THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

ODP.OQ - Q1 2007 Office Depot Inc. Earnings Conference Call

EVENT DATE/TIME: APRIL 26, 2007 / 1:00PM GMT

OVERVIEW:

Co. announced 1Q07 GAAP net earnings of $156m, and GAAP EPS of $0.56.

THOMSON REUTERS

CORPORATE PARTICIPANTS

Ray Tharpe *Office Depot - Director-IR*

Steve Odland *Office Depot - Chairman, CEO*

Chuck Rubin *Office Depot - President-North American Retail*

Pat McKay *Office Depot - EVP, CFO*

CONFERENCE CALL PARTICIPANTS

Matthew Fassler *Goldman Sachs - Analyst*

Colin McGranahan *Sanford C. Bernstein - Analyst*

Gary Balter *Credit Suisse - Analyst*

Dan Binder *Buckinham Research - Analyst*

Bill Sims *Citigroup - Analyst*

Danielle Fox *Merrill Lynch - Analyst*

Steve Chick *JPMorgan - Analyst*

Jack Murphy *William Blair - Analyst*

PRESENTATION

Operator

Good morning and welcome to the first-quarter 2007 earnings conference call. All the 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.

Ray Tharpe - *Office Depot - Director-IR*

Thank you and good morning to everyone. Before beginning today's conference call I would remind you that certain statements made during this call are forward-looking statements under the Private Securities Litigation Reform Act. Except for historical, financial, and business performance information, comments made during this call should be considered forward-looking. Actual future results may differ materially from those discussed on this call due to risks and uncertainties, both foreseen and unforeseen. Certain risks and uncertainties are described in detail in our report on Form 10-K filed with the SEC on February 14, 2007, and in our form 10-Q filed this morning. During portions of this call, we may refer to results which are not GAAP numbers. A reconciliation of non-GAAP numbers to GAAP results is available on the Investor Relations area of our website at www.OfficeDepot.com. Now, I would like to introduce Office Depot's Chairman and CEO, Steve Odland.

Steve Odland - *Office Depot - Chairman, CEO*

Thank you, and thank you for joining us today for Office Depot's fiscal 2007 first-quarter conference call. With me today are Pat McKay, Executive President and Chief Financial Officer, Chuck Rubin, our President of North American Retail, and Ray Tharpe from Investor Relations. I hope you have had an opportunity to read our press release and learn about the first-quarter results. If not, the press release, along with accompanying webcast slides, are available on our website, www.officedepot.com. Just click on Company Information and then Investor Relations.

First-quarter sales grew 7% to $4.1 billion compared to the first-quarter 2006. Sales in North America were up 3%, while international sales increased 21% in U.S. dollars and 11% in local currencies. North American Retail comparable store sales were down 3% for the quarter. Our North American businesses were depressed by a few factors during the quarter -- the launch of Microsoft's Windows Vista operating system; and a continuation of the slowdown in housing sales; and a softening in small-business spending later in the quarter. North American retail division has a heavy tech weighting, whereas this is a relatively undeveloped category in the International division. As such, North American retail comps were materially impacted by the lack of supply of computers in the quarter, driven by Microsoft Windows Vista changeover on January 30. Subsequent to the Vista transition, retail comps have rebounded, but not enough to offset the negative impact in January of the reduced technology and related sales.

North American Retail division, as well as the North American Business Solutions division, have seen a softening in small-business spending. The trend in office furniture purchased mostly for small and home offices continued downward, as January represented the 14th consecutive month of year-over-year declines in total sales. Despite these soft market conditions, independent analyses indicate that Office Depot maintained market share among office supply stores during the quarter.

Office Depot recorded charges in the first quarter of both years associated with the implementation of plans announced in 2005 and disclosed in our previous SEC filings. Excluding certain items from both periods from the first-quarter charges, net earnings, as adjusted, increased to $168 million in the first-quarter of 2007 from $144 million in 2006, or 17%. Despite the challenges of the first quarter, we are very pleased to report an increase in diluted earnings per share, as adjusted by 25%, to $0.60 per share from $0.48 per share in the same period last year.

Gross margin declined 40 basis points due to the lower margins from acquisitions, higher paper costs, and a shift in mix in North American Business Solutions and International. Operating expenses decreased as a percentage sales by 70 basis points due to the leverage of higher sales and higher expense controls. EBIT, as adjusted, was $249 million for the quarter, or 6.1% as a percentage sales, up 40 basis points as compared to the prior-year period. Our as-adjusted effective tax rate for the quarter was 29.4% and we currently expect a full-year effective tax rate between 29 and 30%.

Net earnings for the quarter on a GAAP basis were $156 million, compared to earnings of $130 million in the same period of 2006, which is an increase of 20%. GAAP EPS, on a diluted basis, were $0.56 for the quarter, versus $0.43 in first-quarter of 2006, which is an increase of 30%. First-quarter charges had a negative effect on EPS in both years, $0.04 per share in 2007 and $0.05 per share in 2006. We recognized $12 million of charges during the first-quarter and anticipate charges of approximately $60 million for the remainder of 2007 and $37 million in 2008. However, future charges may change as plans are implemented.

We have provided a reconciliation of GAAP to non-GAAP results, which you can access on our website, www.officedepot.com.com, under the Company Information section and then Investor Relations. Now, Chuck Rubin will take you through the first-quarter results of the North American Retail division. Chuck?

Chuck Rubin - *Office Depot - President-North American Retail*

Thanks, Steve. First-quarter sales in the North American Retail division increased 3% to $1.8 billion. However, comparable store sales in the 1042 stores in the U.S. and Canada that have been open for more than one year decreased 3% for the quarter. Comps were negatively impacted during the quarter by the disruption in PC sales caused by the launch of the Microsoft Windows Vista operating system at the end of January, and a softening in business spending, particularly in furniture sales to small and home office customers.

