THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

ODP.OQ - Q1 2006 Office Depot Inc. Earnings Conference Call

EVENT DATE/TIME: APRIL 26, 2006 / 1:00PM GMT

OVERVIEW:

The Co. reported net earnings for 1Q06 on a GAAP basis of $130m vs. earnings of $115m in 1Q05. GAAP EPS on a diluted basis was $0.43 for 1Q06.

CORPORATE PARTICIPANTS

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

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

Pat McKay *Office Depot, Inc. - CFO*

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

CONFERENCE CALL PARTICIPANTS

Colin McGranahan *Sanford C. Bernstein - Analyst*

Dan Binder *Buckingham Research - Analyst*

Matthew Fassler *Goldman Sachs - Analyst*

Bill Sims *Citigroup - Analyst*

Mike Baker *Deutsche Bank - Analyst*

Gary Balter *Credit Suisse First Boston - Analyst*

Jack Murphy *William Blair - Analyst*

Brad Thomas *Lehman Brothers - Analyst*

Danielle Fox *Merrill Lynch - Analyst*

PRESENTATION

Operator

Good afternoon and welcome to the first-quarter 2006 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 of IR*

Thank you and good morning everyone. Before beginning today's conference call I'd 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 15, 2006 and in our Form 10-Q filed with the SEC this morning.

During portions of this call Office Depot executives will refer to results of our first-quarter 2006 which are not GAAP numbers. A reconciliation of non GAAP numbers to GAAP results is available on our website at www.officedepot.com.

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

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

Thank you and good morning to everyone. Thanks for joining us for our fiscal 2006 first-quarter conference call. With me today are Pat McKay, our Chief Financial Officer; Chuck Rubin, our President of North American Retail; and Ray Tharpe, our Director of Investor Relations. I hope you've had an opportunity to read our press release and learn about the first-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 "company information" and then "investor relations" and the slides are there you can follow along.

The first-quarter sales grew 3% this quarter to $3.8 billion when compared to the first quarter of 2005. Excluding the effects of foreign exchange, total Company sales were 5% higher than the first quarter of last year. Sales in North America were up 6% and North American retail comparable store sales increased 3% for the quarter. Net earnings for the quarter on a GAAP basis were $130 million compared to earnings of $115 million in the same period of 2005. GAAP earnings per share on a diluted basis were $0.43 for the quarter, up from $0.37 in the first quarter of 2005.

And our first quarter of 2006 included a portion of the charges that we previously shared publicly and disclosed in our 2005 Form 10-K. Those charges had a $0.05 per share, per diluted share negative impact on results for the first quarter. So without those charges, our first-quarter 2006 net earnings were $144 million or $0.48 per share which is up 30% from earnings per share for the first quarter of the prior year.

EBIT also adjusted for the first-quarter charges was $218 million in 2006 compared to $170 million in the prior year period. And net earnings for the quarter adjusted again for the charges were $144 million, up 25% from the first quarter of 2005. Return on invested capital was 13.3% for the quarter versus 10.3% in the same period of the prior year. Sales on a trailing four quarter basis were up 5% compared to that of the prior year. EBIT increased 15% and EBIT margins expanded by 40 basis points to 4.9% as we drove improved results on higher sales.

Our overall share count declined on a trailing four quarter basis as compared to the prior year due to the impact of on our shares of the outstanding -- on shares outstanding of our share repurchase programs. Earnings per share for the trailing four quarters has improved to $1.52 per share which is a 30% increase and we're pleased with the significant expansion in our ROIC of 240 basis points to 13.3%.

As part of our previously announced charges we recorded $19 million in charges during the first quarter of 2006. Those charges primarily occurred as a result of actions planned and taken in our International Division in the quarter and are part of the $52 million in charges anticipated for the full year. We have provided a reconciliation of GAAP to non-GAAP results that you can access on our website again, www.officedepot.com under the company information and investor relations tabs.

Now I'll turn the call over to Pat McKay who will take you through the details of our performance for the quarter. Pat?

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

Thanks, Steve. First-quarter sales in the North American Retail Division were $1.8 billion, a 5% increase compared to the same period last year. Comparable store sales in the 966 stores in the U.S. and Canada that have been open for more than one year increased 3% for the first quarter. This represents our ninth consecutive quarter of positive comparable sales led by the strength from the technology and furniture product categories. Comparable average ticket size continued to increase and average sales per square foot was $273.

During the first quarter, North American Retail had division operating profit of $134 million, a 25% increase over the same period last year. As a percentage of sales operating profit for the quarter was 7.5%, up 120 basis points from the same period last year. First-quarter charges negatively impacted those operating results by $1 million. Higher operating profit in 2006 was achieved as a result of broad-based improvements in product margin from category management initiatives and higher private brand sales coupled with reduced operating costs coming from our cost management initiatives. These improvements more than offset incremental expense that was associated with store remodel activities now underway.

During the first quarter, the Company opened four stores and closed two. At the end of the first quarter, Office Depot operated a total of 1049 office product stores throughout the U.S. and Canada. We plan to open about 100 stores this year. Those of you who have followed us know that we have worked through several versions of our new store prototype. After extensive customer feedback and strong results from our test stores, we have refined our M2 format and have begun the process of remodeling our current stores to that format.

