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ODP.OQ - Q3 2006 Office Depot Inc. Earnings Conference Call

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OVERVIEW:

The Co. reported 3Q06 sales of $3.9b, net earnings on a GAAP basis of $133m and GAAP EPS on a diluted basis of $0.47.

CORPORATE PARTICIPANTS

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

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

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PRESENTATION

Operator

Good morning and welcome to the third 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. - IR Director*

Good morning, everyone. Before beginning today's conference call, I would remind you that certain statements made during this call are forward-looking statements under the Private Securities Litigation Reform Act except for historical, financial and business performance information. Comments made during this call should be considered forward-looking. Actual future results may differ materially from those discussed on this call due to risks and uncertainties both foreseen and unforeseen. Certain risks and uncertainties are described in detail in our report on Form 10-K filed with the SEC on February 15, 2006 and in our Form 10-Q filed this morning.

During portions of this call we may refer to results which are not GAAP numbers. A reconciliation of non- GAAP numbers to GAAP results is available on the investor relations area of our website at www.officedepot.com. Now I would like to introduce Office Depot's Chairman and CEO, Steve Odland.

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

Thank you and good morning to everyone. Thanks for joining us today for Office Depot's fiscal 2006 third-quarter conference call. With me today are Pat McKay, Executive Vice President and Chief Financial Officer, Chuck Rubin, President of the North American Retail Division and Ray Tharpe from Investor Relations.

This call is a special call for us this month as we are celebrating Office Depot's 20th anniversary. It is amazing to think about where we all were in 1986. Office Depot started with a single store in South Florida and has grown to be a $15 billion company, a Fortune 150 with over 50,000 associates worldwide selling to customers directly and through affiliates in 42 countries today. We are very proud of how much we have built over the past 20 years and we look forward to the next 20 years.

I hope you have had an opportunity to read our press release and learn about the third-quarter results. If not, you can get the release as well as the company webcast slides are available on our website at www.officedepot.com and then you just click on the Company Information tab and then on Investor Relations.

Third-quarter sales for Office Depot grew 10% in the quarter to $3.9 billion when compared to the third quarter of 2005. Sales in North America were up 10% while International sales increased 13% in U.S. dollars and 9% in local currencies. North American Retail comparable store sales were up 3% for the quarter.

Net earnings for the quarter on a GAAP basis were $133 million compared to a loss last year of $48 million. Now GAAP earnings per share on a diluted basis were $0.47 for the quarter versus a loss per share of $0.15 in quarter three of 2005. This quarter we recognized $5 million in charges associated with the implementation of plans that were announced in 2005 and disclosed in previous SEC filings. Those charges this quarter had a $0.02 per share impact on the results. Without those charges our third-quarter 2006 net earnings were a record $139 million or $0.49 per share, up 40% from last year's earnings per share of $0.35.

In the third quarter of 2005, for comparative purposes, we reported an adjusted EPS of $0.36, but that number excluded option expenses that had a $0.01 per share impact. So now, for comparison purposes, option expenses have been normalized in both periods and so the comparison is $0.49 per share versus $0.35 per share last year or an increase of 40%.

Our overall performance benefited from continuing our strategy of tailored marketing efforts, strong execution for merchandising and store operations and our back-to-school promotions and from expense leverage on increased sales. We are also seeing continued progress in our operational efficiencies. Excluding the third-quarter charges, total operating expenses as a percentage of sales were 25.7% which is an 80 basis point improvement compared to the prior year. EBIT adjusted for third-quarter charges was $203 million in 2006 or 5.3% as a percent of sales compared to $146 million or 4.2% in the prior period.

During the third quarter, Office Depot completed the acquisition of Papirius, one of the largest business-to-business suppliers of office products and services in Eastern Europe. Papirius has annual revenues of more than $56 million in operations in the Czech Republic, Lithuania, Hungary and Slovakia. This business has been included in our International Division results since the date of the acquisition but the operating income impact was not material to the results.

We also acquired a majority stake in AsiaEC, one of the largest suppliers of office products and services in China. Financial results of that acquisition will be included in our operations beginning in the fourth quarter or next quarter of 2006.

Our effective tax rate remained relatively constant for the quarter and the year-to-date tax break reflects that which we now expect to realize, which is approximately 30% for the full year.

Now turning to the trailing four quarters. Sales were up 6% on a trailing four-quarter basis versus that number a year ago. Pro forma EBIT increased 31% from the prior year performance and EBIT margins expanded by 100 basis points to 5.3%. Our efforts to streamline our business have resulted in reduced costs and leveraged further with higher sales.

Our overall share count declined by 9.5% on a trailing four-quarter basis compared to the prior year due to the impact of our share repurchase program.

Lastly, pro forma EPS for the trailing four quarters has improved to $1.78 or a 35% increase. We are also pleased with the significant expansion in ROIC of 300 basis points to 14.8%, as well as the increase in our return on equity of 670 basis points to 19.8%.

As part of our previously announced charges to consolidate and streamline functions, we reported an additional $5 million in the third quarter of 2006 as the plans were implemented. We anticipate an additional $29 million of related charges being recognized over the remainder of the year bringing the full year amount to about $61 million. However the future charges may change as the plans are implemented. We have provided a reconciliation of GAAP and non-GAAP results that you can see on our website at www.officedepot.com.