As we previously discussed, the launch of the new Vista operating system during the first quarter essentially halted sales of laptops and PCs in the month of January, as manufacturers depleted supplies of pre-Vista units and Vista-equipped units were embargoed until January 30. Tech sales improved after the January 30 launch and returned to the levels we have seen prior to the impact of the Vista launch. However, these sales levels were not able to make up for the significant shortfall experienced in January.

A recent poll by Harris Interactive found that only 12% of respondents said that they planned to upgrade to Vista within the next twelve months, and only 20% said Vista would cause them to buy a PC sooner than they had planned. The main reasons cited for the reluctance to upgrade were fear of software bugs and compatibility with other hardware and software. Over time, we believe we could see an increase in laptop and PC sales, as our business customers become more comfortable with the interoperability of their existing software applications in the Vista operating system, and that, ultimately, the enhanced security that Vista provides will also motivate many of our customers to upgrade their operating systems and their computers. A lack of traffic due to the technology sales declined associated with the Vista watch also negatively impacted sales of products in other categories, including those that are directly and indirectly associated with the sale of computers.

Furniture continued to experience soft sales and accounted for over 150 basis point of impact to our overall comp sales decrease, as we believe continued softness in the housing market has negatively impacted our home office furniture sales. Average ticket size continued to increase. Comparable average sales per square foot were $265 for the quarter.

Despite these challenges, the North American Retail division generated a 15% increase in operating profit of $155 million for the first quarter of 2007, compared to $135 million in the same period of the prior year. Higher product margins, expense leverage, cost management initiatives, and a slightly lower remodeling cost helped to drive expanded operating profit margins to 8.4%, an improvement of 90 basis points from 7.5% in the prior year period.

Inventory per store was $946,000 as of the end of the first-quarter of 2007, a little higher than the same period last year due to early stocking of next-generation PCs and laptops at the end of the quarter. We remain pleased with the results of our overall remodel efforts, completing 80 remodels in the quarter. These remodeling activities have a short-term negative impact on our Retail results, but represent an important part of our longer-term Retail profitable growth strategy. We exclude a brief remodel period from our comps to account partially for some of the disruptions.

In addition to the remodels, we also opened 16 new Office Depot stores during the quarter. At the end the first quarter, Office Depot operated a total of 1174 office product stores throughout the U.S. and Canada. Our current plans are to open approximately 150 stores this year. We also anticipate opening approximately 200 stores in 2008. Most of these stores will be opened as fill-ins in markets in which we currently operate. We continue to be very disciplined in evaluating both individual new store openings and our overall execution strategy based on our hurdle rate.

Our financial model recognizes that the opening of stores as fill-ins is likely to negatively impact sales of existing stores. As an example, comps sales in first-quarter of 2007 were negatively impacted by approximately 50 basis points in the quarter by the effect of these fill-ins. Despite this impact, the impact on the total market is positive and the net effect hurdle's our IRR. We feel it is important to maintain and strengthen our market position in core market areas and remain committed to doing so.

To help you better understand our new store productivity, our stores mature over the course of approximately five years, with first-year sales equal to about 67% of their expected sales at maturity. In the first quarter, we completed remodeling 80 stores. As we stated last quarter, our goal is to remodel substantially all remaining North American Retail stores within the next few years. As of March 31, approximately 570 of the 1174 stores in North America were operating in the M2 * format.

Our design, print, and ship business continued to grow as we increased customer awareness through print and broadcast advertising in the first quarter. We are providing our store manager with flyers explaining the capabilities of our design, print, and ship business. Store managers are using these flyers to market to local business organizations in the communities surrounding their stores. Sales now average approximately $250,000 per store for this highly-profitable and growing business category.

We continue to expand private brand penetration in the first quarter, as furniture, supplies, and technology all had positive private brand comps for the quarter. In February, we introduced a new collection of furniture in North America. The collection, which utilizes an innovative hinged assembly method that significantly reduces setup time and effort, is constructed of solid wood and veneers. During the quarter, we also introduced a new premium tier private brand writing instruments called Foray Focus. This premium tier is initially represented by eight new products. Private brand percent penetration for North American Retail has increased to the mid-20s and we believe there is substantial opportunity for further penetration growth, as we continue to expand our assortment in each of our brands. While improving product margins, increasing private brand penetration negatively impacted comp sales by over 30 basis points in the first quarter.

Also during the first quarter, we shifted numerous mail-in rebates to instant rebates. This was part of our overall effort to optimize the value proposition and buying experience for our customers. However, the shift did negatively impact sales comps by 40 basis points in the first quarter.

We have rolled out in-home and in-office technology installation services on a nationwide basis. We also continue to pilot in-store technology services with the Geek Squad in our Orlando and Denver markets, and will likely expand the service more broadly. We are pleased with results so far.

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

Now, I would like to turn the call over to Pat McKay.

Pat McKay - *Office Depot - EVP, CFO*

Thanks, Chuck. North American Business Solutions division's sales increased by 3% compared to the first quarter of last year. First-quarter 2007 revenue reflects growth in the contract channel of 10%, including our Allied acquisition completed in 2006, which more than offset expected declines in the direct channel from our brand consolidation efforts, which deliberately reduced unprofitable business. As with Retail, sales in this division were impacted by a softening in business spending, particularly in small and medium-sized businesses, which is continuing into the second quarter.

The run rate of sales in former Allied office products customers, mostly in New York City area, is down significantly from pre-acquisition. This largely is due to the loss of a significant number of salespeople in New York during the acquisition process, mostly to smaller competitors, and many of whom were significantly out of sync with Office Depot's compensation systems, or had acted as independent contractors under Allied management. We also lost some customers due to service issues in the quarter, as we closed the former Allied distribution center in New York and transition fulfillment to Office Depot distribution centers. Previous integration efforts in markets throughout the country had gone well until this last facility.

