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ODP.OQ - Q4 2002 Office Depot Inc. Earnings Conference Call

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OVERVIEW:

The company reported 4Q02 GAAP EPS of $0.21, sales of $2.82b, and growth in operating profit of 32%. Guidance was for 2003 EPS growth of 5-10%. Q&A focus: comps, use of cash, growth strategies, and currency exchange.

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PRESENTATION

Operator

Good morning. We would like to welcome you to the Office Depot's fourth quarter, year end 2002 earnings conference call. All lines will be in 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 call is being recorded.

I would like to introduce Miss Eileen Dunn, Vice President of Investor Relations and Public Relations, who will make a few opening comments. Miss Dunn, you may begin.

Eileen Dunn - *ODP - VP of Investor Relations and Public Relations*

Thank you. Good morning, and thanks for joining us today for our fourth quarter, year end 2002 earnings call.

Before we begin today's presentation I'd like to remind you that except for historical data comments on this call should be considered forward-looking within the meaning of the Private Securities Litigation Reform Act. Forward-looking statements including projections as to revenues or earnings and other statements related to expected future performance by Office Depot involve risks and uncertainties which may cause actual results to differ materially from those discussed on this conference call. Please refer to our filings with the SEC for further information on risks and uncertainties.

Information going forward will be presented on a GAAP basis, however, certain financial information on today's call will be presented in a non-GAAP form. A reconciliation of operating profits and segment operating profit is available on the IR section of our web site.

Now, I'd like to turn today's call over to Office Depot's Chairman and Chief Executive Officer, Bruce Nelson.

Bruce Nelson - *ODP - Chairman and CEO*

Thank you, Eileen. And good morning to all of you. I hope by now you've had a chance to read the earnings release this morning and the accompanying schedules that go with it. I'll make some highlight comments about the company in total, each of the business units, talk about our outlook for 2003, and then open the call up for questions.

As you saw this morning, we reported GAAP earnings of 21 cents per share, 23 cents if you exclude charges associated with store real estate, exceeding expectations. Our fourth quarter sales grew two percent to 2.82b. Our operating profit in the fourth quarter grew 32 percent, and EPS grew 54 percent.

For the full year sales rose two percent. Operating profit rose 41 percent. EPS increased 48 percent. Our e-commerce sales reached a record level of 2.1b. And our free cash flow in 2002 totaled more than $500m.

Despite a very difficult sales environment in North America that we faced throughout the year Office Depot posted record results both in the fourth quarter and for the year 2002. During the year we virtually met or exceeded every one of our key operating metrics. Our costs are down. Our margins are up. Our operating profit both in the fourth quarter and year-over-year is up. Operating profit on a company-wide basis up 100 basis points over 2002.

We have built a significant leadership team at Office Depot which will drive our results into the future. We've changed our culture at Office Depot. We've invested for growth. A significant amount of earnings have been invested in growth in Europe this year and, you probably saw this morning and if you haven't, we announced additional growth initiatives in Europe where we plan to launch retail in Spain in April of this year. We drove RONA. We have the best balance sheet in our business. It's got lots of cash. The metrics are very good. And when you put it in perspective of the economy and the environment we're proud of our accomplishments both during the fourth quarter, as well as for the full year.

On a sales basis I said earlier that our revenue for the quarter increased two percent. Comp worldwide sales were flat in the fourth quarter and for the year. And as I said earlier, e-commerce reached 2.1b, reflecting a 34 percent increase over 2001.

Now, turning a little bit to more insight on the comps. Our BSG sales were up five percent in the fourth quarter, four percent for the full year. Our contract segment grew six percent in the fourth quarter, three for the full year, and we've been accelerating that business all year long. As I've indicated to you, we've made investments to grow that business, and those growth initiatives are paying off.

We did see some strengthening of our West Coast operations where we've had some weakness in the early part of 2002. Our overall catalog sales at Office Depot and Viking remained negative. We will and have made changes to manage this business going forward. I'll talk of those when we get to the North American segment.

Our domestic e-commerce was up [26 percent] for the quarter, furthering our already industry leadership.

North American retail comps, the number all of you want the most focus on, and I'll give you considerable insight into, were negative four percent for the quarter, and negative two percent for the full year. Furniture, technology lumped together accounted for virtually 100 percent of the negative comps in North American retail during the quarter. I'll talk more about that when I get to the retail segment.

Our international sales were up six percent in dollar, in local currencies in the fourth quarter, up 17 percent in U.S. dollars, as we're beginning to see now for the first time in some time benefits to Office Depot as a result of the comparisons between the dollar, the Euro, and the pound. Our strongest performance were in the Netherlands, Ireland, Austria, and Italy. International sales for the full year were up six percent of local currencies, 11 percent in U.S. dollars.

On an operating profits basis full year operating profit was up 41 percent to $500m, versus 353m in 2001. We hit historical year-end high operating margins in our BSG business at 9.3 percent. An outstanding year any way you measure this business. I'll talk more about BSG in a minute.

Our North American retail operating margins, excluding the increase in lease termination costs that are outlined in our release and the California wage and hour re-settlement which was earlier in the year reached 7.6 percent for the year, full year 2002. This in spite of a difficult sales environment. And we made [immeasurable] progress in making our retail stores more shoppable, a more compelling place to shop, and improved our operating metrics and our quality metrics all at the same time.