From a merchandising perspective, the M2 format offers shoppers better product adjacencies and a layout that is much easier to navigate. From an operations view, the increased modularity of design provides a high level of consistency across all M2 stores and the store is more cost-efficient to operate. We also changed the pure look of our stores with new graphics and color palettes that we believe translates into a more pleasant shopping experience for our customers. We estimate that the cost of these remodels will be about $225,000 to $250,000 for each remodel. Previously we announced that we plan to remodel about 60 stores in 2006 but we may accelerate our plans and remodel about 150 stores this year with a goal of remodeling nearly 800 stores in the next three to five years.

Our store base is the oldest in the industry with an average age of approximately eight years. Those remodeling activities will affect the performance of the North American Retail Division from both the acceleration of depreciation of the remaining assets in those stores as well as from the costs associated with the specific remodel efforts some of which are not capitalizable.

In the first quarter, our advantage loyalty program continued to grow both in terms of total memberships and in terms of sales improvements we are seeing from these loyal customers. Our loyalty program provides an excellent means for us to expand our relationship with our small-business customers and also offers us valuable insight into their product and service needs.

In connection with our NASCAR sponsorship, we're conducting a national in-store and online sweepstakes. Small-business owners register at Office Depot stores and online at officedepotracing.com for a chance to have their company's name and logo featured on the Office Depot number 99 Ford Fusion as well as the right to become the 2006 official small business of NASCAR.

Office Depot hosted our sixth annual success strategies for businesswomen conference in March. This year's conference had the largest attendance in the history of the event and was comprised of 48% women business owners and 30% corporate businesswomen. Over the years this event has been a very effective vehicle for Office Depot to increase its visibility to a large and growing population of business owners and decision-makers across the country.

Finally, marketing effectiveness remains a priority for Office Depot. We continue to review the ROI of all of our advertising and marketing vehicles to ensure that we concentrate on the highest yielding activities. We remain committed to profitably expanding our presence in existing markets as well as targeting new markets where we see opportunities for growth. We believe that the deployment in capital for new stores and the remodeling of our existing stores coupled with other growth initiatives will enable North American Retail Division to continue to deliver profitable sales growth into the future.

In the last few quarters we've made a practice of reviewing previously mentioned cost savings initiatives and providing you with a few examples of new ones. For those of you currently viewing the slides, you can see that the list of initiatives mentioned in the previous quarters was getting pretty long. New examples of cost savings initiatives include improving the distribution process for imported products; reducing alarm monitoring costs; and reducing expenses associated with new employee background screening.

I'd like to highlight that the average for each of these cost savings initiatives shown on the slide is over seven figures. Our continued focus on identifying and executing on opportunities like these will enable us to achieve our cost management goals and position us for profitable growth. We are pleased with our North American Retail results this quarter. We've made real progress but we still have much opportunity in the future.

North American Business Solutions division sales increased by 8% to $1.1 billion in the first quarter compared to the same period last year. Our contract business experienced growth in all three product categories and our direct business successfully completed the catalog migration process from Viking to Office Depot. Division customer transaction counts and average order values both increased compared to the first quarter of 2005. Division operating profit increased 24% to $92 million for the quarter as compared to the prior year and as a percentage of sales was 8.2% during the first quarter, up 110 basis points from the same period last year. First-quarter charges in 2006 negatively impacted operating profit by $1 million.

Overall gross margin for the division declined slightly as compared to the prior year due to cost pressures in certain categories. Expense leverage was achieved from call center optimization efforts and advertising efficiencies including those that were realized from the consolidation of our catalog operations. We also improved our operating expense ratio in our supply chain for the 21st straight quarter.

The North American Business Solutions team remains focused on profitably growing its business. We've already grown our sales force in significant numbers this year and we plan to continue to increase our sales force through the balance of this year to drive our growth objective. The Business

Solutions division is also expanding its use of telephone account managers. This is an efficient and effective way to acquired new business customers through outbound calls as well as to enhance relationships with existing customers.

The International division's first-quarter sales increased 2% in local currencies but decreased 6% in U.S. dollars to $895 million compared to the same period in 2005. In the quarter, direct and contract sales were up and retail comparable store sales in Europe grew by 4%. The change in exchange rates from the corresponding prior year period decreased sales reported in U.S. dollars by approximately $80 million for the quarter. Division operating profit decreased 9% to $53 million for the quarter compared to the prior year and a percentage of sales was 5.9% during the quarter compared to 6% in the same period last year.

First-quarter charges in 2006 negatively impacted those results, however, by $16 million or 180 basis points expressed as a percentage of sales. Gross margin increased slightly despite continuing pressure and pricing and cost pressures in key product categories and broad-based expense savings also contributed to performance in the quarter.

We are encouraged that the International Division sales in local currencies improved relative to sales in the first quarter of 2005. We believe that much of this result is due to the selling culture that is taking hold within Europe. Our new Executive Vice President and Managing Director Europe starts this week and we're hopeful that he will continue the momentum begun in the past quarter in Europe. The International Division grew its sales force in the quarter and increased the use of telephone account managers for customer acquisition activity. These productive activities will continue throughout the rest of the year.