While none of this was unexpected, we always want things to go as smoothly as possible during transitions and we don't like disappointing any customers. We are not happy with the way this New York integration went and we are working very hard to win back that volume. We have restructured our supply chain organization to enhance the service to these new customers in the Northeast and the good news is that most these customers have multiple suppliers and can flex their purchases back as our service problems are resolved. As of now, we have resolved most of the service issues and our launching new marketing efforts to win this business back and are hiring additional salespeople to drive this process.

The North American Business Solutions division had an operating profit of $73 million for the first quarter of 2007, as compared to $94 million in the same period of the prior year. Operating margins declined as expected for the first-quarter of 2007, reflecting a continuation of the temporarily-higher expense levels that were associated with an investment in the expansion of both our contract sales force, as well as the implementation costs associated with a new furniture delivery program. These expenses, which significantly raised operating costs in the first quarter, are expected to moderate over the next few quarters. Continued softness in small business spending will delay operating margin recovery efforts. Therefore, the BSD operating margin in quarter two should be down versus a year ago roughly the same amount, with the recovery efforts in the second half of this year.

The additions we made to our sales force in the fourth quarter are progressing through their training and are becoming productive contributors in the field, pursuing new, profitable customer sales. We expect new sales personnel to be fully self-supporting within nine to 12 months of joining our Business Solutions division.

We've also made excellent progress in the rollout of our new, enhanced furniture delivery service. The service will improve on-time deliveries to the location of the customers choosing and perform that light assembly and packaging removal services. We believe furniture delivery will further differentiate our furniture offering from that of our competition. But short term, this has cost about 25 basis points in margin for the quarter.

Leveraging the competency that we obtained in the Allied acquisition, we have begun to pilot coffee service offerings in select markets. These offerings will enhance our current break room position with small and medium-sized customers. We also continue to focus our selling resources on profitable service initiatives, like the enhancement of our print offering. We are now able to provide file cabinet functionality, enabling our customer base to store documents online and make changes to the documents and print them on an as-needed basis.

The delivery segment of the office products industry is highly fragmented and we are pursuing new profitable customers in this channel, mostly through organic means.

Our Internet sales continue to grow in 2007, with sales for the previous 12 months totaling $4.5 billion, compared to $3.8 billion a year ago. Clearly, the North American Business Solutions division has been challenged this past quarter and will continue to be so in the second quarter, but we are taking the appropriate steps to address the issue to invest and to develop this business and to drive long-term profitable growth.

Steve Odland - *Office Depot - Chairman, CEO*

Let's now turn the discussion to focus on our International division. The International division's first-quarter sales of $1.1 billion increased 21% in U.S. dollars compared to the first quarter of 2006. Local currency sales, including 2006 acquisitions, increased 11% over prior year. Importantly, all channels contributed to positive growth, and the division has realized its fifth straight quarter of sales growth in local currencies. Notably, contract increased by 9% versus the same period last year, reflecting our focus on new account acquisition, as well as expanding sales with existing customers.

Division operating profit was $82 million in the first quarter of 2007, compared to $69 million in the prior year's first quarter. Operating profit was down slightly to 7.6% in the first quarter of 2007. Excluding acquisitions, operating margins for the division expanded by 50 basis points. We anticipate that lower operating margins realized in our recent acquisitions will expand from their current levels as we execute our plans to leverage purchasing power and extract the plan synergies.

During the first quarter, the International division continued to execute against several initiatives to drive profitable growth. We redesigned the contract selling model to improve effectiveness and deliver more targeted value propositions to the customer. To drive incremental sales across Europe and Asia, we continued to expand our use of telephone account managers, and are doubling our sales force in China. These efforts contributed to the significant growth experienced in our contract sales channel during the quarter.

In the Direct channel, we also developed new offerings designed to attract new customers and strengthen relationships with existing customers. Examples of these offerings include the European green book, which highlights environmentally friendly office products, as well as the Work and Life Trends lifestyle products catalog, which has been successful in Germany.

We have expanded our international retail presence, opening six stores in Asia and five in Europe. Similar to our North American retail strategy, these stores are optimizing our density in the markets we currently serve and utilizing an M2 prototype that is customized to that individual market.

We've made great progress in establishing our regional offices in Asia and Latin America. We have opened our regional office in Hong Kong, our sourcing office in Shenzhen, China. We have already transition several of the large Chinese vendors from our former third party sourcing agent to our Shenzhen sourcing office.

Finally, we're pleased to announce that we've hired a managing director for Latin American operations and are establishing a Latin American regional office co-located with our global headquarters in South Florida. During the first quarter, we opened up an office in Poland, which will allow us to serve many of our international customers with operations in that country. We continue to assess further geographic expansion through acquisitions and alliances in targeted markets.

The international division has made good progress against its cost management initiatives in the quarter. We centralized our supply chain management structure in Europe, consolidating what had been 15 separate planning functions. We also successfully converted our warehouse in Ireland to our global warehouse management platform. We implemented several processes during the quarter to reduce spending through tighter expense control. Examples of these processes are standardizing printers in warehouses across Europe and automating the process for receipt of fax orders.

We have been able to reduce some of our inventory carrying costs through the implementation of a virtual stock program. Virtual stock allows us to continue to provide our customers with a wide variety of products, including those products that are not in high demand, without holding the product in our warehouse for long periods of time. We've also effectively implemented standardized tools for product pricing and marketing spend. These tools have been successfully in place in North America and were selected to be part of our global suite of applications.

Finally, we have completely negotiating master purchasing agreements with our European vendors. We now have agreements that are consistent across countries and that recognize our pan-European presence. We're very pleased with the progress that we've made this quarter in International cost initiatives and we look to continually increase our operating efficiency in Europe, Asia, and Latin America. Now, Pat McKay will take you through the cash flow and the balance sheet.

Pat McKay - *Office Depot - EVP, CFO*

For the quarter, free cash flow before share repurchases was $127 million, versus $211 in the prior year. The greater amount of cash flow was used this year for investments made in our core businesses. Cash provided by operating activities was $231 million, compared to $268 million in the prior year. Depreciation and amortization totaled $72 million for the quarter, down slightly from $75 million in period last year. Adjusted EBITDA was $321 million, an increase of 10% when compared to adjusted EBITDA last year.