On a separate but related note, we now measure our division operating profit without the [charges]. We will continue to review our internal financial reporting measures and modify our disclosures as appropriate. One example is that we are evaluating currently the merits of presenting our distribution costs as SG&A expenses versus as cost of sales and we will be deciding how to present those over the next quarter or so.

Now I will turn the call over to Chuck Rubin who will take you through the details of the North American Retail performance this quarter.

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

Thanks, Steve. Good morning, everybody. Third-quarter sales in the North American Retail Division were $1.8 billion, an 8% increase compared to the same period last year. Comparable store sales in the 998 stores in the U.S. and Canada that have been open for more than one year increased 3% for the third quarter. This represents our 11th consecutive quarter of positive comparable sales led by strength in the technology product category and growth in our supplies categories, including our back-to-school products.

Comparable average ticket size continued to increase and average sales per square foot were $259 for the quarter. We remain pleased with the results of our overall remodel efforts and accordingly have accelerated the number and timing of the remodels planned for this year to about 175. During this quarter, we completed the remodels of 64 stores. As we remodel, these activities have a short-term negative impact on our retail results but represent an important part of our longer term retail profitable growth strategy.

Additionally, we opened 50 new stores during the quarter bringing the year-to-date new store openings to 76. The North American Retail Division had an operating profit of $120 million for the third quarter of 2006, up from $108 million in the same period of the prior year. Gross profit expressed as a percentage of sales improved over last year in part reflecting an expansion in product margins driven by category management and an increase in private brand sales from both growth in existing products and the introduction of new products across many categories. These improvements in gross margin were largely offset by an increase in costs associated with the significant acceleration of both our remodeling efforts as well as our new store openings.

Remodeling and new store activities raised operating expenses by 70 basis points compared to the third quarter of the prior year. Despite these cost pressures, operating profit margin improved 20 basis points to 6.8% in the quarter from 6.6% in the prior year period. Inventory per store was $923,000 as of the end of the third quarter 2006, which is relatively consistent with the prior year.

As I mentioned earlier, during the third quarter, we opened 50 stores bringing our total to 76 for the year. At the end of the third quarter, Office Depot operated a total of 1121 office products stores throughout the U.S. and Canada. Our current plans are to open about 115 stores this year. We also estimate opening approximately 150 stores in 2007, an additional 200 stores in 2008. Overall, we believe we can double our store count from where it sits today.

In the third quarter, we accelerated our remodel effort and have completed remodeling 64 stores bringing our yearly total to 113. We now plan to complete 165 to 175 store remodels this year with a goal of remodeling all remaining stores in the next two years.

Our store operations in the Chicago market have been generating a high level of interest lately. The Chicago market is one of our largest with 45 stores. During this third quarter, we once again grew sales, expanded our margin and increased our operating profit. Our customer base is loyal and strong and complements the significant North American business solutions business in that marketplace. Our design, print and ship business grew by double-digit percentages through both the retail and direct selling channels. Office Depot now has nine regional print facilities that allow us to produce large jobs and deliver them virtually anywhere in the United States by the next day all with guaranteed quality.

We also introduced Print On Demand, an enhancement that allows customers to submit their orders online. We now provide our customers the choice of dropping off their order at any of our stores or submitting it to us via our officedepot.com website. We then provide the customer the choice of either picking up the order at any one of our stores in the U.S. or Canada or having it delivered straight to their home or office.

From a marketing perspective, I'm pleased to report that we received over two million entries for our Great Tools For Your School sweeps promotion. In just a few weeks, we will announce the winning school randomly chosen to win over $75,000 in new school supplies, technology products, scholarships and merchandise cards, all to be delivered in person by NASCAR star, Carl Edwards, driver of the Office Depot 99 car.

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

Now I would like to turn the call over to Pat McKay who will take us through the other details for the quarter.

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

Thanks, Chuck. North American Business Solutions Division sales increased by 12% to $1.2 billion in the third quarter compared to the same period last year. Our BSD Division experienced growth in key product categories and division average order values increased compared to the same period in last year. Third-quarter 2006 revenue reflects strong organic growth in our contract sales channel as well as a full quarter of revenue from Allied Office Products, a contract stationer that we acquired during the second quarter of 2006. This growth more than offset declines that we experienced in our direct selling channel as we executed our brand consolidation in this division and deliberately reduced some unprofitable business.

The North American Business Solutions Division had an operating profit of $97 million for the third quarter of 2006 compared to $82 million for the same period of the prior year. Operating profit margin increased approximately 40 basis points to 8% in the third quarter of 2006 from 7.6% in the same period of 2005. This improvement resulted from a slight gross margin expansion as well as cost savings and operating efficiencies. Division results for the quarter also reflect costs that are associated with the continued investment and the expansion of our contract sales force as well as certain short-term costs associated with the integration of our Allied acquisition. Also our supply chain continued its history of improvements in operating expense leverage.

The Business Solutions Division continues to expand its marketshare position through innovative approaches to customer acquisition, retention and penetration. We continue to expand our sales force, both acquisition and penetration resources. New approaches to appointment setting have been tested and are in process of being rolled out on a national basis. Furniture capabilities have been augmented by delivery services that are responsive to customers' needs of placement, light assembly and debris removal. Our furniture assortment has been expanded to include art and carpet with both categories being made available on a virtual basis. The Allied integration continues on schedule with the conversion of customers occurring on a seamless basis.

