transition product sourcing in-house and accelerate the direct sourcing of private branded products.

Global sourcing will further expand the already substantial product margin improvements realized from the migration to private branded products. In addition, our service sourcing office will ultimately source products for all Office Depot regions.

We continue to expand our global reach and have begun greenfield operations in Poland. We expect to grow our contract sales force to support expanded customer acquisitions in that market. The acquisition we completed in the Czech Republic last year is providing the support for this startup and is just one example of how we plan to efficiently leverage our acquisitions to accelerate growth internationally.

The International Division has also make good progress against its long-term cost management initiatives in the second quarter. First, as part of our warehouse and supply chain consolidation strategy in Europe, we opened a new warehouse in Leicester, England, during the quarter. This warehouse is ideally located to serve our existing and new customers and will offer increased efficiencies compared to the warehouses it will replace, which are our oldest facilities in Europe. This does create short-term duplicate costs through the end of this year, until the managed transition is complete.

We continue to have a strong focus on spending through tight expense control and increased efforts around centralization. We're very excited to have begun the implementation of a pan-European financial shared services function in Eastern Europe that will allow us to standardize certain back-office finance and accounting processes and functions. This will result in better service to our internal and external customers, better working capital management, and lower costs.

In addition, we have already begun the centralization of certain procurement and inventory management activities in Europe. We are also expanded our implementation of tools to optimize processes and improve spending effectiveness, including the sourcing of lower-turn products through a virtual inventory model now operational in all major European countries, and are implementing global standard tools to enhance product pricing and marketing spend effectiveness.

As you can see, exciting things are happening in International. We continue to believe we have significant growth opportunities in all regions, as well as significant margin expansion opportunities in Europe. We will focus on realizing these opportunities as quickly as possible and making the investments needed to turn these opportunities into reality.

Now Pat will take you through the cash flow and balance sheet.

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

During the first half of 2007, cash provided by operating activities totaled $293 million compared to $484 million during the same period last year. Changes in net working capital and other components resulted in a $159 million use of cash in 2007 compared to a source of $56 million in 2006, primarily reflecting the timing of cash payments in both periods. Management of the timing of payments to vendors is subject to variability quarter-to-quarter depending on a variety of factors. These may include the flow of goods, credit terms, timing of promotions, vendor production planning, new product introductions, and working capital management.

For example, the timing of back-to-school activity is expected to be later this year than last year. The variability could result in an incremental use of about $150 million in cash during the third quarter versus a year ago.

Year-to-date, free cash flow before share repurchases was $68 million, versus $362 million in the prior period. A greater amount of cash flow was used this year for investments made in our core businesses.

Depreciation and amortization totaled $140 million year-to-date, slightly up from $137 million in the same period last year. EBITDA was $541 million, an increase of 5% when compared to EBITDA last year.

Capital expenditures year-to-date were $225 million, up from last year due to the implementation of previously announced growth plans. CapEx for 2007 are now expected to be under $500 million, in part due to a decrease in planned new store openings from 150 to 125 stores.

CapEx in 2008 are estimated to be between 500 to $550 million, down from the $600 million estimated in the first quarter, which reflects a reduction in the number of planned new store openings from 200 to 150 stores. Office Depot will continue to evaluate spending in accordance with its financial guidelines.

Year to date, we repurchased approximately 5.7 million shares of our common stock for $200 million, completing a $500 million share repurchase program previously improved approved by our Board of Directors. The Company also previously announced that its Board has authorized the repurchase of an additional $500 million of its common stock.

Now on to the balance sheet. We ended the second quarter with $123 million in cash and short-term investments. Our investment in inventories totaled $1.6 billion globally. Our second-quarter inventory includes inventory associated with recent acquisitions.

Inventory per store was $965,000 at the end of the second quarter of 2007, 3% lower than the same period last year. On an average basis, inventory per store was just over $1 million for the second quarter of 2007, which was 4% higher than the same period last year.