We have three strong private brands in Europe, Office Depot, NiceDay, and Viking. Historically promotion of those products has not been a priority but we plan to drive additional sales of private brand by an expansion of that assortment and an increased emphasis in marketing of those products. We see opportunities for profitable growth of our International Division and other areas around the globe as well.

After the end of the quarter, we completed the acquisition of a controlling interest in a $44 million South Korean office supply business, Best Office. Earlier this month we also announced that we increased our ownership interest to a majority stake in Office Depot Israel which generates revenues in excess of $100 million. We will fully consolidate the results of these businesses in the second quarter of 2006. These are just two examples of the opportunities for us that we see in the markets around the world.

We're also very much encouraged that some of our cost management initiatives in the International Division are starting to take hold. Some of our efforts in Europe currently are focused on consolidating our merchandising and marketing activities in our European headquarters. We believe this will benefit both the effectiveness and the efficiency of those functions. For example, as a result of this pan-European focus we consolidate our print contracts in Europe. This provides a significant reduction in the cost of the printing of our catalog and simplifies the production effort as well.

We've also begun the consolidation of our call center operations in Europe with the recent closures of seven of 12 call centers in France. We've also outsourced our call center in Japan and we are continuing to execute against other cost management initiatives that will help us lower the International Division's cost structure. We remain optimistic on the long-term potential of our international business but cautious regarding consistency of the execution we might achieve in extrapolation of additional improvements in those division operating results based on recent performance.

As we've previously discussed, we've been analyzing the further allocation of our general and administrative costs to our division results for purposes of segment disclosure. Beginning with this quarter, we now include in our division operating profit those G&A costs that have been identified as directly or closely attributable to those units. After allocating these costs to the divisions a certain amount of corporate G&A remains unallocated. These costs simply cannot be directly attributable to the activities of any one division so we held out as separately as corporate G&A. These costs amount to 2.3% of sales. We believe this is the most appropriate way to measure each division's performance.

We've provided the division operating profit for the first quarter of 2006 and 2005 which reflects this allocation of G&A as well as certain other minor reclassifications. The schedules attached to the press release, our Form 10-Q, and website all provide information which presents each of the quarters of 2005 recast for this new allocation methodology.

In the first quarter of 2006, cash flow before share repurchases was $211 million versus a -$141 million in the first quarter of 2005. The year-over-year increase is attributable to an improvement in inventory levels, the use of cash for payables and in part due to timing of payments. Cash provided by operating activities was $268 million in the quarter.

Depreciation and amortization totaled $75 million for the quarter relatively consistent with the same period of 2005. EBITDA was $274 million for the quarter. However adjusted for first-quarter charges, EBITDA was $293 million up 22% when compared to adjusted EBITDA in the same period of 2005.

CapEx for the quarter amounted to $57 million. We will continue to identify and execute on investment opportunities that drive returns above our cost of capital. We currently are estimating capital expenditures for the year between 325 and $400 million.

In the quarter, we repurchased approximately 12 million of our shares of our common stock for $398 million under the repurchase programs previously approved by the Board of Directors. The effective tax rate for our based operations was 33.1% for the first quarter and after considering the first quarter charges, the overall effective tax rate reported was 33.4%. Our effective tax rate in future periods can be affected by the variability in the mix of income, the tax rates in various jurisdictions and our assessment of the needs of accruals for various matters, and therefore may be higher or lower than it has been in the past. Going forward we plan to see an effective tax rate of 33%. The effective tax rate is higher in 2006 versus the prior year due to a change in the mix of income coupled with the favorable effect of certain discrete items on the tax rate in the year 2005.

We ended the first quarter with $550 million in cash and short-term investments. Our investment in merchandise inventory totaled $1.3 billion. Our first-quarter inventory balance includes the year-over-year impact of expanding the assortment in key categories in North American Retail and improving the in stock positions across all channels. For the first quarter, inventory per store was approximately 935,000, 9% lower than a year ago. We don't expect future quarters to show this level of reduction from the prior year.

Working capital decreased by 43% as compared to the first quarter of the prior year. We ended the first quarter with an accounts payable to inventory ratio of 100% and we continue to work on initiatives to improve the payables to inventory relationship and are driving improvement in overall working capital levels.

Our long-term debt at the end of the first quarter was $572 million. And at the end of the first quarter, our debt to cap ratio was 18%. Our outstanding 2013 senior notes are rated investment grade by both Moody's and Standard & Poor's and our balance sheet remains very strong. Our return on equity adjusted for charges for the trailing four quarters improved by 410 basis points to 16.1% as compared to 12% for the comparative period of fiscal 2005. Return on invested capital adjusted for charges increased to 13.3% from 10.9% in the prior year.

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

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

Thanks, Pat. First, as a reminder we have a three key strategic growth priorities. First is North American Retail. We want to continue to improve our store productivity and implement our store expansion and remodel plans. Second, North American Business Solutions, we have a plan to profitably grow our market share through new customer acquisition and new product and service offerings. And third, is International. We need to reignite the profitable growth in Europe and over time increase our geographic reach.

We don't discuss earnings guidance. But we remain committed to making decisions and taking actions consistent with the long-term interest of our shareholders. We have a business that generates substantial cash flow year in and year out and we can use our cash flow to profitably grow our business by opening new stores in new geographic markets; by making necessary investments in the core business like our store remodels; by acquiring assets or businesses in our key priority areas; and repurchasing stock as long as we believe it's accretive.