International was an incredible year when you think about what we invested to grow our business. We added three new countries. We increased the support of four new contract countries. We added contract sales forces in Italy and Germany. Added eight new stores in France. We made significant progress on reducing our operating costs in Japan. We launched nine new web sites. And we only took when we did all that a 72 basis point hit on our operating margins. We invested in 2002 more than $50m of EBIT to grow our international business. It's profitable. It has high returns. And we announced this morning further investment as we continue to drive our company's profitability.

Our margins throughout the company more than offset our comparable sales softness. And of those, as I've talked about earlier, were lower levels of technology sales. We did see improved pricing in our contract business, better pricing from our wholesalers, better cost control, and overall good G&A controls.

On an EPS basis, on a GAAP basis, as I said, first quarter – excuse me, fourth quarter earnings were 21 cents excluding the charges of the North American real estate and the discontinued Australia operations which, as you know, we announced we were going to sell and we have now successfully completed that sale. We actually achieved 23 cents for the quarter of earnings, 21 cents on a GAAP basis.

Included in the fourth quarter results were an $8.4m adjustment for the increases in the lease termination costs of the remaining 70 stores we closed in early 2001. At our mid-quarter update in December we talked about the likelihood of having to take additional charges for those stores.

Also included in our full year results is approximately three cents for the accrual for the settlement of the class action litigation in the State of California of which many retailers have had [in their sales], and the adjustments in real estate I just talked about.

North American retail stores. Fourth quarter sales, as I talked about earlier, were down three percent, comps down four, and for the full year were down one percent. Comps in North American retail were negatively affected particularly in December with furniture and technology. Furniture, technology in the broader category, by that I mean hardware, software, and communications in the fourth quarter were $57m less in the fourth quarter this year than last year. The following, the last two weeks of December were particularly soft in these categories, and as I said earlier, that virtually accounts for all of the negative comps in North America retail in the fourth quarter.

Office Depot was a leader in both furniture and technology compared to our competitors. We had a higher percent of our business in these categories long before our competitors did. We suffer more of a difficult comparison as a result. And these had been the primary factors weighting on negative comps, both in the fourth quarter and throughout the year.

The average ticket in North American retail was down about one percent, again reflecting lower furniture and technology sales. Comp transactions were down, as well. Our customer service indexes, those indexes that we measure customer performance, were up. We opened seven new stores in the quarter, relocated one. And at the end of the year we have 867 office supply superstores here in North America.

On the retail operating profit side store operating profit hit 6.3 percent in the fourth quarter, 7.6 for the full year. And excluding the impact of the California wage and hour suit, the litigation I talked about, and the increase in the lease costs our gross margin has improved 42 basis points during the fourth quarter, and 170 basis points for the full year. That's partly a shift away from technology. It's also disciplined category, SKU, and product management. It's the increased reliability we have on private label products and globally imported products which have allowed us to remain competitive at the sale price level, and take higher margins as a result of some of our buying skills.

Our operating costs in retail remained tight throughout the quarter. When you negative comp four percent, as most of you know, it puts tremendous pressure on fixed costs and you get some de-leveraging. But in spite of that our payroll was up only slightly, our complaints were down, our service was better. And as I said, retail, particularly in light of a difficult environment really from our perspective had an outstanding year from a profitability standpoint.

There isn't any question that our highest priority at Office Depot is to grow our North American retail sales. I will comment on that when I talk about the outlook going forward.

Business Services Group, which I talked about earlier, had truly an outstanding year. Sales in the quarter grew five percent. Our contract sales grew the fastest. We continue to invest in this segment. We believe we're gaining share. We believe we'll continue to grow this business going forward.

We made substantial improvements in our operating costs, and I'll talk more about it in a minute. We have, we've done some things to accelerate growth in our Office Depot and Viking catalog brands. We're going to combine the leadership of those two brands under one leader. We're going to put that leadership in Delray Beach, Florida. And we believe we've identified very specific, measurable initiatives that will cause that business to grow in 2003. We're seeing some early signs of that now. It's – the full year is ahead of us, but we're confident we can grow this segment.

The growth in the contract business we think is market share gain, predominantly in the East, but we did see substantial improvement in the West. Our contract average order size is up a slight bit. That's an encouraging sign as it was down earlier in the year putting difficulty in our warehouses.

Our domestic e-commerce business grew by 26 percent during the quarter, continuing the leadership position we have in e-commerce, both domestically and internationally.

On the operating profit basis, this business hit a record 9.2 percent operating margin for the fourth quarter, up 107 basis points over last year. For the full year it's 9.3 percent, 158 basis point improvement over 2001.

Gross margins were actually slightly less in the fourth quarter, nine basis points as a result of the larger impact of [For Sure Dot Com] [ph] business which is growing rapidly at lower margins, and a little bit of mix to larger accounts which historically have somewhat lower margins.

Our operating costs in this business decreased by 115 basis points in the fourth quarter, and 177 basis points for the full year, and that's after substantial improvements in 2001.

This business is profitable, we invest in its growth, it contributes enormous profitability to our company. We believe we can continue to gain share in this business. We made improvements in our DSO, our inventory turns, and our service levels, all of which helped us achieve record free cash flow in our businesses throughout the world, and record service levels from both inventory and customer issues.