Working capital increased 78% as compared to the second quarter of the prior year. But excluding the impact of our adoption of FIN 48, working capital increased by 58%, which reflects the effect of acquisitions completed during the prior year.

Our long-term debt at the end of the second quarter was $564 million, while adjusted debt including leases was approximately $4.6 billion and adjusted debt to EBITDAR was at 2.9 times.

Our outstanding 2013 Senior Notes are rated investment-grade by both Moody's and Standard & Poor's. Our capital structure strategy has been to maintain our investment-grade rating. Our Board remains committed to maintaining flexibility in our balance sheet.

Return on invested capital for the trailing four quarters, adjusted for charges, increased to 15.5% from 13.9% in the prior year. Our return on equity, adjusted for charges and credits, for the trailing four quarters improved by 460 basis points to 22.2% as compared to 17.6% for the previous four-quarter period.

That concludes my remarks. Now I would like to turn the call back over to Steve.

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

Thanks, Pat. I'm pleased to announce today the appointment of two new members to our Executive Committee. Steven M. Schmidt has joined the Company as President of North American Business Solutions Division. Steve succeeds Cindy Campbell, who has served as Executive Vice President of BSD since 2003. Cindy will continue as an Executive Vice President until her planned retirement in March 2008, and we thank her for all of her years of service to Office Depot.

Steve brings to Office Depot 30 years of diverse business experience and leadership. He comes from ACNielsen Corporation, the world's largest marketing information and research company, where he spent 12 years in senior management roles, most recently as president and chief executive officer. Prior to ACNielsen, Steve spent eight years at Pillsbury Food Company, serving as the company's president of Canada and Southeast Asia. He also held management positions at PepsiCo and Procter & Gamble.

Another new member of the management team is Elisa Garcia, who has joined the Company as Executive Vice President, General Counsel, and Corporate Secretary. Elisa succeeds David Fannin, who has served as General Counsel since 1998. David will remain as an Executive Vice President until his long-planned retirement at the end of 2008. Again, we thank David for all of his years of service to the Company.

Elisa has been an attorney for 22 years, the last seven of which have been spent as the executive vice president and general counsel, corporate secretary for Domino's Pizza, Incorporated, in Ann Arbor, Michigan. Prior to joining Domino's Elisa served as Latin American regional counsel for Philip Morris International and corporate counsel for GAF Corporation, one of the largest building products companies in North America. She began her legal career as a corporate associate with Willkie, Farr & Gallagher in New York.

The addition of Steve and Elisa will further strengthen the leadership of Office Depot as we continue to execute our long-term strategic plan.

To that end, I would like to remind you that we have three key strategic growth priorities. First, North American Retail. We will continue to work to improve our store productivity. However, recognizing the current economic environment, we have refined our 2007 store expansion plans. We opened 15 new [resale] stores during the quarter and have reduced our 2007 plan for new stores from 150 to 125. Approximately half of our stores now are in the M2 format. We are in the process of substantially refreshing the remaining stores in our chain over the next few years.

Our second key strategic growth priority is North America Business Solutions. We plan on profitably growing our market share through new customer acquisitions and new product and service offerings, and supplementing with available tuck-in acquisitions.

The new additions to our sales force are progressing right on schedule and will soon be up to full productivity in driving profitable sales. We will lap the merger of the brands in our catalog business during the third quarter and the investments made during the fourth quarter of 2006. Margin recovery from recent investments in this division is expected to sequentially recover over the balance of the year.

Our third priority is International. We want to continue the progress of profitable market share growth in Europe and continue to increase our geographic reach. Our management team in Europe is making great progress, achieving a sixth consecutive quarter of growth and improving. Our management team in Asia is growing our sourcing office that will allow us to globally source a greater percentage of our private brand products and increase margins.

We are also making progress in our pan-European supply chain restructuring with the opening of a new highly-efficient warehouse in Leicester, England, that Charlie talked about that will ultimately replace three current sites.