Capital expenditures for the quarter were $104 million, up from last year due to the implementation of previously-announced plans to profitably grow our business. We now expect capital expenditures for 2007 to be about $500 million, or about $100 million lower than the number we provided last quarter, and we have lowered our estimates for 2008 expenditures to around $600 million and, also, would share with you that we expect CapEx in 2009 to be approximately $209 million -- excuse me, $500 million in 2009, as we continue to evaluate capital spending in accordance with our financial guidelines and refine the lease versus buy decisions. As we previously said, we may refine these estimates over time as we evaluate them based on our hurdle criteria.

During the quarter, we repurchased approximately 2.6 million shares of our common stock at an average price of $35, or $90 million in total. Subsequent to the end of the quarter, the $110 million remaining authorized for repurchases was substantially completed. Additionally, the Board approved an additional $500 million authorization to repurchase shares.

Now, onto the balance sheet. We ended the first quarter with $194 million in cash and short-term investments. Our investment in inventory totaled $1.6 billion globally. Our first quarter inventory includes inventories associated with recent acquisitions. We ended the first quarter with average inventory per North American store of $946,000, a little higher than the same period last year due to the early receipt of next-generation computers and notebooks at the end of the quarter.

Working capital increased by 34% as compared to the first quarter of the prior year, but excluding the impact of our adoption of FIN 48, working capital increased by 15%, which reflects the effective acquisitions completed in the prior year. Our accounts payable to inventory reissue remained relatively constant at 106%.

Our long-term debt at the end of the first quarter was $568 million, while adjusted debt, including leases, was approximately $4.5 billion. Our outstanding 2013 senior notes are rated investment-grade by both Moody's and Standard & Poor's. Our capital structure strategy has been to achieve a solid investment grade credit to access commercial paper markets and to lower our overall cost of capital. Our Board remains committed to maintaining flexibility in our balance sheet.

Return on invested capital for the trailing four quarters, adjusted for charges, increased to 16.1% from 13.3% in the prior year. Our return on equity adjusted for charges and credits for the trailing four quarters improved by 690 basis points to 23%, as compared to 16.1% for the previous four-quarter period.

As a reminder, we continue to review our internal financial reporting measures and may modify our external disclosures as appropriate. For example, we continue to evaluate the merits of presenting distribution costs as a component of cost of sales. That concludes my remarks and now I would like to turn the call back over to Steve.

Steve Odland - *Office Depot - Chairman, CEO*

Thanks, Pat. Shifting to the future, I will remind you that we have three key strategic growth priorities. First is North American Retail. We want to continue to improve store productivity and have accelerated our store expansion remodel plans. We are in the process of substantially refreshing our chain over the next few years. We opened 16 new retail stores during the quarter, with plans to open about 150 this year.

Second is North American Business Solutions. We plan on profitably growing our market share through new customer acquisitions and new product and service offerings, supplemented with available tuck-in acquisitions. We have not only grown our sales force, but we've devoted more of our existing sales resources to customer acquisitions. We have expanded our outbound sales and customer retention calls with our telephone account management group, and we have supplemented growth with a recent acquisition in the Northeast.

We've also introduced robust technical services offering for our small-business customers. We will lap the merger of brand in our catalog business by quarter three and the investments made since the quarter four of 2006, so margin recovery from recent investments in this division will be expected in the second half of this year.

Finally, International, our third strategic growth priority. We want to continue the progress that we've made in profitable market share growth in Europe and continue to increase our geographic reach. Our management team in Europe is making great progress achieving a fifth consecutive quarter of growth and improving. Our new management team in Asia has established a sourcing office that allows us to globally source a greater percentage of our private brand. We still need to complete a few of our restructuring initiatives in Europe and to realize the synergies from acquisitions made over the course of the year.

We have a business that generate substantial cash flow year in and year out. We can use our cash to profitably grow our business by opening new stores in new geographic markets, by making necessary investments in the core business, like store remodels and distribution facilities, and by acquiring assets or businesses in our key priority areas, and then, finally, repurchasing stock. While the launch of Vista operating system and the general business softening created a challenging condition in the first quarter, I'm very pleased that, still, we were able to deliver EPS growth of 25%. Remember, though, that the second quarter that we are in right now is our seasonally lowest sales quarter and will be difficult to show cost leverage, as small-business spending remains soft. But we are very pleased the progress that we've made to date relative to our growth in cost management initiatives and remain excited and confident about the long-term opportunities that lie ahead of us.

While no company is completely immune from the effective external events, we have established an environment here that insures that our team has every incentive to optimize results for our customers, employees, and shareholders over time. We've built a strong track record of delivering winning solutions both within the organization and to our external stakeholders and we believe that the initiatives we have described will yield profitable growth over the long-term. Now, I would like to open up the call for questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS) Matthew Fassler.

Matthew Fassler - *Goldman Sachs - Analyst*

I would like to ask two quick questions. The first relates to International. You discussed in the release and on the call the pressure on International EBIT margins from acquisitions that you did not own in the prior period. I know that -- I think all of these acquisitions were part of Office Depot in the fourth quarter, as well. Did they exert pressure, on a year-to-year basis, in Q4 that we just didn't see because of that organic growth? I'm just trying to get an understanding of when they began to have a detrimental impact on margin on a year-to-year basis.

Pat McKay - *Office Depot - EVP, CFO*

This is Pat McKay. One of the things that -- we had about a pretty consistent influence on the acquisition, perhaps a little bit more because we started to invest in developing some of the synergies in Q1 that we had not done in Q4. In addition to that, we made a number of investments. As we have talked before, Matt, one of the things that we do, like in our Business Solutions division and International, we invest in -- investment in that business actually occurs in the form of expenses. We had about 30 basis points in Q1, as well, in our base business of investment spending to be able to drive future performance. It's a combination of those two factors are some of the things that you saw influence the Q1 operating margin.