On the international side for the fourth quarter sales grew six percent in local currencies, 17 percent in U.S. dollars. The exchange rates favorably impacted the quarter by about 40m and 67m for the full year, and so we did get some benefit. The biggest benefit of which was in the fourth quarter. We do have the benefit of three new direct mail countries in our numbers, Switzerland, Spain, and Portugal. Switzerland and Spain in the early part of the year, Portugal late in the fourth quarter. We have ramped-up contract sales in four countries. We added two new countries in contract; Italy and Germany. We added eight new stores in France. We have a new warehouse in France to support the growth. We have nine new websites, three of them, six Viking direct, and three BSD Net.

We substantially improved our operations in Japan. We've combined to one single brand. We reduced our operating losses by almost 50 percent. Japan is still a challenge. We are encouraged by some of the signs we see in Japan. A number of our stores achieved profitability in Japan at the store level. We continue to believe we can make Japan work. An important part of our future, albeit we'll still sustain losses in Japan in 2003.

On the operating profit basis internationally, gross margins increased by 11 basis points primarily attributed to better buying, global purchasing, and some private label products. Also, 18 basis points on the full year, basically the same story. Operating costs on a year-over-year basis did increase, but they do reflect the tremendous investment I talked about earlier to grow our existing business in Europe. We've said all along that Europe is the primary focus of our international growth. We are a significant player in Europe, want to be a bigger one. We believe we can do this and continue to grow our business both cash, profitability, return on sales, return on investments.

We did complete the sale of our Australian operations in the first quarter of this year, and so that transaction will be recorded in our first quarter results. So Australia was successfully sold to Cole Myer, and so our results have excluded Australia on an ongoing basis. And so we've presented our results for ongoing operations.

In summary, as we look to both the quarter and the year we faced enormous challenges, economically here in North America, some challenges in Europe, as well. But as we look back we basically promised or delivered all that we promised, either met or exceed. We're proud of our accomplishments. We are highly focused on continuing to grow RONA, to keep the best balance sheet in this business, to continue to generate enormous free cash flow in spite of investing for the future. We have a Leadership Team I'm extremely proud of.

We certainly have a challenging environment short-term, both in North America and potentially outside the United States given the world events. But we're more optimistic than ever about a our long-term ability to grow this company's sales and earnings in the ranges we've outlined which is long-term growth of at least 15 percent EPS.

What I'd like to do now is turn a little bit more to our outlook for 2003. We are six weeks into it from a perspective. One of our enormous challenges is to predict for you and us what the economic environment is going to be like, and what that means to us. All of you would like us to be able to predict EPS within a penny or two. I would remind all of you that basically EPS with us is about a $5m number. And so, to predict EPS within two or three cents you're asking us to predict in January what EPS might be like within $15m. It's challenging. It's challenging for us, challenging for you. But let's take a look at our overall assumptions for 2003 at this point in time.

We do not see encouraging signs particularly here in North America of an improving economic environment. The signs we say still say that small and medium-sized businesses which are the core of our retail business are conservative. I am not overly optimistic about the short-term future.

As a result of this very early view we now believe that our GAAP EPS growth will be in the five to 10 percent range over 2000 EPS GAAP of 98 cents a share. We think EPS in the first half is likely to be flattish. For those of you that don't recall, we had a significant increase in EPS the first half of last year. And particularly the first quarter. We think our EPS growth in the first half is liable to be flattish, but will pick up in the second, a sequential improvement in the second half of the year.

We do expect our worldwide e-commerce business to continue its rapid growth. We expect that business to exceed $2.5b.

Now for each of the segments. North America retail, we do expect to see sequential improvement in each quarter, but we now believe that comps will be negative in the first half in the mid single-digit range with flattish to slightly positive comps in the second half of this year.

Our number one priority, as I've said to you, is to grow North America retail sales. I am sure when we end this call you're going to have an awful lot of questions on how we're going to do that. I am not going to be as specific as you would like, but I will tell you that we have identified significant things we believe we can do in the immediate near future to grow North American retail. This management group is focused on it. It's a difficult environment, but we're confident we can deliver. And when we start to deliver on those initiatives we will fully tell you what they were, what they are, where they are, and how they impact our business. But I want you to understand it's our number one priority.

We plan to open about 40 new stores in North America this year, predominantly focused where we have density. We intend to build-out our presence in a few of our major markets. That's important to us because where we have density and a strong presence every other aspect of our business does well. And so, we are slightly ramping up store openings in 2003. They will be generally smaller stores, but there will be more of them.

From a gross margin perspective we believe we can make small improvements in margins in 2003. That's going to be a little bit dependent upon the shift in mix. Technology should it grow will cause margins to come down on a consolidated basis. But we do think there's small improvements in margins we continue to get as a result of our buying and pricing initiatives.

From an operating margin perspective with our outlook on comps, as I have articulated, we will be experiencing de-leveraging of our costs, but we think while there will be some quarterly fluctuations compared to last year, we believe that our operating margin performance in North America retail should be very comparable to our performance this year in spite of our cautious outlook on North America comps.

On the North American deliveries business we expect to see this business continue to grow in 2003 as it did in 2002, particularly in the second half. Our growth will be SKU'd towards our contract business, where we've invested and believe we can take share.