We have a business that generates substantial cash flow year in and year out. We can use our cash flow to profitably grow our business by opening new stores in new geographic markets globally; by making necessary investments in the core business, like store remodels and distribution facilities; and acquiring assets or businesses in our key priority areas; and finally, repurchasing stock from excess cash flows as long as we believe it is accretive.

We are pleased with the significant progress that we have made to date relative to the cost management initiatives and remain excited and confident about the long-term opportunities that lie ahead of us. We are less bullish in this period of US economic challenge, however. Our comps have not improved since the second quarter ended, and it will be difficult to show earnings per share growth until the macro situation allows sales growth again.

We will do our best to balance long-term investment and short-term returns. While no company is completely immune from the effects of external events, we have established an environment that ensures our team has every incentive to optimize results for our customers, employees, and shareholders over time.

We're building a strong track record of delivering winning solutions both within the organization and to our extended stakeholders -- our external stakeholders. We believe that the initiatives we have just described will yield profitable growth over the long term, and we remain confident about the long-term opportunity to drive long-term profitable growth.

Now I would like to open up the call for questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS) Matthew Fassler.

Matthew Fassler - *Goldman Sachs - Analyst*

I would like to dig into just two brief issues. First of all, if we could go a little deeper into the balance sheet. Your leverage ratios are still quite moderate. Your stock price has obviously come off, and the multiples on the earnings estimates out there are reasonably low. What is your view on perhaps levering up a bit more? Where do you stand with the rating agencies in terms of review processes? Would you be inclined, perhaps, to accelerate your stock buyback activity at these levels?

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

We continue to view our opportunities to ensure that we drive for a long-term profitable growth in accordance with our overall strategic plan. As you know, we routinely have -- we review our plan and our Board is very participative in terms of the review of that process.

As we look at, again, our overall long-term prospects, we believe that our -- and the Board believes -- that the best approach to that is to remain financial -- retain our financial flexibility. Which means that our investment-grade rating is still the appropriate way to look at things.

So as we move forward again, we would be looking to making sure that we are funding with our cash flow any appropriate opportunity to be able to grow our business profitably at the -- with investments that meet our hurdle rates. Then to the extent that we have excess cash flow, as we described before, we will continue to return that to our investors and our shareholders in the form of share repurchases, to the extent that we believe it is accretive.

Matthew Fassler - *Goldman Sachs - Analyst*

Got you. Just a second question. If you could elaborate a bit more on what you are seeing that is leading you to expect a somewhat more promotional back-to-school season. It sounds like that is essentially what you are indicating. So any sense of what you are taking note of out there.

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

Yes, we are seeing back-to-school, first of all, has shifted later in many parts of the country. The actual opening of school dates. When you combine that with some of the moves that are just out in the retail field -- I am sure you have read about other retailers lowering prices on a lot of products, specifically focused in the back-to-school arena -- I think those are going to combine into a relatively aggressive time frame.

Matthew Fassler - *Goldman Sachs - Analyst*

Are those -- we certainly have read the press releases. Are you seeing those cuts reflected in the field these days? Actually have they been implemented yet, to your observation?

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

To my knowledge? Yes, they have.

Matthew Fassler - *Goldman Sachs - Analyst*

Got you, thank you so much.

Operator

Mike Baker.

Mike Baker - *Deutsche Bank - Analyst*

Really it is a follow-up to Matt's question. So I am trying to understand some of the initiatives that you have to stimulate demand within the third-quarter promotional environment. Are you implementing the same strategy in the second quarter, where you're going to be less promotional? Then therefore that might impact sales but help the margins. Or are you sort of following along with that promotional activity?

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

I think in the second quarter, we had success in trying to balance the basket that the customer bought. So we will be promotional. We have talked before about our category management approach and that is what we will continue to be. So there were certain items at certain times that we will be promotional about.