The direct segment of office products industry is still highly fragmented. We are pursuing new, profitable customers via this channel. Our use of telephone account management continues to grow. The use of this resource is both efficient and effective in retaining and growing our share of wallet with our customers who will also assist our telephone account management resources in the application of private brand opportunities have been developed and deployed to ensure anticipation of customer needs in that area.

During the quarter, we expanded the depth and the breadth of our Internet keyword search. Progress continues to be made on our site redesign, which will improve the usability of the site, allow for enhanced personalization of the Web experience and enable assistance intervention based on customer behavior.

Unidentified Company Representative

Now turning to International. The International Division's third-quarter sales increased 13% in U.S. dollars to $882 million and grew by 9% in local currencies when compared to the same period in 2005. We have all channels contributing to positive quarter-over-quarter sales growth in International. This represents the third straight quarter of sales growth in local currencies and is attributable to both organic growth as well as to revenue from the acquisition completed during the second and third quarters of 2006.

Division operating profit was $55 million in the third quarter compared to $42 million in last year's third quarter. Operating profit margin expanded by 90 basis points to 6.3% in the third quarter from 5.4% in the same period of 2005 due to continued improvements in operating activities coupled with the stabilization of gross margins.

During the second and third quarters of 2006, we completed several acquisitions, including Best Office, which is an office supply company located in South Korea and Papirius, one of the largest business-to-business suppliers of office products and services in Eastern Europe. We also increased our ownership interest to a majority stake in Office Depot Israel. The results of these acquisitions have been consolidated into our results for the third quarter and for a portion of the second quarter after the acquisition dates.

Last week, we acquired a majority stake in AsiaEC, which is an office supply company in China with annual sales of about $40 million. Sales on an annualized basis for all of these acquisitions aggregated were approximately $180 million and reflect the efforts around our stated expansion strategy in the International Division. We intend to continue to seek out opportunities to expand our International operations, which provide opportunity for organic growth in these emerging markets and importantly provide footprints for the needs of our global customers.

Today, we provide businesses with the most extensive global presence as we serve customers in 42 countries around the world. The International Division increased the size of its contract sales force in the quarter and increased the use of telephone account managers for customer acquisitions. These activities are expected to continue through the rest of the year.

Also during the quarter, we launched our Green Book, which is a catalog of environmentally friendly products that many of our European customers have been requesting. The Green Book will enable us to differentiate our offering from our competitors and drive incremental sales. We have three strong private brands in International -- Office Depot, NiceDay and Viking. Our private brands are helping to distinguish us versus other office suppliers in this highly competitive market. We plan to drive additional sales to private brands by an expansion of the assortment and increased emphasis in marketing of these products. Additionally, we intend to expand our direct sourcing efforts.

We are also encouraged that our cost management initiatives in International have taken hold. We have continued the consolidation of our supply chain operations in Europe, closing four locations year-to-date. As a result of these and other initiatives designed to improve our operating efficiency, operating costs in the quarter have declined significantly compared to the prior year. We are pleased with the progress both in the top line as well as the bottom line of this division and we are very optimistic on the long-term potential of our International business.

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

With regards to our statement of cash flows, for the year-to-date, third quarter 2006, free cash flow before share repurchases was $575 million versus $213 million in the prior year. This year-over-year increase is primary attributable to improved profitability, as well as working capital improvement, including the timing of cash payments. Cash provided by operating activities was $792 million.

Depreciation and amortization totaled $205 million on a year-to-date basis and was consistent with the same period of 2005. EBITDA was $780 million on a year-to-date basis. However, adjusted for charges, EBITDA was $812 million, an increase of 21% when compared to adjusted EBITDA in the same period of 2005.

Capital expenditures year-to-date have been $218 million. We 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 of around $425 million, which reflects the acceleration of our store remodels and new store openings for the year, as well as initial spending associated with distribution facilities. For the next two years, we expect CapEx of between $600 million to $700 million, which reflects higher levels of store openings and remodels, as well as spending on our supply chain. We don't expect this level of capital spending to cause dilution in ROIC.

During the quarter, we repurchased approximately 5.3 million shares of our common stock at an average price of $38 for $200 million in total. At the end of the quarter, approximately $300 million remained authorized for future repurchases under programs previously approved by our Board of Directors. Year-to-date, we have repurchased approximately 24 million shares of our common stock for $871 million at an average price of $36 under those approved plans.

Now turning to the balance sheet. We ended the third quarter with $329 million in cash and short-term investments. Our investment in inventory totaled $1.4 billion globally. And our third-quarter inventory balance includes improving in-stock positions across all channels and recent acquisitions. We ended the third quarter with average inventory for North American retail store of $923,000, which is relatively consistent with the same period last year. Working capital decreased by 47% as compared to the third quarter of the prior year. This was driven by an increased Accounts Payable to inventory ratio of 109%, an improvement from last year's level of 101% and we continue to work on initiatives to drive improvement in working capital.

Our long-term debt at the end of the third quarter was $592 million and our debt to total book capital ratio was 19.1%. Our outstanding 2013 senior notes are rated investment grade by both Moody's and Standard & Poor's. Our balance sheet remains very strong.