Matthew Fassler - *Goldman Sachs - Analyst*

To the extent that you disclosed that organic, apples-to-apples, International businesses were up 50 basis points in terms of EBIT margin in the fourth quarter. How does that -- in the first quarter, excuse me. How does that compare to the fourth-quarter trend?

Pat McKay - *Office Depot - EVP, CFO*

It is, if you look at -- again, if you included the effect of the investment spending, you would see about a similar type of increase in Q1, perhaps a little bit moderated.

Matthew Fassler - *Goldman Sachs - Analyst*

Got you. Second question, if you could talk to the softening in demand that you seem to see in North America and whether it impacted your core supplies business. You talked about technology in terms of Vista. You talked about furniture in terms of the macro or demand slowdown. What did you see in supplies during the quarter? Did that moderate, as well, late in the period as you saw this demand issue?

Chuck Rubin - *Office Depot - President-North American Retail*

Matt, good morning, it's Chuck. The supplies business was soft. It did moderate as we came back in the quarter. Keep in mind, we have spent a lot of time over the past couple of years building on our efforts in the stores on building a market basket and selling a solution. So as we saw at the beginning of the quarter, the slowdown due to the PC issue, the PC and laptop issue, that trickled over to other issues, but it did moderate as we got back into the computer business. The reason that we feel confident about the long-term future is that, overall, those efforts in the stores to sell that basket, to sell something in addition to a computer, and that includes core supplies, really has taken good traction. We feel good about it as we look out.

Matthew Fassler - *Goldman Sachs - Analyst*

Got you, but if you take a look at things like writing equipment and paper and things like that, did that experience some of the challenge that you talked to late in the period?

Chuck Rubin - *Office Depot - President-North American Retail*

You know, Matt, when we are out of computers, store traffic is hit all over, so I don't -- I think the supplies business is strong. The issue that January, we just went out of business. I think going forward, as we look at this, though, the estimates are that 75% of the world supply of computers are going to have to be replaced in order to effectively run the Windows Vista operating system. Now, the question is when that is going to kick in here, and I don't think it is going to happen next week, but I think in the next few quarters people are going to have to start to catch up here. So that is what we saw early on. We recovered nicely after Vista, but, you know, across all the categories, except really furniture, where the softening has been continuous over the past year.

Matthew Fassler - *Goldman Sachs - Analyst*

Got you, thank you very much.

Operator

Colin McGranahan.

Colin McGranahan - *Sanford C. Bernstein - Analyst*

A couple questions. First, focusing on the BSD division, can you talk about the organic growth rate of the business, excluding Allied, and possibly give some color on the difference in trends between contract organic growth, X Allied, and catalog, and if you saw any change in the catalog business?

Steve Odland - *Office Depot - Chairman, CEO*

Yes, the organic growth rate was 4%, X Allied. The contract business was up very strong and, again, we are continuing to lap the catalog consolidation. We should be lapped by the end of the second quarter and then the second half of this year, we're back to normal trends. If you look at the catalog business linearly, after we consolidated the catalogs, we've had a pretty stable business there. Therefore, we have pretty good confidence, here, that what we're seeing is just continuing to lap year ago. We're pleased with the results going forward in the catalog business.

We're also pretty pleased with our organic contract business. The Allied thing was a first-quarter issue. We had had great success in the Allied consolidation up to that point, but the important thing to know is that the service issues are solved and we are in the process of trying to hire salespeople to fill the slots. So we still have great confidence that that acquisition is going to be a positive one for us. It is just going to take a couple of months to get that back on track here. But most of this was in the New York City area, unfortunately, so different elements of the contract business, to answer your question indicated, here, but we're feeling pretty good about the second half of the year in BSD.

Colin McGranahan - *Sanford C. Bernstein - Analyst*

Okay. And then you said, obviously, the second quarter is a seasonally-linked quarter and expense leverages is a lot tougher. And in the first-quarter, you showed G&A dollars actually down year-over-year. Is that a sustainable trend to see an actual reduction in G&A dollars?

Steve Odland - *Office Depot - Chairman, CEO*

We've got hundreds of projects going on and a lot of people have asked us, well, is it over? The answer is no, the cost-savings efforts are not over. Hundreds of projects that we think can continue to bear fruit over time. Some of those are longer-term projects. Some of those are short. Some of those we've had to make capital investments to get the cost savings and so forth. So we think that the SG&A savings is something that we're going to continue to see.

The problem with the second quarter is that, particularly in the BSD business, expenses and cost structure in BSD are relatively structured, rather than the Retail business, where you can flex hours out along with sales, so you get more of a variability and you have more levers to pull in that business to gear the cost structure towards whatever you're experiencing. BSD needs volume to leverage it and given the seasonally-slow period, this happens. This is the seasonally-slow period every year. It has been going on forever. It is going to be tough to see it, which is why we're saying that the margins in BSD for the second quarter should be down, versus year ago, about the same amount that they were down in the first quarter, and that margin recovery should happen in the third and the fourth quarters. So we feel pretty confident about that happening.

Colin McGranahan - *Sanford C. Bernstein - Analyst*

Okay, and then just, finally, a couple of housekeeping items. Can you tell us what the $12 million charge was? Then, Chuck, you quantified the impact of cannibalization, private-label rebates, and furniture, but actually you did not quantify Vista. I know it is a little bit tricky because of the issue that traffic is generated by the PC category, but do you have any sense of how much that Vista hit your comps in the first quarter?

Pat McKay - *Office Depot - EVP, CFO*

Vista comps is, as we see it, actually I will give you the number and then Chuck will embellished on it a little bit, but impacted our comps by about 200 basis points in the first quarter. Chuck, if you want to talk a little bit further about that.