But we are pleased with our efforts in our stores, with our customer service efforts. Our scores have improved nicely on customer service in the past quarter. And building a basket, which is good for the customer in providing a solution to them, and it is good for our financials because we are able to balance out the margin of the products that we actually offer to the customer.

Mike Baker - *Deutsche Bank - Analyst*

Okay, that makes sense. Then finally, one quick question. Can you discuss how many --? Where are you in terms of leases signed for this year and next year towards the goal of 125 stores this year and 150 next year?

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

For this year, we are -- give or take a couple, we are substantially complete. So we expect to be opening those 125 and we are well on the way for next year.

Mike Baker - *Deutsche Bank - Analyst*

Okay, thank you.

Operator

Gary Balter.

Gary Balter - *Credit Suisse - Analyst*

Steve, what I am trying to get a handle on, you can probably help here, is one of the things that I think has hurt the stock is we get these margin surprises each quarter. Like one by one. Like this quarter, International was down 130 basis points based on investments that we didn't see -- we didn't know about from the first-quarter conference call. BSG last year in fourth quarter was down a lot on investments again that we didn't know about from the third quarter.

As we look at retail, which is up now, are there things that you're investing in, in retail, that we should be aware that could have similar impacts?

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

I think we have talked about our investments so far. Our remodels and our new stores, we have articulated where those stand. Long term, we continue to see margin improvements. Short term, we have commented on the promotional environment that is there.

Gary Balter - *Credit Suisse - Analyst*

But there is no other spendings that you're doing? Like International you picked up the Korea change, etc., some of that stuff that really is the first time we are hearing about it. Is there other things you're doing in retail we should be aware of? Or that is -- or we know what is going on?

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

No, for Q3 our margins will be -- what we are seeing is higher property cost due to the new stores. So that is having an impact to our gross margin. That is a deleverage just as a result of the sales that we are seeing overall, with the challenging economic environment.

Beyond that, it is balancing that with the promotional environment that we commented on for back-to-school; and then mixing out the products to try to offset that.

Gary Balter - *Credit Suisse - Analyst*

Okay, thank you.

Operator

Mitch Kaiser.

Mitch Kaiser - *Piper Jaffray - Analyst*

I was wondering if you could talk about the sequential improvement in BSG in the margin, just the drivers behind that.

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

Yes, we have -- as we have been talking about, some of the investments that we had been making in Q4, beginning with Q4, that continued to occur during Q1 as well as Q2. So we had sequential improvement in the overall operating margins from Q1 to Q2. So we will see, again, more of that occurring as we move into Q3 and Q4.

But again, had substantial investments in sales force expansion, as well as telephone account management, as well as the furniture delivery, that again had impact in Q4 through Q1 and Q2. But again, we will see some sequential improvement as we get into Q3 and then 4 as well.

Mitch Kaiser - *Piper Jaffray - Analyst*

Okay. Does the mix impact that at all? Just the seasonality of the mix with back --?

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

Yes, one of the things that we did talk about as well is we have had very good success as it relates to our large and national account businesses; and particularly in the government and education sector. During this period of macroeconomic challenges, our smaller business customer segment has been more challenged. Those tend to be a little bit higher-margin businesses, so part of the margin move as well -- although not the bigger driver -- is really the mix in terms of that larger customer segment that tends to be a little bit lower margins.

But predominantly, really, it was related to the investments that we have made and the other items that I mentioned.

Mitch Kaiser - *Piper Jaffray - Analyst*

Okay, thank you.

Operator

Bill Sims.

Bill Sims - *Citigroup - Analyst*

Steve, you brought in Brad Bacon about six months ago to help clean up stores. Can you give us an idea of what the strategy is that Brad is pursuing, and what are you seeing to date, and what do you expect to see over the next six to 12 months?

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

Bill, what we are seeing in the stores is a cleanup on multiple levels. We are about halfway through; actually we commented in the script, about halfway through on an M2 format. So we're presenting a more uniform environment for our customer, and we are going to continue on that path.