Our return on equity adjusted for charges for the trailing four quarters improved by 670 basis points to 19.8% as compared to 13.1% for the comparative period of 2005. Return on invested capital adjusted for charges increased 300 basis points to 14.8% from the 11.8% in the prior year. That concludes my remarks and now I would like to turn the call back over to Steve.

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

Thanks, Pat. First, as a reminder, we have three strategic growth priorities. First is North American Retail. We want to continue to improve our store productivity and have accelerated our store expansion and remodel plans. We now have plans to complete 165 to 175 stores this year and to completely refresh our chain over the next couple of years. We also opened 50 stores during the quarter and are on track to open approximately 115 for the year.

Next is North American Business Solutions. We plan on profitably growing our marketshare through new customer acquisitions and new product and service offerings and supplementing with available tuck-in acquisitions. We have not only grown our sales force, but we have also devoted more of our existing sales resources to acquire new customers. We have expanded our outbound sales and our customer retention calls with our telephone account management group and we are supplementing growth with recent acquisitions in the Northeast.

Finally we're making strides to enhance our e-commerce site with content and functionality. And finally International, we need to continue with progress of profitable marketshare growth in Europe and to continue to increase our geographic reach. Our new management team in Europe is making real progress in achieving the third quarter of consecutive growth and improving profitability.

We completed acquisitions in the quarter and year-to-date reflecting our confidence in opportunities to expand our reach in emerging markets around the globe.

As you all know, we don't issue formal earnings guidance, but we remain instead 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 to profitably grow our business as we have by opening new stores in new geographic markets, by making necessary investments in the core business like our store remodels and new distribution facilities, by acquiring assets or businesses in our key priority areas, and finally by repurchasing stock as long as it's accretive. Now I would like to open up the call for questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS). Colin McGranahan.

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

I wanted to focus on the top line a little bit. First of all, in the third quarter, it looked like the 10% top-line growth was probably the strongest and I know there were some acquisitions in there, but still probably about 9% organic growth, is probably the strongest in five years in terms of organic growth. If you could, Steve, maybe just comment a little bit more on your view of profitable growth opportunities and in terms of what kind of acquisition criteria you consider, how that growth going forward might be geographically concentrated and then the store opening plans for '07 and '08 -- it sounds fairly aggressive. How far along are you in the real estate process with the '07 or '08 openings at this point?

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

These have been -- this has been a great quarter of top-line growth. I'm especially pleased that these were record numbers in all three of our divisions. So we finally have things going in each of our areas. All of our activities though are focused on profitable growth as you said and I want to make sure people understand that. We are not chasing growth for the sake of growth and we haven't and we won't. Everything that we do is committed to a formal financial process. Our acquisitions are subject to detailed cash flow analysis and [must] hurdle and any kind of acquisition we believe will be -- will not be dilutive to our overall return. So these are the kind of acquisitions that we like to do, tuck-in acquisitions. We obviously have been trying to fill out some of the emerging markets and do so in a relatively low-risk way by buying small companies, but they are also very large companies in their area. They are some of the largest and most well-established, but I don't think any of these acquisitions that we bought have even a 1% marketshare. So there's just a tremendous amount of growth available in the International market.

As it relates to North American store openings, yes, we are being more aggressive. We will be more aggressive. We think that we can double our current store base and we have ramped up our internal resources to do that. We believe that all of these new stores that we open will hurdle our 13% IRR requirement and we will subject that to that kind of -- that kind of hurdle going forward.

Operator

Bill Sims.

Bill Sims - *Citigroup - Analyst*

I have two questions. First, I want to follow up on International growth opportunities. Steve, can you give us an idea if you were seeing the growth from marketshare gains or from [back door pick-up] and is there any area, particularly whether in Europe or International, that you're seeing a particular strong growth and what are the challenges to seeing the sustainability of that growth?

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

Well, it is hard to say. There are no formal suppliers for marketshare data. So what we try to do is get our best estimates of how the industry is growing versus our own growth. We think that we did pick up a little bit of marketshare in Europe, but it would be modest. The growth is strong in the Continent. We are pleased with the results really in all of our areas. We have positive store comps in virtually every retail business. We had growth in every single channel for the first time in a very long time in International and look -- it is not -- it is a very competitive environment still, particularly in the contract area. But I am really pleased with what we have been able to do and the focus of our people.

In Asia, you can see we are trying to develop the business there. We now have businesses in Japan and Korea and then we just closed on the Asia -- AsiaEC acquisition, which is the Chinese company, last week. So those results will be put into our fourth-quarter results. So we are making good progress there.

Bill Sims - *Citigroup - Analyst*

Thank you. And just one second question. Can you give us an update on current remodel costs in North America and what type of returns you are generating on the remodels?

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

Returns on remodel -- again, here, our remodel costs in North America are relatively small compared to most retailers. We are spending somewhere in the order of $250,000 a store. Now remember a lot of these stores are very old, eight to ten years old and they have a lot of maintenance that are required. So included in that $250,000 are just things like paint and floors and counters that most companies would just include in maintenance. We are including it in the total remodel costs. Having said all that, these remodels are hurdling our IRR hurdle of 13% and so again we are very pleased with the results.

Bill Sims - *Citigroup - Analyst*

Thank you very much. Good luck.

Operator

Matthew Fassler.