We do anticipate growth in our catalog businesses, at Viking and Office Depot. I spoke earlier of some decisions we've made to more consolidate these two businesses. Headquartered in Delray Beach that means during 2003 we will be moving a number of people from Torrance, California, our Viking headquarters, to Delray Beach. We will fully integrate Office Depot and Viking's order entry systems. And we expect the cost of that integration throughout 2003 could be in the neighborhood of $10m to $20m, and that's already in our outlook for earnings for 2003.

Growing our North America catalog business is our second highest priority at Office Depot. Growing North America retail is our first. And we continue to focus on that, and at the same time continue to invest in our international businesses.

In North American delivery we expect mid to high single-digit growth. And we expect to continue to gain share, as I said earlier, in our contract business.

Our For Sure Dot Com business, the company we acquired a year or so ago, is doing extraordinarily well. It's a virtual seller of technology to small and medium-sized businesses. Its virtual inventory, it has lower margins. As it becomes a larger part of our sales it has the impact of lowering the overall reported margin for the group. And our growth in contract in 2003 will be the biggest part of our growth. It will put some pressure on our gross margins as a result, and we expect gross margins in this segment to drop during the year between 150 to 175 basis points as we grow contract and For Sure is a bigger part of our business.

On the expense side we continue to believe in spite of two years of extraordinary quality and expense improvements we can get enough expense out of our North America delivery businesses to offset any margin deterioration, and therefore, we think our operating margins will be pretty much in line with our record levels of 2002. Which I remind you were over nine percent.

On the international side we expect this to continue to be our fastest growing business, and we'll grow in U.S. dollars, we now believe, to the mid high-teen range. This comes from consistent mid single-digit growth in our mature direct catalog business operations coupled with growth in e-commerce, as well as new country growth and new channel growth in our contract business.

While we've not announced any new contract countries for 2003, as you know, we did announce this morning we will enter Spain in April with five to six retail stores in Madrid. We already have an existing operation in Spain. We have warehouse, we have call center, we have infrastructure, we have G&A, we have administration. We've identified Madrid as the most important market of Spain. We believe we can build a significant presence of superstores in Spain. We think first mover has an advantage. We've identified five sites. We have leases signed, and in the process of a sixth. We plan to open these stores in April or May, and start to add retail into an already existing infrastructure in Spain.

Gross margins, internationally basically will feel some impact of increased prospecting, but as a result we see gross margins as a result of improvement in global purchasing and private label pretty flattish for the year 2003 versus 2002.

From an operating margin basis in spite of these enormous investments in new countries, new channels, new brands, and Spain retail we think that we'll get in the 50 basis point range improvement in operating margins in this segment for 2003.

Our capex for 2003 we now believe will be in the $250m to $300m range, slightly more than it was in 2002. And we now anticipate that our free cash flow, and something we've accelerated in, will be in the $250m to $300m range.

That's our overall outlook for 2003 as we see it the second week of February. One of the things that we started to do a few years ago was to provide you great insight into our business on a mid-quarter update. We will continue to provide you insight into our business on a mid-quarter update basis to give you more insight to how we're performing.

I know in a minute you're going to want to talk an awful lot about comps. And I understand why that's important. And I understand there's going to be enormous numbers of questions about what we're going to do to drive them.

I want to summarize and say this company in the two-and-a-half years, that in the last two-and-a-half years, has made enormous progress. We have delivered or exceeded virtually on every promise we've made. From our balance sheet to our operating statements, to our costs, to our margins, to our RONA, to our pristine balance sheet, to our capital ratios, to our DSOs, to our inventory turns to supply chain, and frankly, in most if not all of those categories we lead our competitors and we lead the industry.

Clearly our challenge is to grow our North America retail business, and secondarily, our North America catalog business. And, again, I'll tell you we have a list of very specific by market, by geography initiatives that we believe will get North American retail comps positive in the near future.

And so, with that, I'd like to turn the call over to you for any questions you might have about the quarter, the full year, or our outlook in 2003.

QUESTIONS AND ANSWERS

Operator

Thank you, sir. If anybody would like to ask a question, please press *, 1 on your touchtone phone.

Our first question comes from Matthew Fassler from Goldman Sachs.

Matthew Fassler - *Goldman Sachs & Company - Analyst*

Thanks a lot, Bruce, and good morning, and thanks for the very comprehensive overview. I have so questions, and so as not to disappoint you, the first one will involve comps. I want to reconcile the traffic and ticket discussion with the discussion of the mix shift. You alluded to furniture and technology being major culprits -- but the ticket, average ticket, was not down dramatically. If you could just give us a sense of how you comped in some of the supplies areas, and how you think about the relationship between traffic and mix.

Bruce Nelson - *ODP - Chairman and CEO*

Well, I think if you take the comment I made, Matt, that furniture and technology virtually accounted for all of our comps – negative comps – you then have to assume that the total chain comped kind of flattish. And within that, there are some different changes. And I would say core supplies did fine; some pressure on some other categories. I think traffic is one of the issues we're focused on. We've spent a lot of effort on what it takes to drive traffic in stores; we believe we can increase it.

I think part of the reason why the average ticket didn't drop more in light of furniture and technology, is I think that our core customer in our retail stores – and this is really critical to understand – our core customer is not a personal user. Our core customer is a small and medium-sized business. And we have the biggest share of that business where we line up against our competitors. And I think, while they're conservative in terms of their outlook for high ticket items, I think they continue to have to use consumables, and therefore I don't think the comp transaction dropped as much as the impact of furniture and technology.