What Brad has been focused on, along with the whole store operations group, is improving our standards both in how we present the store as well as how we wait on our customers.

We are seeing good results on both fronts. As I mentioned earlier, our customer service scores as measured by outsiders have shown improvement during the second quarter. So we're not where we want to be ultimately; we think we still have runway ahead of us. But we are pleased with the progress that the store operations group has made so far.

That will be continuing. That will be their continued focus for the balance of this year as well as getting these remodels and new stores up to par quickly.

Bill Sims - *Citigroup - Analyst*

Thank you. Just one other follow-up from some earlier callers' questions. With transactions down and competitive pressure obviously on pricing, what is the strategy to drive sequential improvement in comps? Or is this more just waiting for macros to improve?

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

We're not waiting for the macroenvironment. We are fighting as hard as we can every day to deliver on profitable sales. I think that we need to continue to be focused on what the customer wants, and provide products as well as services to that customer.

In all of our businesses, we see growth opportunity. The question is how quickly we will get that. So I mentioned in my comments that in furniture, we have shifted more to a take-with strategy. So a customer can come in, and while we still offer the big collections which are delivered to a customer, you'll be seeing an increasing amount of actual take-with furniture that someone can throw into their car or truck and take it home and assemble it.

We have added lower price point, lower package size, quantities within a package, really to tailor more into a very small business customer. Sole proprietor, for instance.

So it is those kinds of efforts, multiplied multiple, multiple times, that we are working hard on to attract more customers into the stores.

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

And we continue to use advertising. We continue to use our weekly circular, our ROPs, all of our direct-mail efforts, our Worklife Reward card efforts to be as effective as possible in driving store traffic.

What we're trying to do is balance the level of promotionalism -- so that we don't just give away margin on sales that aren't going to increase -- with trying to drive that increase in traffic. I think Chuck has done a good job of laying out all sorts of examples of things that we're doing and trying.

Suffice it to say there are dozens of things beyond what we have talked about that we are testing and we're trying. As soon as the market becomes reactive to that, we are going to be a position to roll them out. But we're really trying to balance the short-term and the long-term, we are trying to balance driving transactions with not just wasting margin.

Bill Sims - *Citigroup - Analyst*

Understand, thank you.

Operator

Armando Lopez.

Armando Lopez - *Morgan Stanley - Analyst*

Just two quick questions. I guess, first, maybe could you -- you talked a little bit about like housing and putting pressure on the small, medium businesses. Can you talk? Have you seen -- or what trends you're seeing, maybe by region, how the regions are playing out?

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

Well, we don't typically discuss regional situations, but suffice it to say that we are seeing the housing market impact several of our categories, including furniture and things that are related to home office. Small businesses sometimes are in commercial office parks; but they are often in households. So the kinds of trends you're seeing across the country in the housing market are being experienced by us as well.

The transaction issue is the biggest frustration. The store traffic is being impacted, and there is a combination of factors that have gone into that.

The larger businesses seem to have held up. In fact were doing reasonably well in our BSD Division there. But as you know, we are weighted to smaller and medium businesses in BSD. Of course, our North American Retail Division is two-thirds small businesses and one-third consumer, so that is getting hit on both fronts.

Armando Lopez - *Morgan Stanley - Analyst*

Right, okay. Then second, on the International side, with some of the incremental investments that it sounds like are supposed to start realize the benefit of next year; and then I think you talked about Czech Republic and some of the other opportunities that you are pursuing. How should we think about margins with that incremental investment on the International side of the business?

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

Yes, good morning Armando, this is Charlie. I think what you have in the International Division is really an emerging business. We have a core that is solid in Europe; but we're going to be adding. As we added the Czech Republic, now we are adding Poland. We are going to fund those. We expect the margins to start improving early part of next year.

Armando Lopez - *Morgan Stanley - Analyst*

Okay.