Matthew Fassler - *Goldman Sachs - Analyst*

The first question I would like to ask is a follow-up on the domestic store opening plans. Can you give us a sense as to the mix between fill-ins and major markets? And as you think about a couple of the more obvious opportunities that you have in North America, some of the major markets in the Northeast that the Company has retreated from in the past, would those be on your agenda for growth over the next two years?

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

Matt, this is Chuck. I think we've said before that we are looking at all areas. We think -- to your question specifically, we have lots of opportunities in markets that we don't have store representation today, but the same is true for markets that we do have stores in today. We just have great opportunities to build it out. So we are -- both of them are very much on the table and are included in the numbers that we have talked about today.

Matthew Fassler - *Goldman Sachs - Analyst*

And Chuck, as we think about the kind of prototype you will be rolling out is consistent with the store size that we are seeing today in 2006?

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

Yes, the M2 model that we have today is really the foundation of what we have and that is what you will see us continue with for the most part.

Matthew Fassler - *Goldman Sachs - Analyst*

Great. Second question, just to follow up I guess to Pat on the Delivery business on BSG. Can you talk about -- you talk about average order size coming up. Can you talk about sort of ticket or product inflation versus share of wallet as you see very nice revenue coloration on that business?

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

We have been able to achieve an expansion of the average order value with our customers and price inflation -- we have been talking about in the last several quarters about the impact of paper pricing in terms of cost on our business. But in terms of the implication on the overall sales, it really has not been impactful in terms of driving overall top-line expansion and sales dollars there. So really been average ticket and being able to change the overall market basket with our customers versus anything else.

Matthew Fassler - *Goldman Sachs - Analyst*

Got you. And then third and finally, just as we look at the income statement, I know that as you have started to allocate a portion of G&A to each of their divisions there is an unallocated piece that I guess we have to solve for based on the press release but we will probably see in the Q. Correct me if I am wrong. It looks like that was down a bit from a pretty big number a year ago. If you could just give us a little bit of color on that unallocated G&A number.

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

Yes, it is down from the prior year and last year you'll remember we talked about some incentive costs, etc. that were included in the prior year results.

Matthew Fassler - *Goldman Sachs - Analyst*

So the number that we see now is kind of a normalized number for the quarter?

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

Correct.

Matthew Fassler - *Goldman Sachs - Analyst*

Thank you very much.

Operator

Daniel Binder.

Daniel Binder - *Buckingham Research - Analyst*

Just a couple of questions for you. One, could you just give us a little color on the comp trends through the quarter if you can and then maybe a little bit more detail on the categories. It sounds like supplies were a little bit better. I was curious how furniture tracked and then whether or not traffic was flat, up or down slightly?

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

Good morning, Dan. It's Chuck. The trend through the quarter was relatively stable. Back-to-school, which is so key, did come a little bit later. Back-to-school is a bit of an odd season. The actual back-to-school date does alter geographically and it alters year over year and that impacts when the back-to-school push on sales come. So we did see some of that moving around and it seemed as though more schools were going back later into the season so we saw our back-to-school sales, which we were very pleased with, come a little bit later.

The categories -- to your point, technology business was -- continued to be good across both the computers that we sell as well as the higher margin products that go with it that really build up a solution for the customer, the cables and the networking gear, etc. Our supplies business was also generally good and we saw strength in the number of categories. I mentioned back-to-school was good.

We also saw good business in our basic commodities and supplies so we were pleased with that. Our furniture business continued to be softer than we would like. Really that is coming from the larger vignette, the larger collections of furniture and we have got a number of programs in place to try to get that refreshed and get that business at a better level than it has been. We want that business to be performing better than it did in this quarter.

Daniel Binder - *Buckingham Research - Analyst*

Okay. And then did traffic -- was that slightly up, slightly down, flattish?

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

Our total traffic was up with our new stores included in the mix. So we did see increases.

Daniel Binder - *Buckingham Research - Analyst*

I mean in the comp stores.

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

Comp stores were about flat. We actually look at traffic both on a comp as well as a total because of the store openings that we have had. But on a comp it was about flat.

Daniel Binder - *Buckingham Research - Analyst*

I'm just trying to reconcile the accelerated square footage growth plans with traffic that has been essentially flattish I guess the last few quarters. I guess what gives you the confidence that you can double the size of the current store base? Is it just -- obviously you're assuming you're going to take some big marketshare gains. So I'm just curious if there is something else there that I am missing?

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

Well again, we only have a small portion of the market that is out there today and we have -- as we have opened our new stores, as Steve mentioned before, we are pleased with the performance of these. We are serving customers that we didn't necessarily serve before and we are opening these stores and achieving the thresholds, the financial returns that we expect. So as we look forward, both in existing markets as well as markets we don't currently operate in, we think there is opportunities for us to open.

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

Remember, Dan, the traffic in total is an important number because we are not entering new markets. So all the stores that we have opened in the past couple of years have been in fill-in markets and so therefore you put a store in between two stores and you are going to take some of the traffic. Overall incrementally, it's the right financial decision because that new store hurdles even with some of the attrition. So if the same stores are flat to slightly growing in traffic, which they are, then -- and all of the store additions have been fill-ins, which they have been, then the total traffic number going up is a good way to look at it.

Daniel Binder - *Buckingham Research - Analyst*

Right. Now I guess with the -- now you're going to layer in --

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

New stores -- I mean new markets. We are not in Ohio at all. We're not in Arizona. We are not well penetrated even in some of our largest Midwest markets. We are nonexistent in the Northeast and so forth.