Our Company is making a lot of progress. We achieved both profitable sales growth in each of our divisions as well as expansion of the divisions' operating margin excluding the charges. As a result, our EBIT margin for the total Company expanded and ROIC increased 240 basis points to 13.3%. We are mindful, however, of the significant work that still needs to be accomplished to drive continuous improvement in our results. In the first quarter of this year we measured our performance against quarter one of 2005. That quarter had flat earnings per share growth and a 1% North American Retail comp.

In the second quarter of this year, I just want to remind everyone that we will be comparing our results to a quarter last year that had 26% quarter-over-quarter earnings per share and a 3% North American Retail comp.

Going forward we need to continue to drive topline growth as well as achieve results from various cost management activities. We have several growth initiatives in place and we plan to execute against these and other initiatives in coming quarters to drive profitable growth and create shareholder value.

Now I'd like to open up the call for questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS) Colin McGranahan of Bernstein.

Colin McGranahan - *Sanford C. Bernstein - Analyst*

Good morning. A couple of questions. First, if you can talk about the gross margin improvement in the quarter, it clearly looks like category management and private label contributed. I'd assume that some of that was from the new tools that you have available to you with Retek. Can you talk a little bit more specifically about where private label is, what kind of benefits you saw? And then a little bit more broadly about the merchandising improvements that drove the gross margin?

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

Colin, good morning it's Chuck. You touched on a couple of the core components, category management, our progress and there continues. We're pleased with those results. As you know we've completed our Retek implementation and we're seeing the usefulness of those tools in the revised processes around those tools. So that has helped us quite a bit.

You touched on private brand. We are pleased with where that is. I think we have said before we have significant potential in private brand across almost all of our categories and we look at it as an asset for us across different price levels. So the category management approach to where we have essentially a good, better, best really has started to take hold in private brand and believe that it has future potential as well.

Colin McGranahan - *Sanford C. Bernstein - Analyst*

Okay. But will you share with us where the penetration is our where you think it could be?

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

No, I think we wouldn't do that. We're very pleased with where it is and believe that as we've said before that there is further potential that we've just started to tap into.

Colin McGranahan - *Sanford C. Bernstein - Analyst*

Okay. Second question on the remodels. Obviously going from I think that you said at least 60 before to maybe 150 would suggest that the early results of what you are seeing are very positive. Can you comment on initial learnings so far and any comment or color on the results you've seen in the early remodels?

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

Colin, it's Chuck again. We won't provide any details on that but as you know we have about 200 M2's out there. And as any good retailer, we've continued to learn from quantitative analysis of the performance of the store format as well as customer reaction. We've done a lot of customer feedback surveys. And we've tweaked a couple of things just making some product adjacency changes and some minor layout changes as well as a visual change -- there's a different color palette that is more consistent with our brand color palette as we go forward. Those results have proven to be very encouraging and that is what has led us to pick up the pace at which we will remodel these stores.

Colin McGranahan - *Sanford C. Bernstein - Analyst*

And the comp lift that you are seeing, is that primarily from larger average transaction due to better adjacencies?

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

It's a variety of things. The market basket has improved, the adjacencies that you just touched on, we are very pleased with. We're actually seeing good growth in all of our primary product divisions in these M2's.

Colin McGranahan - *Sanford C. Bernstein - Analyst*

Okay, thank you.

Operator

Dan Binder of Buckingham Research.

Dan Binder - *Buckingham Research - Analyst*

I have a few questions for you. First on the -- I think on BSG you had mentioned that there was some --?

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

Hey, Dan, we can't hear you. Can you speak up a little bit?

Dan Binder - *Buckingham Research - Analyst*

Yes, sure. I guess I just wanted to address the gross margin in BSG. You had mentioned some cost pressures there. I was wondering is that a reflection of a tougher pricing environment?

And then my second question was related to also your gross margin initiatives. It seems like at retail there's probably some opportunities on things like copy center and attachment rates. I was wondering if you could give us a little color on that? And then lastly if you could just give us more of the housekeeping a bit of traffic trends at retail?

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

Okay, in the BSD gross margin we had a very slight decline. It was due to some cost pressures on paper. Remember BSD is largely contract and so we've got fixed rates out there on prices and as markets move sometimes we're not able to move quite as fast on that. So we got just slightly behind. But good mix move also in BSD on private label following on what Chuck was talking about in retail. So we are pleased with the progress there and we are not concerned about the growth in BSD going forward.

From a traffic standpoint, we are seeing good pick up now. This first quarter is what we call back to business which is following the holiday season and people are coming back. And it is typically a very strong quarter for us. We were pleased with the traffic results. The M2's of course helped in picking up -- you know when we remodel, it helps in picking up the traffic trends as well.

Dan Binder - *Buckingham Research - Analyst*

Okay. And then on the gross margin initiatives, is there anything we can take away from efforts of the copy center business? I guess just been hearing a little bit more focus on that recently. Any specific plans in terms of how you plan to grow that business and get the gross margin out of that?