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

And moving sequentially towards historic levels.

Operator

Colin McGranahan.

Colin McGranahan - *Sanford C. Bernstein - Analyst*

Two questions. First on BSD, I think originally you had expected the margins to sequentially improve in the second quarter and even potentially flatten or be up year-over-year in the second half. Obviously, that sounds like it's not the case anymore. Understanding that there is a softer environment and, Pat, your comments on mix away from some of the smaller businesses. But it sounds like the new account reps are doing even better than had expected.

Can you comment on the turnover in existing account people in the contract business, given 4% growth includes the Allied decline in revenues? Is that pressuring margins? Can you just talk about other factors that might have changed relative to your previous expectations? And then I have a follow-up for Charlie in International.

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

I don't think we have seen a change in our expectations in the BSD margin pattern. What we have said is that the second quarter was going to continue to show the results of our investments that we started to see in the fourth quarter and through the first quarter. So that is what we said.

We have said pretty consistently that the results -- the margins will improve sequentially beginning in the third quarter and extending through the fourth quarter. So we still believe that.

We planned the investments in BSD in order to drive long-term growth. So it was a deliberate effort to do that. So nothing has changed with that.

We are seeing -- remember, we tested the addition of salespeople pretty heavily and tracked their productivity curves through the maturity of their lifecycle, if you will, with us. We made that decision to expand beginning in the fourth quarter of 2006 based on that result.

Those new people that we added beginning in the fourth quarter of 2006, where we added quite a few, are progressing consistent with our experience in the pilots of that. So we are seeing the results and we are pleased with the results in that.

So I think what -- so we are seeing good results from that investment. We're seeing good results in the high-end. It is the smaller customers where the slowdown has happened consistent with what we have seen in North American Retail.

Colin McGranahan - *Sanford C. Bernstein - Analyst*

Okay, Steve, that's helpful. But just is there -- has your turnover in your existing account reps been consistent with what you expected, or is that higher?

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

No. It's been very consistent.

Colin McGranahan - *Sanford C. Bernstein - Analyst*

Okay. Then Charlie, could you give us just a quick update on the transition from SAP to Oracle in Europe? I know you will be -- I think you are relocating some jobs, possibly, to the Netherlands through the year. Just any update on there. Are those costs being run through the P&L currently?

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

In terms of the costs that you're talking about, relocating jobs, as I mentioned we announced last week the kickoff of our shared service center in Eastern Europe. That is going to result in the movement of several hundred jobs from Western Europe into Eastern Europe.

That is going to be -- I will leave it to Pat to talk about where that is going to show up. But that movement is happening. That is going to give a substantial reduction in our back-office support costs.

In terms of -- I think that that's it.

Colin McGranahan - *Sanford C. Bernstein - Analyst*

Charlie?

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

Yes.

Colin McGranahan - *Sanford C. Bernstein - Analyst*

Just the SAP transition to Oracle?

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

Yes, that will start in Europe probably in 2008.

Colin McGranahan - *Sanford C. Bernstein - Analyst*

Okay.

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

It will start here in North America first.

Colin McGranahan - *Sanford C. Bernstein - Analyst*

Okay.

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

But we only have SAP in some of the acquired businesses in Europe.

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

The old contract business.

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

Right, and so we are in the process of migrating more than -- it is more than the SAP to Oracle ERP. It is the whole variety of systems that we have globally throughout the Company. So, we already have begun migrations, for instance in PeopleSoft; and we will do so in finance and so forth. So we are doing this sequentially.

One piece of it is to take the remaining ERP, the SAP piece in Europe, and convert that. So this is a multiyear project to convert all of our systems and get us all on the same systems globally.

Colin McGranahan - *Sanford C. Bernstein - Analyst*

Okay, that's helpful. Thank you.

Operator

Danielle Fox.