Daniel Binder - *Buckingham Research - Analyst*

As you layer in a greater number of stores in the coming years, where do you expect the self cannibalization rate to go and are you including that cannibalization into the return threshold that you need on those new stores?

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

Yes, that's what I said. We definitely subject this to an incremental analysis and that is what we have been seeing is incremental growth even with some of the movement from the existing stores. So going forward, we are going to subject this to very stringent financial hurdles, all incrementally and the results today have been great. Look at Chicago for an example where that market has received an incredible number of new stores from all participants and we continue to grow our sales, our margins and our profitability there. So there is just a ton of room.

The growth in new businesses, small businesses and the fill-in opportunities are incredible on this business. So we only have about a 3% or 4% total marketshare in retail. I know that that is surprising but it is true with all of the business that is spread through all the various sources of office supplies.

Daniel Binder - *Buckingham Research - Analyst*

So maybe just one last thing, if you could give us an idea of what you think the impact on comps today is from self cannibalization and where you would expect that to go as you accelerate the square footage growth.

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

We haven't shared all -- that level of detail analytically. What we can say is that our comps are up. They are up with the infill of stores that we have built over the past couple of years and we have put a couple hundred new stores into the same markets. Those new stores incrementally have hurdles -- are 13% IRR. They have been accretive to our ROIC. As you see, we have added 300 basis points to our ROIC, which is almost unheard of in the market like this. So all of that would suggest then if this was destroying shareholder value, you wouldn't see a 300 basis point lift in ROIC. So clearly these capital investments are the right ones to drive value and so therefore we are going to go forward with them and we have the confidence to go forward with them.

Operator

Danielle Fox.

Danielle Fox - *Merrill Lynch - Analyst*

I was just hoping that you could give us a couple of examples of category management. I think you cited it as a source of gross margin expansion at North American Retail in spite of the fact that technology, which we usually think of as having a depressing effect on the mix, grew nicely. So I am just wondering if you can give us an example of category management.

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

This is Chuck. The principles of category management are really just pretty fundamental. There is offering a good, better, best assortment, which means both the qualities and the features of the product and the prices that go along with the product that marry up to how important the product is for us. So as an example, if you look at our PC assortment, we carry laptop computers that will range from a few hundred dollars up to a couple of thousand dollars and they vary based on the features of the laptop. They appeal to different types of customers. We price them differently. We advertise them differently. So it is really -- that is just one isolated example, but it is that mindset and how we merchandise it, price it, advertise it that really caters to different types of customers.

Danielle Fox - *Merrill Lynch - Analyst*

Then I have two other questions. First, just to clarify on this acquisition versus organic growth at North American Delivery and International. We estimated about 5% organic growth at North American Retail -- excuse me -- North American Delivery and about 2% International. Is that about right? I know you gave us the $180 million contribution from all of the businesses that you have acquired this year, but does that sound about right, about 5% at Delivery and about 2% on International?

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

I think you are within the ballpark in terms of those kinds of numbers. We haven't disclosed those explicitly, but it could be as high as 6% in BSD and you could be up about 3% in the International arena.

Danielle Fox - *Merrill Lynch - Analyst*

Just one final question. It sounds like you are feeling more confident in the store performance and you are accelerating your rollout for '07 and '08. I'm wondering also if real estate availability has changed at all over the past few months so that the pipeline has actually changed.

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

We don't see a big change in that. Steve mentioned we have geared up our internal team looking at this and we are finding some pretty good opportunities.

Operator

Michael Baker.

Jason West - *Deutsche Bank - Analyst*

It's actually Jason West calling in for Mike. Just a question on the margin trajectory going forward. I know you guys don't give guidance on that, but just -- I guess thinking more about retail, should we think about the accelerated growth plans just maybe having a drag effect on margin growth at retail similar to what we saw in the third quarter?

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

Jason, I think that -- we have talked a lot about private brand and the margin potential that goes along with the private brand as well as the differentiation of the product and we think that that continues to be an opportunity. We do believe private brand will continue to grow in product count as well as category penetration. So we think that that is an up side. The market this past quarter was pretty rational in terms of its pricing. So if that continues we think private brand will be helpful to our overall margins and help us deliver what we are aiming for.

Jason West - *Deutsche Bank - Analyst*

Okay. I guess just more broadly, does the change in the investment strategy change your outlook on getting to your competitors sort of I guess 7%, 8% kind of margin that you guys have targeted. Does it change the timing there at all?

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

We haven't targeted it and we haven't given timing. I think what we've said is that there is -- that we don't see any structural impediment to achieving those kind of margins over a long period of time. So we are not changing our outlook on that as a statement. But we don't have any firm timetables here, Jason, on that.

Jason West - *Deutsche Bank - Analyst*

Okay. And then just the last thing on the cash flow and just sort of thinking about what are you guys going to think about from a balance sheet and cash flow perspective? It looks like the free cash flow will be pretty minimal if you are investing at that level the next couple of years. I mean would you look to maybe issue some debt to continue the share buybacks or would you sort of just keep it status quo and use whatever free cash comes in to buy back shares?