Matthew Fassler - *Goldman Sachs & Company - Analyst*

Fair enough. Second real quick one. Obviously, no one in this environment is going to penalize you for sitting on a hoard of cash. But if you could give us an updated sense -- given that the free cash flow prospects remain strong, given that your cash net of debt remains very substantial – your latest thinking on uses of cash including acquisition and buy-backs, to the extent that those are [simultaneous speakers].

Bruce Nelson - *ODP - Chairman and CEO*

Well, I should tell you, I love this question, because it's really a great position, to have to try to explain to the world how we're going to use all of our cash. It's sure a lot nicer position to be, than to explain where we're going to get some.

I'll come back and say, we said that this company was going to focus on increasing shareholder value. The way you do that over a long period of time, is you grow your business. And you grow RONA. Because there's a high correlation between companies that grow RONA and companies that grow shareholder value a la stock price. And I have promised, and I continue to promise, and if you know a lot about our organization – some of you do – we make promises I believe we can keep. And we do our best to exceed them. I have promised that we'll use the cash to generate shareholder value. My preference all along is to find ways to reinvest that cash back into our business to grow the top line, to grow our presence, to grow our market share. I've been saying that for 18 months; I'm going to say it for another 18.

I don't really have any comment, nor can I comment, about the rumors circulating about acquisitions, nor do I have any comments, nor can I, about stock buybacks. My promise to the shareholders of this company – and our new management organization, and frankly, my own Board of Directors, our own Board of Directors – is that we will grow value in this company. If we can't find ways to invest that cash in our business, to grow it, we will find ways to grow shareholder value. That's a promise. We've had this problem for about four quarters, or five quarters. We continue to run our business to generate positive cash flow. We're going to generate more positive cash flow next year, and that that's kind of our view of cash.

So it's hard to be more specific than that; I know that everybody would like me to be more specific, but it's all about driving shareholder value.

Matthew Fassler - *Goldman Sachs & Company - Analyst*

Thanks, Bruce.

Operator

Our next question comes from Danielle Fox from J.P. Morgan.

Danielle Fox - *J.P. Morgan - Analyst*

Thanks, good morning. Bruce, can you talk a little bit about the competitive environment? And also, to what extent do you think rational pricing has helped margins, but hurt top line, at the Office Depot Superstores. Thanks.

Bruce Nelson - *ODP - Chairman and CEO*

Well, I think if I tried to define the competitive environment – and by that I assume you mean North America, and further by that, I think you mean North American retail.

Danielle Fox - *J.P. Morgan - Analyst*

Yes.

Bruce Nelson - *ODP - Chairman and CEO*

To define that [indiscernible; technical difficulty], I've got to go by channel. I would say that the environment in North American retail, particularly in the last six months, I think – if I say our competitors for a moment are Office Max and Staples, which are only part of the competitive set – I would say that there are more signs of some promotional activities. They tend to be focused promotional activities, either one-to-one, or offers to get people in the stores. They are not widespread; they are not across the board. And therefore, I think that is activity that's being seen.

Second of all, I do not believe that our pricing has caused pressure on sales growth. I think, when you go through the process, and look at our stores, our SKU's, we're price competitive. We have to remain competitive. We have a low price guarantee. We honor it; we keep it. We have gotten smarter, and I think our competitors have as well, about the elasticity of pricing on certain SKU's. But on key, critical, commodity-type items which drive revenue, we are priced competitive, and I don't think it's caused us to lose revenue as a result of margin improvement.

There are some signs that there is more aggressiveness on promotional pricing. We did some promotional pricing in December to try and drive costs; we all do. But it's highly selective; it's highly focused; it's not across the Board, and it's not a price war, from where we sit today.

Danielle Fox - *J.P. Morgan - Analyst*

And just one real quick follow-up question on the cash. The 5 to 10 percent EPS growth guidance – that assumes that cash stays on the balance sheet; so it assumes no specific use of cash?

Bruce Nelson - *ODP - Chairman and CEO*

Yes, that assumes the cash stays on the balance sheet, that's correct. And I might add – and this might not surprise all of you – that cash is not earning an extraordinarily high rate of interest today. So it's not helping drive RONA at the moment. But yes, that assumes the cash stays on the balance sheet. And that guidance also assumes – because that's GAAP, if you will – that also makes the assumption that we will, in the year, incur in the neighbor of $10m to $20m in costs integrating Viking and Office Depot more fully. And that's in our guidance, and that'll be GAAP. As you all know, GAAP disclosure, GAAP requirements, have changed substantially, and like other things, we intend to fully comply with those regulations.

Operator

Our next question comes from Dan Binder of Buckingham Research.

Daniel Binder - *Buckingham Research Group - Analyst*

Good morning, Bruce. A few questions for you. First, at your recent analyst meeting, it sounded like there were strong opportunities for gross margin improvement. Given that you're planning flat gross margins next year, and you've kind of acknowledged more promotional activities; your own fliers seem to be more promotional in January – is it fair to say that as you try and drive traffic yourself into your stores, that it will be focused on very specific promotions week to week? That's the first question.

The second question is on Viking, given the softness there – and I think we all know that Viking's not been the lowest priced – in this heightened cost-focus environment, is that an issue? Is it losing share on price?

And then the third question is on some of the recent merchandising and consumer SKU's – if you could give us a sense of what your testing, what your thinking is, there?