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

Okay, if I understand your question, it is the impact of the copy centers on gross margin and our plans to grow that. Our copy center business is very solid; it is a growth opportunity for us. I think that you will see us evolve from an historical view of that business which is sort of a walk-up copy business to more of a service that we provide both at retail but also for our direct business whereby we are able to be a little more flexible in our printing and so forth. That does contribute to our gross margin. But I think the primary contributors to our gross margin will be the kinds of things that Chuck talked about which are our category management efforts in blending the good, better, best ranges; private label; and certainly the cost reduction efforts that we have going on.

Dan Binder - *Buckingham Research - Analyst*

Okay. Can you give us a sense, you mentioned earlier in the call the stepped up remodel activity would have an impact from an accelerated depreciation standpoint and then obviously some of the remodel cost. Can you give us a sense of -- of that to 225 to 250, how much is expense versus capitalized and then how we should be thinking about the impact from accelerated depreciation? In terms of basis points?

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

Yes. First of all we are pleased with where the M2's are performing so therefore we put a stake in a ground and said we got it and we are going forward as Chuck said. We had accelerated the number of remodels and we hope to go through the balance of the chain in the next three or four years. So as a result, we need to accelerate depreciation of the improvements in those stores during that period of time.

In terms on the remodel costs themselves about -- they are about 225 to $250,000 a store and 70 to 80 of that is expensed with the balance being capitalized.

Dan Binder - *Buckingham Research - Analyst*

Okay, great. Thanks.

Operator

Matthew Fassler of Goldman Sachs.

Matthew Fassler - *Goldman Sachs - Analyst*

Thanks a lot and congratulations on the good quarter.

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

Thanks, Matt.

Matthew Fassler - *Goldman Sachs - Analyst*

I'd like to start with BSG. You saw real nice acceleration in your top-line there. You said, Steve, that directionally the contract is the bigger piece of that business. But if you could talk about sort of the sources of the pick up both in terms of underlying demand and perhaps the impact of the follow through on the Viking integration, that would be helpful?

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

Yes. The contract business is growing very nicely. You may recall that we added sales people in the latter part of fiscal 2005. We also are expanding our sales force in 2006. We find the expansion very profitable and are continuing to do that. So we are very happy with the progress that we have made there. We also simplified this business with the merger of the two catalog operations. The Viking and Office Depot catalogs were separate in customer facing dimensions only. All the back office activities had been consolidated a long time ago. So it was simply driving expense. We were having to advertise and prospect with two customer bases. We were having to keep multiple steps of private label, private brand inventory and separate distribution facilities in a couple of cases.

So we just finished all that. We now have focus on the Office Depot catalog and the Office Depot brand. We're prospecting for one and the direct business now has rebounded as a result of that. So the predictions of what could happen through a transition have not come to fruition. In fact, things are very positive there. So we are very pleased overall with the performance in BSG.

Matthew Fassler - *Goldman Sachs - Analyst*

Second question, on the working capital front, your inventory management was particularly impressive. Can you talk about where you were able to scale back, kind of where in the supply chain in terms of business and kind of how far forward that inventory was that you were able to reduce?

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

Well, it is in comparison to last year. You may recall a year ago we were having some service issues. And in order to address the service issues we ratcheted up the inventory and that is what hit our cash flow last year. So what we focused on is more fine-tuned application of the inventory and we used our new merchandising systems to help us do that. As a result we've actually been able to increase our service trends at the same time as we've taken the inventory back out of the system resulting in the cash flow pick up in the quarter. So we are very, very pleased with the supply chain efforts.

Matthew Fassler - *Goldman Sachs - Analyst*

And was there any particular piece of the business, Europe, Retail, BSG that had the inventory overages a year ago?

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

No, well, actually it was deployed across all of our businesses pretty evenly. Our systems now have allowed us to affect our inventory application and we share that globally.

Matthew Fassler - *Goldman Sachs - Analyst*

And finally, just a follow-up on the first answer that you gave in terms of the sales force growth. Can you quantify in any way the kind of sales force expansion that you've seen in BSG?

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

I would prefer not to for competitive reasons. But we have been able to -- we've tested lots of different versions of that but we are very pleased with the ability to add salespeople. We've not found an upper limit on that. And as we add them they become productive fairly rapidly in payout in about a year. So we are pleased with our ability to continue to do that.

Remember we have a very small marketshare in total. I think that we tend to focus on just a few of the competitors. But in fact even the largest competitors combined only have about a 10% market share. So we had 2%, 2.5% to 3% market share. So any time we pick up our marketing and our sales activities in addition to taking advantage of the natural 3% to 4% growth in the industry, we also are showing ability to take marketshare. And we think that that marketshare is coming from the vast 90% of the fragmented ways that people buy office products out there.

Matthew Fassler - *Goldman Sachs - Analyst*

Understood. Thank you very much.

Operator

Bill Sims of Citigroup.

Bill Sims - *Citigroup - Analyst*

Thank you. Good morning. With the exception of paper, can you comment on the price intensity of the competitive landscape in the BSD division?

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

Well, the paper issue was mostly a cost increase due to the reduction in supply in paper. Paper has been a difficult industry over time and they've been bringing mills down and so you have seen the manufacturers try to bring supply and demand into balance. That is really what is going on there. Pricing overall in the industry to our customers has been relatively stable. We are seeing a we think a rational pricing environment and that has been good for our business.