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

Well, I think as we note and as you know we generate a substantial amount of cash flow. So I think even with the CapEx levels that we are describing we don't see that there is going to be a need to be able to have to go out and borrow or to increase our debt. So I think there will be plenty of cash to be able to do the things that we need to do and to talk about and to work through those choices that we have in terms of the spend on CapEx, spend on acquisitions as we need to grow our business and then also taking a look at the overall share repurchases as well. We showed in our trailing four quarters we have over $1 billion in EBITDA. So it is a pretty strong starting point to be able to the think about how we want to allocate those cash resources.

Operator

Brad Thomas.

Brad Thomas - *Lehman Brothers - Analyst*

A couple of questions if I may. First on the retail side, maybe, Chuck, I was wondering if you could give us some thoughts on your initial outlook for the holiday. I know you all don't provide specific guidance but given the strength in the back-to-school season I was just wondering if you had any reasons that you thought this would not continue going into the holidays?

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

Well the holiday time span is always a very competitive period. We feel good about our plans. We are coming off of a five comp from last year but we think we have the right product, the right marketing plans. We think our stores with all the remodels that we are anticipating doing still and the ones we have completed position us to do well during the fourth quarter.

Brad Thomas - *Lehman Brothers - Analyst*

Then, Pat, you had mentioned that part of the increase in the CapEx outlook would be for distribution and would that be fair to assume that those distribution expenses would be associated with the retail store rollout? And then that being the case, could you talk about will those distribution investments be for new distribution centers or will you be just reinvesting in the existing distribution facilities?

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

I think as we had shared even last year as we were talking about what are our needs and especially with our charges is we recognized that there were some things that we would be looking at relative to our network, which includes our distribution facilities. So what we are looking to do is to make sure we have got the appropriate facilities both here in the U.S. to support the -- and Canada to support our North American businesses as well in the International arena. So there could be opportunities for us to think about, as we have been doing, consolidation of facilities as well as putting in new distribution facilities to support our growth over the upcoming years.

Brad Thomas - *Lehman Brothers - Analyst*

Okay. Then one last question if I may, just circling back to the private label, I know that you all don't like to give out specific numbers on penetration, but could you maybe just talk a little bit about which channel you have seen the most success in thus far between Retail and Delivery and the International segment and then maybe where you think you have the most opportunity over the next year or so? It would be very helpful.

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

This is Chuck again. That's what's exciting about private brand. We are actually seeing growth everywhere we look. So we are seeing growth across our different channels. We are seeing growth across the different divisions. So both here and North America, as well as Internationally. So as I say, there is not a channel or a place that a customer reaches Office Depot that we are not seeing our private brand take hold.

Brad Thomas - *Lehman Brothers - Analyst*

Well, thank you and congratulations on a good quarter.

Operator

Chris Horvers.

Chris Horvers - *Bear Stearns - Analyst*

It seems like all the superstores are having very strong trends in North America and International is rebounding very nicely. Specific to North America, where is the share coming from? Is this simply a rising tide of business spending that is going on and does the weakness in the furniture category worry you at all as a leading indicator?

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

The growth in the industry over time has been 3% to 4% in total. Our growth has been higher than that most recently. But if you take all the office superstores, so-called office superstore players together, it is under a 10% marketshare. So still the vast majority of the share is tied up in all the mom-and-pop, small dealers and so forth.

In addition to that you've got competition coming from virtually every retailer out there, the mass merchants, drugstores and so forth. So this is a very competitive area. We are seeing a rising tide to some extent with the strong economy and small business growth, but in our case we are picking up marketshare by all the initiatives that we have talked about. So I think both are valid.

On the furniture situation, we really don't think it is any indicator at all. It has never been an indicator. What we are talking about are the large, full room kind of vignettes where we just have been stale in that area and we haven't introduced new ones in quite some time. So we think that our slowness there is just our own doing and we think we can freshen that. All other elements of the furniture business are fine. So we are positive on the long-term outlook. Chuck, I don't know if you have any other comments.

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

I would support that and concerning the long-term outlook, we are continuing to see good progress on other, what I would consider larger ticket sales. So back to our technology business and my comment before about the range of computers that we sell, we are seeing good, healthy sales in higher ticket PCs for instance. That is what I would add to Steve.

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

Just [append] to the question a moment ago on holiday sales. 80% of the volume in our stores go to businesses and everything on the Delivery side is to businesses. So a holiday is of much lower importance to Office Depot than it may be to other players. So if it is a great holiday season in retail that doesn't necessarily translate over to us and we are [lapsing] 5% comps from last year. Having said that, there is nothing to suggest that the business spending should be any different going forward into the fourth quarter. I just want to point out that it's -- we are not basically a consumer business.

Chris Horvers - *Bear Stearns - Analyst*

As a follow-up on the technology side, can you quantify how much the technology mix has changed year over year as a percentage of sales?

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

I don't think we publish that. Our technology has been -- has grown the -- has been the biggest grower for our retail business. That is not the same for our direct business in North America where we have seen stronger growth in our supplies business.

Chris Horvers - *Bear Stearns - Analyst*

And then on the -- the key there is obviously to attach accessories to that technology sale. How do you measure -- have you measured that and how is that trending?

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

It is trending well first of all. We measure it pretty exhaustively and analytically. It is a measure that we track daily across a variety of accessorizing products with the core technology product. It also is something that we measure down to the individual store level and our field organization is incredibly focused on being sure that our associates in the stores have both the technical skill as well as the selling skills to actually help a customer pick those attachment items out to go with their primary purchase.