Chuck Rubin - *Office Depot - President-North American Retail*

Yes, Colin, to Pat's point, it was about 200 basis points. It was a combination of the actual hardware and all the peripherals that went with that that really dragged it down.

Colin McGranahan - *Sanford C. Bernstein - Analyst*

Okay, and then the $12 million charge?

Pat McKay - *Office Depot - EVP, CFO*

Then on the $12 million charge, what that includes is a number of things that we've been talking about in our disclosures. A number of the cost consolidation efforts that we been doing in Europe, as well as some of the continued efforts here in the United States and some of the network and supply chain consolidation efforts are what's being reflected in those charges.

Colin McGranahan - *Sanford C. Bernstein - Analyst*

Okay, thank you.

Operator

Gary Balter.

Gary Balter - *Credit Suisse - Analyst*

A couple of follow-ups, really, on Matt's earlier question just to understand. On the International, you mentioned that some of these acquisitions cost some money, but I think some of those were there in the fourth quarter, as well, so I am just trying to understand the difference between the Q4 results and the Q1 results.

Pat McKay - *Office Depot - EVP, CFO*

Gary, one of the things that we will do as we take on acquisitions, we will identify areas, just like in the rest of our business, where it is appropriate to make sure we make continued investments to be able to drive performance. So for example, we mentioned on the call that one of the things that we're doing, like in the U.S. and like in Europe, etc. is expanding our sales force. So the influence, for example, of expanding sales force or doing other kinds of things that help us to develop the business overtime has short-term degradation of those overall margins of those newly-acquired acquisitions. But, again, long-term, will end up bearing fruit, so those are the kinds of things that we've been seeing happening in the first quarter that weren't there in Q4.

Gary Balter - *Credit Suisse - Analyst*

Okay, so it is not the actual Company operating results. It is your decision to reinvestment back in to grow it, obviously. That's the way we should think about it.

Steve Odland - *Office Depot - Chairman, CEO*

Is really two things, Gary. If you think about the base business, the margins have expanded on the base business pretty consistently between the two quarters. The issue is, then, you have got the mix hit from the acquisitions. Remember, the acquisitions were not dilutive, but they were lower margin, and so you've got that mixing in, but at the same time, like, we think we mentioned that we're doubling the sales force in China, as an example. We've opened six stores in Asia, and so we're trying to invest early on, which was planned, again, and that's what is causing a little bit more of the impact from the acquisition. But we're very pleased with the results of the acquisitions and the growth that we're getting. Actually, they are little ahead. The growth is a little ahead of our pro-formas.

Gary Balter - *Credit Suisse - Analyst*

Okay, and on the core business, you talked about Vista and hitting 200 and you gave us some other reasons earlier in the call. Just to be clear, other than specific impact where you saw customer traffic down because of Vista, office supply sales sound like they have stayed relatively consistent, so that is when you're referring weakness in the business, you're not referring to the core business? It is furniture and computers. Is that the way we should read this?

Chuck Rubin - *Office Depot - President-North American Retail*

The Vista impact, we were out of business, essentially, in computers in January. That hit our store traffic entirely, so hit the whole market traffic and the (inaudible). So yes, it hit the core, that hit the core business, as strange as it sounds, because computers are so important to our traffic and our overall business and building the basket. It hit the whole business. So that is one way to think about it. If you exclude -- if you bucket the impact of Vista with that traffic and the impact to the rest of the store, than the rest of -- the core business, then, is relatively healthy after that. Obviously, furniture continues to be an issue. We are the largest office products -- office furniture supplier in the country and that ties very strongly to small office and home office.

Gary Balter - *Credit Suisse - Analyst*

So the comment from the press release later in the quarter by softening in spending by small-business customers, that is referring to furniture?

Chuck Rubin - *Office Depot - President-North American Retail*

Is furniture, but it is also BSD. We just did not see a lift in the back part of the quarter as we had hoped from -- following Vista. Part of that, Gary, is Vista, too. People are waiting on Vista, and so some of the softening, we think, is just people holding back until they perceive that Vista is ready for primetime.

Gary Balter - *Credit Suisse - Analyst*

Which could be, like, four or five years? Okay.

Steve Odland - *Office Depot - Chairman, CEO*

I'm not going to live that long, Gary.

Gary Balter - *Credit Suisse - Analyst*

Okay, thank you.

Operator

Dan Binder.

Dan Binder - *Buckinham Research - Analyst*

A couple of questions for you. First, I just wondered on a housekeeping item, can you give us the organic growth for International in local currency? I think you said it is up 11 total local currency. What did the organ number look like?

Pat McKay - *Office Depot - EVP, CFO*

The organic growth would be about 3%

Dan Binder - *Buckinham Research - Analyst*

3%, okay. Secondly, there was a line item in your P&L, amortization of deferred gains, I think, on the sale of a building. Is that number included in the $0.60 or included in the charges or net charges?

Pat McKay - *Office Depot - EVP, CFO*

That is included in the $0.60, because if you think about it, just took some of the accounting nuances, that is just taking -- we do the sale leaseback and there's a gain on the sale of this building and that is just really, effectively, part of the net rent cost.

Dan Binder - *Buckinham Research - Analyst*

Is that a ongoing -- are we going to see that line item going forward for some period of time?

Pat McKay - *Office Depot - EVP, CFO*

Just for the of couple of years that we're still our existing corporate offices, and then that will go away as we move. So for just the next two years.

Dan Binder - *Buckinham Research - Analyst*

Okay, and then on the contract growth rate of plus 10% in the quarter, as I recall, and maybe I am mistaken on this, but I think the contract growth rate last quarter was close to 20%. If that is correct, it would seem that the large business spending may be slowing, in addition to small and medium. Is that accurate?

Steve Odland - *Office Depot - Chairman, CEO*

Our contract business has some of the Fortune 500 in it, but our business would actually skew a little bit smaller than most. We have a lot of medium-sized businesses. We saw the softening on the small side, predominantly. Your question of -- small and medium, then in the contract side.