Bill Sims - *Citigroup - Analyst*

Are you seeing a decreased use of retention payouts by some of your competitors in the industry?

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

Well, I think, remember this is -- by saying what I did, I don't mean to indicate that this isn't highly competitive, it is. We are out there scrapping every single day with all sorts of varieties of sales and marketing techniques to gain customers as are our competition. But I think that in doing so we are interested in profitable growth and that seems to be the general trend in the industry.

Bill Sims - *Citigroup - Analyst*

Okay, thank you. And then Steve can you just comment on the European microeconomic environment, any change there one way or another?

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

Unfortunately we have not seen a huge change. Just when we get optimistic about one country, another country changes. We've had difficulties with in the quarter in France where we have a significant business given some of the demonstrations and riots over there. Whenever that happens, businesses shut down and they are less productive and they are buying fewer supplies. The unemployment rates continue to remain high.

But I'm pleased that with our international results, our people have worked very hard to turn that business and one quarter does not a trend make, I understand that. But we are up 2% in local currencies. That is the best performance we've had in eight or nine quarters. And it didn't happen by accident. We are putting a lot of focus on consolidating the businesses over there. So when you see, whenever you try to merge the acquisitions and take costs out and so forth there is always a risk at the top line.

So when you see us able to both merge the businesses and combine operations at the same time put a positive sales number on the board, it is very, very encouraging. So I am very pleased with the performance of our European colleagues.

Bill Sims - *Citigroup - Analyst*

Well, thank you, and good luck.

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

Thank you, Bill.

Operator

Mike Baker of Deutsche Bank.

Mike Baker - *Deutsche Bank - Analyst*

Thanks. So a lot of the questions have been answered. I'm not sure if you will answer this, but just thinking about -- I think when you do the adjustments, it looks like your EBIT margin was up about 100 basis points this quarter. Looking ahead, was there anything specific to this quarter that really helped you and might not repeat? I guess looking ahead, we can think of maybe you do have a more difficult comparison, you might have some more COGS with your models. Paper pricing I think is going to rise again. But is there anything else in there that would preclude this kind of performance in subsequent quarters?

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

On the EBIT margin, I don't see any significant onetime positives in there that would have resulted in that 110 basis points.

Mike Baker - *Deutsche Bank - Analyst*

Okay, that is great. And quickly just on store openings, so you are looking at about 100 here. You did fewer than that, obviously, in the first quarter. Can you help us allocate out how those might break out for the rest of the year?

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

Yes. We only opened four in the quarter. We're a little bit behind where we want to be, and so we're concerned about that. I want to make sure, though, that we don't chase the number and sacrifice quality. So the 100, we say about 100 because I don't want to lay that number out there and then try so hard to make it that we end up with problems later. So if we end up with 90 so be it. There are all going to be our best efforts going forward. You're going to see the numbers skew towards the back half of the year. That has been our pattern for a very long period of time. You know given a 24 to 36 month development pipeline it just takes time to change that. We will work on that as we go forward.

Mike Baker - *Deutsche Bank - Analyst*

Thanks. So are the delays associated with trouble getting real estate or is it construction or just sort of the normal --?

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

No, it is just sort of the natural ebb and flow of this business. You'd like to get these developers all to close properly; you'd like to be able to get all the contractors marching. But I think anyone who has done any work even on your home, it is hard to get people to get working and get people to show up and so forth.

So it has been a challenge on the construction side. It has been a challenge on the development side. I don't think that the hurricanes helped the situation from last fall. It sucked up a lot of resources around the country. But we are hopeful that things will loosen up here toward the middle of the year and that we will see more coming in the back half.

Mike Baker - *Deutsche Bank - Analyst*

Great, thanks for the insight.

Operator

Gary Balter of Credit Suisse.

Gary Balter - *Credit Suisse First Boston - Analyst*

Thank you. Two questions. Steve, you had a chance now to allocate all the costs so and I know you knew the numbers beforehand. But as you look at the new margins, does that change some of your thinking or were there any surprises as you saw where everything went? For example, you talked in the past about getting to the same margins as the leader in the retail side. When you look at your margins now is that still something that you see as a very doable goal?

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

Yes, that's a good question, Gary. Obviously we knew what the numbers were all along. The issue is always trying to make sure that we are fairly allocating these costs. We have the benefit of a very integrated and closely associated business. In other words, we are not a multidivision business with different kinds of industries where things are so discrete. And so in some ways calling out three divisions is somewhat arbitrary. I mean certainly you -- we've chosen to carve it up partially by geography and partially by customer. But when we run advertising, it affects all of our businesses in that certain geography.

So it is a long-winded answer but I want to make sure you understand our thinking. I think that the businesses are all profitable; they are all worthy of investment; they are all capable of significant profitable growth. We understand the risk profiles that are slightly different in each one and modify our financial analysis to match up with those risk profiles. I don't think that you should anticipate any strategic change in direction as a result of how we are now reporting the G&A.