Bruce Nelson - *ODP - Chairman and CEO*

I'm going to give you some insights into some of your questions and not others. Let me comment. First of all, on promotional activity. I think, while all of you would like to compare inserts, first of all, you've got to have a lot of them to compare, because we all regionally price. Two is, don't be misled by a price on an insert on a front or back page. While it does drive some business, it is not the key driver of business in North American retail stores.

Third is, I'm not going to comment about what our promotional plans are. I'm just not. I mean, I've said all along we're going to grow our business; it makes no sense, in this business, to take an across-the-board price decrease to try and do it. You get highly targeted, highly specific, and I'm simply not going to comment on what our promotional plans are going forward in retail, or frankly, any of our businesses. I'll clearly tell you the impact of what we've done after we've done it. And tell you clearly what it has meant to us in both growth and other kinds of things.

Relative to Viking, I think it is fair to say that the Viking model, which was basically an on-sale, off-sale model for its history, did perform extremely well. And by the way, in spite of having some difficulties grow, this is still an enormously profitable business. I mean, this is a very, very good business. It struggled here in North America to grow. And there is more price pressure on Viking, and as a result, I think some of why we're going to integrate more is to take better advantage of brand rationalization, of which customer gets what brand when.

Some customers do like on and off sale. They respond better to it. Others want everyday low price. By combining the order entry systems, the data warehouses, and the information systems more fully than they provided, we think we can rationalize that, and we can grow both businesses. But the specifics of how we're going to do it, I just won't comment about.

The third question you had, Dan was – I forgot?

Daniel Binder - *Buckingham Research Group - Analyst*

Regarding just some of the consumer pipe SKU's that we've been seeing in the stores lately.

Bruce Nelson - *ODP - Chairman and CEO*

Well, I don't know – it depends on which store you go and where you go. And again, I'm not going to comment – let me try this. Our core customer is a small to medium-sized business. That's the heart of our business. That's where virtually all of our SKU's are focused. We do have some stores in some markets that tend to have a higher non-small and medium-size business mix. We know where they are; we know what they do, and they tend to respond a little bit better to some other kinds of SKU's. Where they are, how many they are, and what we do, I won't talk specifically about -- but to say to you we are not losing focus of who our core customer is; we are not losing focus of getting more share of [orders] [technical difficulty] from that core customer. And it's the kind of items that customer wants to buy from us.

And on the subject of tests, it doesn't make any sense on this kind of a format, on this kind of a call, to communicate in advance what we're testing and where we're testing and how we're testing it, from a competitive perspective. We live in a competitive business. Needless to say, we've got initiatives we believe can drive revenue. We believe that it will be profitable revenue. We believe we're focused; we believe we've got some things to do. When we start to see the impact of those, I will articulate clearly what we did, where we did it, how we did it, and what it generated. In the meantime, I want you to understand, we're going to do it.

Daniel Binder - *Buckingham Research Group - Analyst*

Okay. Thanks.

Operator

Our next question comes from Colin McGranahan from Sanford Bernstein.

Colin McGranahan - *Sanford Bernstein - Analyst*

Good morning, Bruce. Two questions. One, focusing on the North American business – North American retail business for a minute, and looking at the gross margin. Maybe if you could just give me a little better sense sequentially why it was [I think up 40 BPS] [phonetic] on a year-over-year basis; sequentially it was down considerably. How much of that is seasonality; how much of that was a more promotional environment, how much of it was mix shift – and what to expect going forward?

And then the second question is the competitive environment actually in the contract space. You sound fairly confident that you continue to gain share there; can you just comment on what the competitive environment is like, how Corporate Express is acting, and how pricing looks in the contract business today?

Bruce Nelson - *ODP - Chairman and CEO*

Sure. First of all, in the fourth quarter, historically, our margins in retail are always lower. We do some holiday advertising, holiday gifts -- I mean, so historically, over a long period of time – a long period – recent times – we always have somewhat lower margins in retail.

Two is, 40 basis points to me, on an overall basis, is not a meaningful change. You get mix changes, and to try to quantify for all of you what those are, doesn't make sense. We clearly know what they are, and we're not concerned about pricing trends; that all of a sudden we've got enormous pressure on our margins.

So it's really by category, and Colin, as much as I'd like to, I'll just tell you we clearly understand the mix change and where it is, and what it occurs in. But 20, 30 basis points of margin change quarter to quarter, I'm not sure we're that accurate to be able to predict mix enough to know what it is.

And on that basis, when I said in 2003, back to one of Dan Binder's questions -- I mean, I'm basically saying margins could be 10, 20, basis points better. I mean, it's up or down a little bit. It's just basically, I think the real significant opportunity for margin gain for retail is primarily behind us. I think we'll still globally buy better; private label is growing faster. We have more private label in our business than it appears our competitors do, and we'll continue to leverage that.

On the contract side, I would say that from where we sit, from the level we sit at, from the noise you hear in the field -- and recognize that filters up through lots of different filters – Corporate Express is highly aggressive and still remains aggressive. And that's particularly true at larger accounts. I think there's also aggressiveness on the very large segment. I look at some of the requests for quotations in the last couple of months, and take a look at what we are doing to try to earn the business and others – I'd say that's a tough environment. Corporate America is not adding jobs, and to grow this business, you've got to take it from somebody. So that's a little bit in our plan about saying that this segment, we'll have somewhat lower gross margins in 2003, as we compete more direct, if you will, on the larger account segments.