Dan Binder - *Buckinham Research - Analyst*

Okay, then on the cannibalization issue that you raised during the call during your formal remarks, I think you said about 50 basis points from new store builds. As the growth rate of stores accelerates, what would you expect that cannibalization (technical difficulty) to increase to over the next one to eight quarters?

Chuck Rubin - *Office Depot - President-North American Retail*

That will increase just a little bit. There seems to be some misunderstanding out there. We've had some questions and heard some comments that people think that our new store productivity is not as high as it used to be. And that is just simply not the case. These new stores are producing very well and that is why we have tried to provide a little more color on that. We're very pleased with the results and what we do is when we do in-fill markets like this, we take the entire market into account, including cannibalization, and with the new stores as well as including in the cannibalization from the existing stores, they are hurdling our 13% IRR hurdles and are very productive. So these are the right financial decisions to be making in the marketplace and, frankly, if we don't do it, our competitors will do it. So that makes it even that much more accretive to us. So as we expand, it is about 50 basis points this quarter. It will be a little bit more than that in future quarters.

Dan Binder - *Buckinham Research - Analyst*

Were the comp benefits from being open Easter Day this year meaningful at all?

Chuck Rubin - *Office Depot - President-North American Retail*

We were only open a couple hours and we were not open in every store, so it helped a little bit.

Dan Binder - *Buckinham Research - Analyst*

Then my final question, in terms of pricing at Retail, when you look at your pricing versus the competition, it looks like it has inched up a little bit over the last several quarters. You feel like it has maybe gotten a little too far ahead and is there anything that you would tie to the softness in comps to that?

Chuck Rubin - *Office Depot - President-North American Retail*

Dan, it's Chuck. We have talked many times before about our category management approach. We apply that approach to our pricing and we watch the marketplace in total. As we have talked before, it is a very diversified marketplace, a lot of people selling what we sell. So we're very conscious of our pricing. We still very good about it and we are competitive on all the critical products that we need to be.

Dan Binder Okay, great. Thank you.

Operator

Bill Sims.

Bill Sims - *Citigroup - Analyst*

Steve, a follow-up to the Vista question and your comments earlier. Given the sluggish response consumers are having to Vista and keeping in mind that your sales have improved since January, first, one, is there any risk, the markdown risks we should forecast in the quarter if we don't see any real pickup in Vista, which most people are not expecting? Two, alternatively, is there any discussion internally to try to bring back XP-enabled machines to drive the traffic until we do get that pick-up in Vista demand?

Steve Odland - *Office Depot - Chairman, CEO*

No, there is no markdown risk, because we just don't have that much inventory. The issue is, in our case -- remember, the vast majority of our business is to small and medium-sized businesses, right? Even the stores, two-thirds of our business is to small business customers, so this is not a consumer issue. It is a small business issue. Converting a small business is a decision that everybody is going to wait until they have to do this, but when they do it, is going to go quickly, I think. It is going to start quickly, because you have to then start converting whole offices. You can't just do it one machine at a time. So I think that by the end of the year, Vista sales are going to pickup. People -- there isn't going to be any XP, according to Microsoft, back in the marketplace and so their not going to sell it, so we can sell it.

Bill Sims - *Citigroup - Analyst*

Right, I just recently saw one of the large direct sellers of computers announced that they would start selling XP machines again after a very strong feedback from their customers demanding XP until some of the kinks of Vista were worked out, but that could be more a consumer customer, rather than a small-business customer.

Steve Odland - *Office Depot - Chairman, CEO*

It is a consumer customer. I can't imagine any business customer wanting to continue to do that, because that would just set them -- you amortize those machines over and the software over, what, three years? So it would just start the amortization cycle and it would put them, really -- I think people are just running out the amortization on machines and will convert as that happens. A lot of these things are leased and the software is tied to the hardware.

Bill Sims - *Citigroup - Analyst*

Okay, very good. Thank you.

Operator

Danielle Fox.

Danielle Fox - *Merrill Lynch - Analyst*

I have two questions. First, Chuck, your comments on new store economics were very helpful. I think you mentioned the 67% new store productivity target. Could you talk a little bit more about how they ramp up, particularly given the fill-in strategy? Should we expect these store to be accretive to comps in year two and three as they go from 67% of existing sales per square foot closer to 100?

Chuck Rubin - *Office Depot - President-North American Retail*

I'm glad you asked, because this is really important for people to understand, because we are investing more capital in the stores, but frankly, if these stores did not hurdle, we would not be investing any capital in new stores. But we're very pleased with the investment. And so what we see is it is about two-thirds of their total productivity happening in first year and that, as everybody knows, doesn't count in the comp. We see comp improvement, then, or contribution, in years two, three, four, and a little bit in year five.

So you see that over the course of time, but net-net, even when we open up our stores in our existing markets, what we do is we take a formula that takes all the attrition from the surrounding stores, adds that into that new store model, and we deduct that. We're seeing is that new store, deducting all of the attrition, still drives a hurdle above our 13% hurdle rates. So these are really good economic decisions for our capital. Now, if we see that diminishing, which we have not for the last two to three years, if we see that diminishing, we will back off and not open the stores.

Danielle Fox - *Merrill Lynch - Analyst*

Like I said, they're very helpful. Second thing is can you talk a little bit about the outlook for gross margin? It has kind of bounced around a little bit here over the quarter, and there were some one-time items, or there was sort of an extra week that you were lapping in the fourth quarter. I don't know if that have any impact, but should we expect gross margins to be up, down, flatfish for the rest of the year? If you can't provide that level of detail, just to think about some of the things that might change over the course of the next few quarters?

Chuck Rubin - *Office Depot - President-North American Retail*

You're right that the gross margins do bounce a little bit, because we have different mix and different seasonality and so forth. Remember, the first quarter is the back-to-business period. Second quarter is typically our softest quarter. Third quarter, we have got back to school in there, which is our heaviest consumer period. Fourth quarter is s pretty good quarter from a business standing. So that mix contributes across the Company at various points in time.