Gary Balter - *Credit Suisse First Boston - Analyst*

Your comments specifically like on the retail side of getting to industry leading margins are matching those is still something you see doable? (multiple speakers)

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

I don't think of it as strictly is in retail, Gary. I think as you look at our Company versus other benchmark companies out there, retail or otherwise, we have opportunities here. And you've seen us make a little bit of progress this quarter. We have a lot more progress to go. I think we need to take cost out of this Company. Now there is no silver bullet and I think people keep saying we keep sharing all these little projects, little meaning seven figure projects. But there is no silver bullet. There is no one thing out there, there is no one big capital investment we could make in order to drive costs down. And I think that is why it has been so difficult to do.

But we now have a focused effort on it and we have hundreds of projects going. I think that you'll see us continue to make traction on that. But all of this is in order to drive our profitable growth. Nobody should misunderstand and be careful of characterizations of a focus strictly on cost-cutting. I think if you ask our people what is our focus? I think they would tell you our focus is on profitable growth.

Gary Balter - *Credit Suisse First Boston - Analyst*

Which actually leads right into my second question because when you look at your strategic growth priorities, it [sounds] like under international of the three of them, the first one is improved profitability but the second is grow European contract and third is increase geographic reach, which kind of implies that you feel comfortable on the expense side of it or you feel you are going in the right direction so it is time to look out. Is that the way we should be thinking of it?

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

You are speaking of international specifically. I think -- .

Gary Balter - *Credit Suisse First Boston - Analyst*

Yes.

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

We've got to finish the integrations in Europe and that is what we have hastened here. You see some of the charges this quarter and this year as a result of that integration. You see us moving from 11 call centers in France to five, for example. There are more opportunities there. You see us moving our supply chain, the number of our warehouses in Europe to a fewer number of warehouses. So there's still work to be there but now that we have the plan completely laid out it is a matter of execution. And we have a pretty good feel on where that is going to go which allows us then to start to look out, as you say.

And so in this quarter you saw us to take the majority stake in a Korean company. But you see the pattern that we are establishing here which is we're not making big vests internationally but we are trying to get footholds into markets around the world that are more developing markets so that as these economies mature that we are there to take advantage of that and grow our business over time. But we have deliberately said U.S. retail is -- North American Retail is our number one priority. North American BSG is our number two priority and International is third in terms of our investment.

Gary Balter - *Credit Suisse First Boston - Analyst*

Thank you very much and good luck in future quarters.

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

Thanks, Gary.

Operator

Jack Murphy of William Blair.

Jack Murphy - *William Blair - Analyst*

Thanks. Steve, on an earlier answer on International you mentioned that the pace of activity always has a topline risk in terms of all the internal improvements you are making. Are there specific areas that in international you feel where you may have -- are still leaving some topline on the table because of all the improvements you are doing on the margin side? And that you are more likely for recovery as we move throughout this year?

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

Jack, what I was trying to say earlier is that I was very pleased that as we were consolidating and integrating our businesses that we are also at the same time able to put a positive sales number up for the first time in eight or nine quarters. So actually I was trying to communicate the opposite that actually that I was pleased by the ability to do both at the same time. But as we go forward, we definitely want to grow this business. And I think what has happened is that our fragmented businesses particularly in Europe which had been put together through acquisitions over time, that fragmentation got in the way of our growth. And so as we get these businesses integrated, it gives us ability to grow faster because we are able to look across country at our customers and so forth.

The economic situation too is sort of an overall governor on this thing. But our intent is to growth this business and I think you'll see us focusing on doing that in the future.

Jack Murphy - *William Blair - Analyst*

So those internal changes are a relatively small impact to the topline and the macro is a much larger factor?

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

I would agree with that.

Jack Murphy - *William Blair - Analyst*

And then just one last question back to the remodels for a second. Just trying to think of how the model kind of works as you are doing these updates. Should we think about the incremental expenses of the remodel as being partially offset or largely offset by any type of sales list or is the sales productivity improvements that you expect to come over a much longer period of time?

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

Well, first of all we probably are being too hard on ourselves as we consider these remodels. Because I think most retailers would consider a large proportion of what we are doing to be just common maintenance. Our stores are the oldest store base in the industry. We have not touched them in a very long period of time. I think most people who follow retail understand that you should really be keeping up with the stores every five to seven years. We've not touched them in an average of eight to nine years. And so what we are doing could be just considered maintenance. We however are accounting -- so in that 225 to 250, there's a lot of stuff that people would not call remodeling costs.

But as we go forward I think Chuck talked about where the improvements were, the topline improvement tends to come reasonably quickly and hence when we're getting a good return, good financial return even in total including the things that would be considered maintenance. Chuck, I don't know if you want to follow up with any other characterizations of the sales?

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

I think I would add that the topline improvement but it's a margin improvement as well due to the basket of what we are selling. And that is especially attractive in what we're seeing in these M2 remodels.

Jack Murphy - *William Blair - Analyst*

Okay, thanks. Congratulations on the quarter.

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

Thanks, Jack.

Operator

Brad Thomas of Lehman Brothers.

Brad Thomas - *Lehman Brothers - Analyst*

Thank you. First of all congratulations on the quarter.

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

Thanks, Brad.

Brad Thomas - *Lehman Brothers - Analyst*

And then I think most of my questions have been answered. So maybe a little bigger picture. Steve, now that you've been at the Company for just about a year here. Could you maybe talk a little bit about what you see as the biggest challenges and the biggest opportunities versus how you thought of things a year ago, now that you have a deeper understanding of the business?