Danielle Fox - *Merrill Lynch - Analyst*

I have two questions. First, could you be a little bit more specific on how you were able to expand the retail operating margins, especially on the SG&A line, with the negative 5% comp? Where did you find opportunities to cut costs, essentially?

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

Well, as I mentioned in my comments, it was both product margin expansion as well as cost management. So we saw a good margin expansion through some of the efforts that we had, through market basket efforts and the such.

On the cost side of it, it wasn't focused on labor. We really became very focused in on continuation of some of the things we have talked about before, some of the backroom efforts that we have in there. So there is hundreds of smaller projects that continue to reap some benefit for us overall.

Again, the margins really were delivered through some good, strong efforts on the product margin side of it. As I mentioned, again, in my comments, a good part of that was as a result of fewer promotions.

Danielle Fox - *Merrill Lynch - Analyst*

Okay, so it sounds like you were able to moderate the deleverage, but the gain actually came from the gross margin line. Is that fair to say?

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

It came from both higher product margins as well -- which were as a result of a lot of things that we, in fact, did. What we sold, less promotions, also in addition to strong cost management on the retail group's part.

Danielle Fox - *Merrill Lynch - Analyst*

Okay, that's helpful. Then the second question is I was just wondering if you could talk a little bit more about the NPD data that you cited? Where are the market share gains coming from? Do new stores account for a lot of the market share gain? Sort of what does the data say about industry growth, sales growth in general for the quarter? Were industry sales down, for example, in the quarter?

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

What we look at is the market share information. I would refer you to NPD for further expansion. But we saw sequential improvement in most categories across.

Danielle Fox - *Merrill Lynch - Analyst*

Okay, thank you.

Operator

Chris Horvers.

Chris Horvers - *Bear Stearns - Analyst*

Can you talk about sequential changes in different aspects of your business? Has the consumer worsened over the past four months? Is it spreading upward now to medium and kind of trending, and eventually we see something hitting the large business customer?

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

You know, we are not economists, so we can only talk about what we have experienced. We have seen, beginning in the first quarter, a pretty -- [just] slowdown. We said it started at the back part of the first quarter and continued all the way through the second quarter; and we're seeing it continue now year-to-date or quarter-to-date in the third quarter.

So an unchanging situation with the consumer, traffic slowing down, as well as the small business. We have found that small businesses tend to act more like consumers than they do like medium to larger businesses. Those small businesses are typically under nine employees; a lot of them are home-based, one or two person kinds of operations. Their source of financing for startup and operations tend to be more consumer-based kinds of sources of liquidity and borrowing.

So all of the impacts of the housing market, including home equity access, including rate adjustments and so forth, gas prices, seem to have hit those small businesses more than you would see in a larger business.

So we have not seen the larger businesses impacted at all. In fact, we have said we are doing better in the larger business segment, because of particularly in our BSD division.

All of what we have talked about economically has been the US. I want to point out that our International businesses have improved, and the economies in Europe and Asia continue to improve, as well as Latin America, continue to improve.

Chris Horvers - *Bear Stearns - Analyst*

So characterization is the consumer not really getting better after that stiff slowdown. Any change in the medium businesses or the 50 to 100 employee businesses?

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

I don't think that we have seen a big discrimination between the medium to large size businesses. So it is mostly in the smaller end.

Chris Horvers - *Bear Stearns - Analyst*

Could you talk about the category performance? Just curious that at the retail side that technology is holding up. Did it comp positively? What are your thoughts on that?

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

Technology was growing really very strongly and fast for the past couple of years. We had the VISTA slowdown. Technology still continues to be positive but at a lower level of growth than it was before.

Then of course, the furniture business is down substantially, and that ties directly to the housing market. When people move, they tend to replace their home office furniture. Our furniture tends to be more geared to collections that are suitable for home-style offices. So it is a matter of movement of houses; and that has hit it pretty strongly.

Chris Horvers - *Bear Stearns - Analyst*

Thank you very much.