Also we have been diminished by our catalog business lapping. The catalog business, the direct business is good margin and so we have mixed down as a result of that. As we lap that in getting to the third and the fourth quarter, you should see the margin change come back. So we believe that our gross margins and our operating margins can continue to expand over time. We believe that because we have been able to leverage our incremental sales, even with the acquisitions. We believe that because we've got hundreds of projects going on right now, which are driving cost savings and are producing cash for us, and also we are working category management very strongly.

We think there is pricing upside over time. We have been hit with paper pricing, as we have talked about in the past and that has diminished our margins, particularly in contract, where we are hung out on a few paper contracts, but we're revising as many contracts (technical difficulty) for float paper, and so forth. Finally, we've got private brand penetration and we have now opened up our sourcing offices. As those ramp up, we ought to be able to contribute to the margin through our higher private brand efforts.

Danielle Fox - *Merrill Lynch - Analyst*

Thank you.

Operator

Steve Chick.

Steve Chick - *JPMorgan - Analyst*

Pat, just a simple question on your cash flow statement and your investing section. You have a line about proceeds from disposition of assets and advances returned and so forth. Is that -- what exactly is some of the activity there? Does that have any P&L implications?

Pat McKay - *Office Depot - EVP, CFO*

No, that was just basically we've done some lease-versus-buy decisions, so we have just had shifting in terms of how we're going to be able to financing some of our CapEx.

Steve Chick - *JPMorgan - Analyst*

Okay, this isn't -- there is no, kind of, disposal of assets and gains there that is in the P&L?

Pat McKay - *Office Depot - EVP, CFO*

No.

Steve Chick - *JPMorgan - Analyst*

Okay. (technical difficulty) acquisitions and payments for acquisitions, are these earn-outs or payments that you've made for acquisitions that you made previously? Or did you actually acquire some assets during the quarter?

Pat McKay - *Office Depot - EVP, CFO*

No, that was an earn-out payment, or earn-out payments.

Steve Chick - *JPMorgan - Analyst*

How much -- do you have a sense of where that, how much more earn-out payments you make as the year goes on?

Pat McKay - *Office Depot - EVP, CFO*

Think we're done, or we should be done. So there are some real small things that could happen in the future, but again, very diminutive relative to this.

Steve Chick - *JPMorgan - Analyst*

Okay, and last, if I could, it looks like you guys kept your store development, you know, 150 store target, intact and with the CapEx target being lowered a little bit, I'm sorry, maybe I missed it, but what -- were you coming in a little light on the CapEx spending?

Steve Odland - *Office Depot - Chairman, CEO*

Remember, we had CapEx laid out for our IT projects as well as supply chain. The biggest change was in our supply chain. We had planned the CapEx to purchase facilities and those facilities were planned for the latter part of this year and into next year, which is mostly why the CapEx ramped up. It is the most substantial piece of it. As we're coming off leases on our existing facilities, we're having to replace those.

So the initial assumption was that we would own, buy and own those facilities. We're now finding that that is more difficult than we thought and that we are, in fact, planning to lease those facilities again. So that has moderated the cash flow. So you're right. I think we need to make sure everybody understands this. We brought our cash, our CapEx numbers down substantially as a result of this change in lease verses buy, as well as some moderation in spending. So the numbers are substantially different over the next few years. We have said about 500 this year, 600 next year, and then back to 500. So this is not a continual ramp. This is a period in time. But those will continue to move over time as our plans change. We do not expect them to go up significantly from here, but they could wiggle.

Steve Chick - *JPMorgan - Analyst*

Okay, great. Thanks. That's helpful.

Operator

Jack Murphy.

Jack Murphy - *William Blair - Analyst*

A couple of quick follow-ups and then a question. First, Pat, could you just clarify, in the 200 basis point impact you said from Vista, did that apply just to January or -- I noticed a full-quarter number, but is there really anything outside of January in that 200 basis point number?

Chuck Rubin - *Office Depot - President-North American Retail*

Jack, its Chuck. The 200 basis points is the quarterly impact. It obviously was skewed to January, but we did see some higher returns post the Vista launch, we believe, from early adopters who were unhappy with the experience or something about their purchase, so they brought that machine back. But the 200 basis points is the overall quarterly impact.

Jack Murphy - *William Blair - Analyst*

Another follow-up is you talked a little bit about pricing. Could you talk about the competitive environment, both on the delivery and the retail side, in terms of what you are seeing? Have you seen any real change, given the pressure from some weak small business, home office spending?

Chuck Rubin - *Office Depot - President-North American Retail*

No. Generally, the pricing environment has been pretty stable and ongoing, so we have not seen any significant changes there.

Jack Murphy - *William Blair - Analyst*

Just the last question on the BSD side of the business, given the somewhat slower sales numbers, could you just remind us of how the sales force are compensated and how much of that is dependent upon just overall topline growth, and what impact if any that had on the P&L, both in terms how you think that might impact retention and turnover in sales force?

THOMSON REUTERS

Chuck Rubin - *Office Depot - President-North American Retail*

Yes, our BSD sales force, our contract sales force, remember, has been built. We have added hundreds of people over the past year. They reach productivity, meaning they pay themselves out, in nine to 12 months. We are still lapping that part of that investment and as we said, will continue to do so in the current quarter. And then we lap it into -- recover, the, and see greater productivity starting in the third quarter. They are -- they have base and bonus. The bonus is paid off of profitable growth, so sales, but also margin in that. If the sales do not come in, that part the bonus is diminished. But we have not -- look, we're very proud of our sales force and they are working very hard. The new people are very productive and we have very good retention and we intend to do so going forward.

Steve Odland - *Office Depot - Chairman, CEO*

We have run out of time. This concludes our conference call this morning and we would like to thank everybody for participating.

Operator

And that concludes today's call. Please disconnect at this time.