Chris Horvers - *Bear Stearns - Analyst*

And then the final question that I have is -- you talked about in the last quarter the number of products that you had added on a SKU basis as private label products. Would you be willing to supply that again?

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

Last quarter, we added about 200 items or so of new product. This quarter we were about the same.

Operator

Mark Rowen.

Mark Rowen - *Prudential Equity Group - Analyst*

Most of my questions have been answered, but just a follow-up and one other question. On the new stores, can you give us a sense of -- since that is going to be a pretty important driver of growth -- can you give us a sense of what you're modeling for new store productivity going forward either on a square foot basis, sales per square foot or a percent of what your average stores are doing?

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

I'm not sure we want to get into that detail with you. We obviously -- as Steve mentioned before and I have talked about before, all of our new stores have to pass through our internal expectation of the return at least of the 13% that Steve commented on before. The footprint that we are going forward with is the M2 that we have out there right now. So much below that in terms of details I am not sure we would get into right now.

Mark Rowen - *Prudential Equity Group - Analyst*

But I mean typically would you assume that a new store in its first year would do 75% or 80% of what an existing store average would do or something along those lines?

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

There is a maturity curve that goes with stores and certainly we have that maturity curve built into our model. That is part of the return expectation that we do on that store. I am not sure that we want to get into the details of what our maturity curve looks like.

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

It's not too dissimilar from other retailers. You see it mature over about a five-year period. We are seeing that the M2 store is an easier store to operate and so we get a little bit of lift on productivity in the M2. So the new stores going forward obviously are M2s as we remodel the other stores. I don't want to make too much of -- it sounds like there is -- that we might have come across as more aggressive than we intended to. We are opening about 115 stores this year. We're going to open about 150 next year.

In past years, going back a few years, we were far more aggressive than that on a much lower store base. So these are not unusual numbers in the whole scheme of things. But we have said that our total capital numbers ought to lift from somewhere between low 400s to 600 to 700 over the next few years. And we are trying to help out -- since we don't give specific earnings guidance, we are trying to help everybody model the next couple of years from a cash flow standpoint. Clearly with $1.1 billion in EBITDA just in the past trailing four quarters and the capital of 600 to 700, a couple hundred more in capital, which we need to invest in these stores -- these are not new announcements. These are -- what we are saying today are continuations of everything we have said before.

So we are not changing anything or announcing new news today except for a little bit of help on the actual capital spending. So the store remodels and the store openings are consistent with what we have said before. But obviously there is a considerable amount of excess cash flow beyond the capital numbers. We have been buying back our stock. With our excess cash flow in the future, we do expect to continue our share repurchase program.

Mark Rowen - *Prudential Equity Group - Analyst*

Okay. And then next year, do you have to do anything special in South Florida given Staples announcement that they are going to be opening 25 or 30 stores there? Any extra expenditures in that market or management time? What do you have to do there to kind of protect your turf?

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

Well I think we have shown in Chicago our ability to take a market that is big for us where other competitors have come in and we have shown an ability to make sure our stores are right for sure, make sure our stores are remodeled, but at the same time grow our business and grow our profitability.

So I think as you compare year over year there is always some market somewhere where somebody is expanding and so forth and so you are laughing pretty consistent kinds of behavior year-to-year and so our efforts to remodel all stores in the entire North American chain are considerable and that is what that capital is for. I think that we have been trying to find the right prototype and now we have found it in M2 and that is what we have been saying for the last several quarters and we just try to articulate the speed at which we are going to do that, which is the next couple of years.

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

I think we have time for one more quick question.

Operator

Colin McGranahan.

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

Thank you. I just had a quick follow-up for Chuck. Chuck, maybe if you could talk about marketing effectiveness a little bit and the mix with the loyalty program, mass media, Internet and how you are thinking about your marketing dollars today and how that allocation has shifted?

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

Colin, as you know, we have talked about over the past couple of years the need for us to have become more analytical in that marketing spend and be sure that we are getting a return out of it, treat it as an investment, which we believe it is. What you have seen in the shifts in some of our marketing over the past couple of years reflect that analysis. So the mix of media and the content of what we put into that media has been driven to a large degree over the effectiveness over the past couple of years.

As we look forward, we constantly revisit this because vehicles change and new media comes online or comes available. Online is one component of it. So you will continue to see us stay really focused on the effectiveness of that marketing spend. As we look through next year and beyond with all the new media types, we will start to test into those and based on that, we will move into it.

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

I'm not trying to make you give guidance, but as you think about growing the store base especially, should that give you a better ability to leverage that media spend given that today that mix is still fairly mass media oriented?

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

The short answer is yes. We are pleased. Our loyalty program continues to grow and we are very pleased with the results we are seeing of that. And as we backfill into markets, you get the leverage over a higher sales base. So we do have high expectation on that component.

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

Thank you. Good luck.

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

Thanks, Colin. Just to wrap up here. Our Company continues to make a lot of progress. We achieved record sales and profits for all three of our divisions this quarter. EBIT margins expanded. ROIC increased 300 basis points to 14.8% and on a trailing 12-month basis, our EPS growth has been 35%. Going forward, our growth strategy combined with the continued focus on cost management should enable us to drive profitable growth and create shareholder value. This concludes our call. Thank you very much for participating today.

Operator

That concludes today's conference. Thank you for participating. You may disconnect at this time.