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

Okay, it looks like we have got time for one more question, so why don't we take one more and then we will end it.

Operator

Dan Binder.

Dan Binder - *Buckingham Research - Analyst*

A couple questions for you. First, you talked earlier about the Board wanting to maintain flexibility in the balance sheet. I guess taking that into consideration and what is going on in the industry, can you comment at all about your appetite for acquisitions at this point? Whether it is relative to a year ago or recent quarters, or how you are sort of viewing that opportunity going forward? That is the first question.

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

Yes, I think our focus on acquisitions continue to be primarily fold-in acquisitions internationally to expand our geographic reach. These have been nondilutive acquisitions. Our focus has been on relatively small, established businesses, which give us a base of operation in new countries. We have done so in Asia and we have done so in Eastern Europe. There are others that we are interested in doing.

These are important to us because it gives us a low-risk way to expand geographically while also being able to care for our global customers better. So oftentimes, we are able to take these acquisitions, these companies, improve their margins through our global purchasing cost and direct import efforts, private brand efforts. And at the same time, add the overlay of the global customers that we have elsewhere and begin to take care of them. So that is really our primary focus on acquisitions.

Dan Binder - *Buckingham Research - Analyst*

Then I am struggling to understand the reason that you need to switch the Viking brand to Office Depot. I guess my understanding was that Viking's brand in Europe was even more powerful than it was here in the US. There are multiple examples in retail here in the US and elsewhere where companies have successfully built and grown and operated dual brands. I guess I am trying to understand where you see -- what it is you see in that brand consolidation that can get us comfortable with it.

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

This is Charlie. I think the important thing to consider is how we are going to go about it. Literally, initially, all we are doing is putting a co-brand, Office Depot Viking, on the cover of the catalog, on our delivery boxes. So I mean, it is not a wholesale change.

Also, this drives a tremendous amount -- by initially moving to Office Depot, it removes a tremendous amount of complexity out of the back office in terms of being able to simplify your SKU assortment, being able to simplify your marketing materials, and actually being able to prospect across multiple customer databases. So we see a huge amount of benefit there.

Importantly, in this whole transition we are not going to touch the business model that has really built this very loyal following. So it is really kind of a reeducation of the customer that they can get the same service they have been accustomed to getting from Office Depot.

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

I think -- you know, I think people are reacting to -- we did this in the United States. And by the way, we gave up deliberate unprofitable business. I think we have got to remember that the change was made deliberately.

But it is apples and oranges US to Europe. Because in the US we had two separate businesses, two separate catalogs. In Europe, it is one business.

The way to think about it is, we are going to add the Office Depot name to the cover of the Viking catalog for a multiyear period to begin to start to get the Viking customers to understand that we are Office Depot; introduce the Office Depot private brand; and go through a slow, deliberate, multiyear conversion.

Now if we find that there is resistance to it, we won't do it. That is what a multiyear process of dual branding does to us. But it allows us to do the things that Charlie said as well as to access cross channel shoppers, which are your best shoppers, and to leverage the business across Europe.

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

Also, you know that in Europe, some of our country's operations are larger than others. We are going to start this process in the smaller, the smallest of the countries. So that will also further mitigate the risk to the point that Steve raised.

Dan Binder - *Buckingham Research - Analyst*

Okay. Just one last thing. On the NPD data, you talked about the sequential improvement. I am just curious, if you look at the year-over-year data, does this sequential improvement just mean that you have lost less market share versus a year ago? Or do you actually have market share gains year-over-year?

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

The sequential is over the past quarters. On an overall to last year, it was essentially flat.

Dan Binder - *Buckingham Research - Analyst*

Okay, great. Thanks.

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

All right. Well, thank you. It looks like we are over our time, I apologize. But thank everybody for joining us. This concludes our conference call and we appreciate your participation.

Operator

Thank you. This does conclude today's conference call. We thank you for your participation. At this time you may disconnect your lines.

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