So competitive – I'd describe it as very competitive, particularly at the large account level. It would appear to us that Staples is getting more aggressive on the contract side, and I say 'appear' because I don't know, but from all outward appearance, they're getting more aggressive on price at the larger account level. That's what it appears to be. Now, whether that's true or not, I don't know.

Colin McGranahan - *Sanford Bernstein - Analyst*

Thanks, Bruce.

Operator

Our next question comes from Michael Baker of Deutsche Banc.

Michael Baker - *Deutsche Banc Alex, Brown - Analyst*

Hi, thanks. Just wanted to discuss – I know you're not going to give away too much on the initiatives that you're talking about for North American retail -- but I'll ask two questions. Do you have any kind of time frame that you're thinking about as to when we should expect some of these initiatives to take hold? And these initiatives – are they significantly different than some of the things you outlined in December? Or is it maybe just building on those type things? And then finally, one more question – just following on someone's question earlier on the trends in the core office products in the fourth quarter, and those have been positive throughout the year. You said that they did fine – does that mean a continuation of positive, or probably about flattish, based on some of your other comments? Thanks.

Bruce Nelson - *ODP - Chairman and CEO*

Well, first of all, on the retail initiatives – and as much, Michael, as I'd like to give all of you specifics – and I know the minute I don't, you say "Why aren't we?" -- I'm just not going to comment on the magnitude of the inits, where they're going to be, and what they're going to be. I just want you to understand we have them. And some are more of what we've done; some are quite different than what we've done. And as we give you either mid-quarter updates and/or report our progress on a quarterly basis, I'll let you know how we did.

What really counts is not what we say we're going to do, and to communicate to our competitors precisely what we're going to do – and trust me, we're going to do some things – I want to wait and see, one, did they generate profitable revenue? And two, if and when they do – which I believe they will – I'll tell you exactly how they did. There are some of them that are very immediate and very short-term, in terms of actions we're taking. I want to wait and see what it means to us, and I'll let you know.

On just buying side, on the supplies -- if you again, go back, Michael, and say look, virtually all of the negative comps in retail in the fourth quarter were in technology and furniture – then, by definition, the rest of the categories were flattish. Some were up and some were not. I don't want to go more specific than that. Core office supplies did fine. Did it grow as much as I'd like? No. But it did fine. So that's as specific as I'm going to get, in terms of categories.

Frankly, one of the things – we break out far more by category, by segment, than any of our other two superstore competitors. I just don't want to go any deeper than that. So I apologize, but that's as deep as I'd like to go.

Michael Baker - *Deutsche Banc Alex, Brown - Analyst*

Okay, thank you. Fair enough.

Operator

Our next question comes from Peter [McMullin of Vineback] [phonetic].

Peter McMullin - *Ryan Beck & Company - Analyst*

Good morning, Bruce. Three quick ones. First of all, the currency assumptions you made in your planning, if you could comment on that. Two, you've had great success with private labels. Where does that stand? Is there more room to grow that business as we go forward? And you sort of talked around it; I just wondered what the breakdown in the percentages of categories in the fourth quarter -- you know, tech furniture, etc., and if you anticipate any major changes going forward. Thank you.

Bruce Nelson - *ODP - Chairman and CEO*

Okay, on currency – just to clarify the quarter for a minute, on an income basis. We did get the benefit of about a penny a share in the fourth quarter on currency translation as a result of the dollar and the euro. We're basically, for the moment, assuming currency stays at about the same level it is. So our forecast, our outlook, if you will, assumes that the euro stays in the $1.07, $1.08 range, and the pound in the range it's in today. That's kind of our big, broad assumption about going forward. And we baked those into our plans, if you will, and so we can compare ourselves internally against last year. And those are much weaker dollars, if you will, than they were a year ago.

On private label, a couple things. One is, we believe we have the highest percentage of our sales in private label; it's more than 9. And it's growing. And there's tremendous room here. We've just hired an individual, highly experienced, and in global purchasing we think there's huge opportunity to expand our offerings in private label. We'll do it gradually; we'll do it smart; we'll do it in cooperation and conjunction with some of our key suppliers. And it's one of the reasons why we think, even if there's some pressure on selling prices, that we can mitigate some of that as a result of our size. We're the largest seller of office products in the world. And we intend to leverage that size, as we buy both in this country and outside this country.

Relative to the categories, going forward, part of our cautious outlook in the first half of this year in North American retail continues to be as a result of continuing significant weakness in technology and continued weakness in furniture. That continues, and in fact, in some categories of those two – subcategories – the weakness so far in the first six weeks is exasperated. And again, I'm not going to go into the specific categories, except to say our own outlook is that we'll continue to face tough sales environment in technology. By a lesser degree, furniture, but nevertheless, that's our outlook for certainly the first half of the year, and it kind of weighs on our view of the first half of the year in North America retail.

Peter McMullin - *Ryan Beck & Company - Analyst*

Thank you. Is there some goal, long-term, on the private label?

Bruce Nelson - *ODP - Chairman and CEO*

The answer is, we have a very specific goal internally. But the goal we'll talk about externally is, it'll be a bigger percent of our sales on a go-forth basis, gradually increasing. I don't think it's appropriate to talk about the goal from a variety of aspects. We do have one; we measure it; we understand how to get it. We're focused on doing it; it'll take us a while to reach our goal; this is not a one-year goal; it's directionally where we want to go.