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

Yes, I think first of all I'm very pleased with the quality of our people in the Company. It is something which is so important, and I'm not sure that most people who look at only the financial statements really get. But in order to make things happen, in order to grow these businesses, in order to integrate, in order to take costs out and so forth, you rely on the quality of your people. We have 47,000 people in the Company. We had a couple of retirements that were going to happen one way or the other. But mostly we are doing what we are doing with the people that were here before. And I'm just so proud of that and it gives me great confidence in the capability going forward.

Secondly, I think the power of the brand name is critical. I know people think of us and characterize us as a retailer and they also characterize us as number two. However, I'm just not sure that that characterization is right. Remember, more than half of our business is direct; less than half of it is retail. Second of all, the top two players in the entire industry are very close in size. That is unusual in industries where you usually see a step function difference between the two.

And so the third thing I would say is the differences then in the financials and in the economic performance, I've found not to be structural which is very good news. I found them to be things that we can fix. They are not silver bullet kinds of things as I said before. But they are things that we can address and are addressing. So I think you see morale very high in our Company. I think you see confidence that we can profitably growth this business and change this business.

We have been very careful. We've never stated our goal to be number one or any characterization like that. But we can add terrific shareholder value over time by executing the plans before us. And if you look at the gap in our margin just at the bottom line versus other benchmarks out there, if we are even able to close half of that gap, the amount of shareholder value creation possible in this business is enormous.

So overall, after a year or so, a year or more on this business I remain as confident as ever as our ability to execute on those plans.

Brad Thomas - *Lehman Brothers - Analyst*

Okay, thank you. Maybe just a quick follow-up then. Could you just remind us especially with gas prices up substantially over the last two months, what it is that you are able to do to control those costs or to pass them through to your customers?

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

The fuel impact on our business is relatively modest compared to fuel impact on other kinds of business. We do have some delivery vehicles that we run. But we don't have a company-owned fleet and so forth. We have been able to take advantage of some fuel hedging to take some of the volatility out of our business and so forth. So we've not seen a huge impact.

The bigger impact would be on what would happen to consumer spending, which is a macroeconomic situation that would affect all of American business, quite frankly. And to date, we've not seen a big impact on the business as a result of that. Chuck, I don't know if you have any other comments?

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

We are seeing some impact on product costs as one of the raw imports. We are able to manage that for the most part relatively well through some of the things that we've talked about before. We are working closer than ever with our core vendors. We also are going to market in a global way. I think I've talked before about our global purchasing, leveraging the purchasing power of Office Depot around the world. So that is how we are managing through some of those costs. But that is causing some pressure on raw material.

Brad Thomas - *Lehman Brothers - Analyst*

All right, great. Thank you very much.

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

We have time I think for one more question.

Operator

Danielle Fox of Merrill Lynch.

Danielle Fox - *Merrill Lynch - Analyst*

Thank you. I was wondering if you could just give us a little bit more detail on where the increase in the international gross margin came from this quarter? You mentioned the consolidation and integration activities. I would think those would be more of a benefit to the SG&A. And you mentioned that the increase in international gross margin came in spite of some pressures. So I'm just trying to understand the driver.

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

Yes, Danielle, the international gross margin includes some supply chain costs. So as we integrate the various supply chain activities there, you will see some impact there. But also I think the other contributor was our private brand penetration. We have three different private brands over in Europe predominately. And those are NiceDay, Viking and Office Depot. We are very pleased with our ability to grow our private brand business there.

And I think that you are going to see us -- we have an opportunity here to treat our businesses more globally. We have historically purchased separately between international and North America and we have now integrated those efforts and you will see us expanding the use of global tenders which should have impact on our category management efforts around the world.

Danielle Fox - *Merrill Lynch - Analyst*

That is helpful. And just one final question. I'm wondering if the decision to accelerate the remodels in any way affects your appetite for new store openings whether or not there is any sort of an interplay in the way you think about allocating resources to remodels versus new stores?

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

No, and the reason is I think we can do both. I think we have to do both. Actually the results of the new models have contributed positively to our overall new store model. If you think about what Chuck said about the M2 prototype and the ability of this prototype to not only have a higher sales result but also a higher margin result, that allows us to more confidently expand our new store openings because they are more productive with this new store prototype than they were with the old.

The second thing is we have plenty of cash flow here. In fact we are using a lot of excess cash flow for share repurchases right now. But we have a lot of cash flow that we can allocate to our growth priorities including North American Retail where we can remodel these stores at a faster rate and make them more productive as well as open new stores.

Danielle Fox - *Merrill Lynch - Analyst*

Thanks very much.

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

Thank you, Danielle. Hopefully you all will agree with me that we've had a terrific quarter, top-line positive in all divisions. We've expanded gross margins. We've reduced costs. We've had higher cash flows. We've had lower inventories, better customer service. We've improved working capital utilization. We've expanded our ROIC. We've expanded our ROE and finally, a 30% EPS growth ex the charges. So I am very pleased with the results for the quarter and I'm sure you are too.

So with that I'd like to wrap things up. Thanks for participating on today's call.