Peter McMullin - *Ryan Beck & Company - Analyst*

Thank you.

Operator

Our final question comes from Bill [Patzner] [phonetic] of Merrill Lynch Investments.

Bill Patzner - *Merrill Lynch Investments - Analyst*

Hi, guys. I wanted to ask a little bit more about – and I think maybe you've given us some clues – about the currency. Currency alone should add a fair amount of income this year, if it stays where it is, given the timing of the currency. Isn't that true?

Bruce Nelson - *ODP - Chairman and CEO*

The answer to that is we got a penny in the fourth quarter, to be specific, on the currency. So currency is going to give us a boost, but I also want to bring you back. We're heavily investing in our European businesses. I told you on an EBIT basis, we invested more than $50m of EBIT in 2002 in our growth initiatives, predominately in Europe. We just launched Spain. We've got the impact of new countries that came later in the year. We've got a ramp-up of our contract business. And so those things are offsetting some of the currency gains.

I think when you then step back and you mix all that together and say, this company's is investing a disproportionate share of its cap ex -- in Europe predominately -- growing countries, channels and brands. And having said that, we still are going to report, we believe, offering profit increases.

I mean, I think it's inevitable performance. I'll also tell you that the dollar started to get weaker in our third quarter, so we really got a first half that's quite different, a third quarter that's a little different, and the fourth quarters would be about the same.

So I haven't quantified exactly, precisely, at these currency rates, what the impact is, but it's probably 2, 3, cents for the year – maybe 4 at the most. If you call it 2 to 4, and remember, a penny at Office Depot is about $5m -- to get more precise than that is extraordinarily difficult to do. I think you've got to put it in that light.

Bill Patzner - *Merrill Lynch Investments - Analyst*

Okay. And so, then what you're saying is the increasing investment in other things in Europe sucks some of that 2 to 3 cents back out, because you're going to need to put money into it.

Bruce Nelson - *ODP - Chairman and CEO*

Yes, sure. Because this business is growing at double digit; it's got enormously high RONA; it generates free cash flow; it's got opportunities to grow. I mean, you talk about what separates Office Depot from our two primary North American competitors – it's our international presence; it's our international profitability; it's our multi-brand multi-channel. And the thing that's focused predominately non-retail -- although we just talked about Spain – and we intend to leverage that. I mean, as you know, interestingly enough, while we focus enormous amounts of effort on North American retail, it is less than 35 percent of our operating income.

The story about our company clearly is focused on retail – I told you it's our highest priority; we're going to do everything we can to drive it. But we've also changed the complexion of this company over the last two or three years, where we focused on awful lot on delivering ecommerce, and we'll continue to do that. And that's what will drive this company's long-term future. We will find ways to grow comps in North America.

Bill Patzner - *Merrill Lynch Investments - Analyst*

Right. Can I ask one little detail? Continuing lease termination costs. Are there any projected in 2003?

Bruce Nelson - *ODP - Chairman and CEO*

Well, I don't know. I mean, that's the subject of real estate. Ideally, if I'd had a crystal ball, when we closed 70 stores, we would have had a reserve that was $50m bigger, and I'd be reporting to you that we're leasing stores at a faster rate than what we thought. So the answer is, I don't know. I mean, that's a process where you go through the remaining portfolio store by store, and you say, "What are my assumptions about that store and my ability to sublease it?" It's a more difficult environment because of all the store closings, not the least of which are K-Mart.

We have put a high priority on getting rid of these properties. I have no idea today whether or not we'll have to take any additional reserve in this area or not. I don't know. We look at that on a quarterly basis; we true it up, if you will, and we come back and say, "This is our best guess." And those are our best guesses. I don't know how to answer it any differently than that.

Bill Patzner - *Merrill Lynch Investments - Analyst*

That's fine, thank you.

Bruce Nelson - *ODP - Chairman and CEO*

Thanks very much for your attention, for your questions, for your support of Office Depot. I'd summarize and say, I know, and I can hear, and I understand, all of the concern about North American retail. This company is committed to grow it. But this company also had an enormously successful 2002, and it shouldn't by overshadowed by some challenges in retail. I also might point out, by the way, in terms of leverage, and you all know this, but basically, a 1 percent change in North America retail comps in the quarter it occurs is almost a penny a share.

And therefore, if you look at the fourth quarter, and say that on a non-GAAP basis we made 23 cents, in spite of the fact that our North American retail comps were, on average, 2 full points below what most of you thought, we not only made that up, we exceeded it – it should give you some insight to the enormous earning capacity this company has, when we grow North American retail, and when the economic environment begins to improve – and sooner or later it will.

This is a company that knows how to leverage its cost structure, focus on the right kinds of things -- focus on a balance sheet. The leadership of this company has never been stronger and never been better. It's the first full year since I've been CEO that I'm going into a year with a fully cooked, fully baked leadership team. All the positions are filled. I think that continues to drive results. I told you about our culture; I think it's a competitive advantage. We're in a tough environment.

Thanks for your support; thanks for your insights. Appreciate your questions, and appreciate the fact that you spent an hour with us this morning. To all of you, have a great day. Good day.

Operator

That concludes today's conference call. You may disconnect at this time.
