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ODP.OQ - Q4 2006 Office Depot Inc. Earnings Conference Call

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OVERVIEW:

ODP announced 2006 sales of $15b and 4Q06 sales of $3.8b. 4Q06 EPS were $0.48. 2006 EPS were $1.79.

CORPORATE PARTICIPANTS

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

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

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

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

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Colin McGranahan *Sanford Bernstein - Analyst*

Matt Fassler *Goldman Sachs - Analyst*

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Danielle Fox *Merrill Lynch - Analyst*

Daniel Binder *Buckingham Research - Analyst*

PRESENTATION

Operator

Good morning and welcome to the fourth-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. Ray Tharpe, you may now begin.

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

Thank you and good morning. 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 a report on Form 10-K filed with the SEC this morning.

During portions of this call, we may refer to results which are not GAAP numbers. 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*

Good morning and thank you for joining us for Office Depot's fiscal 2006 conference call. With me today are Pat McKay, our EVP 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 our fourth-quarter and full year-results. But if not, the press release along with the accompanying webcast slides for today's call are available on our website at www.OfficeDepot.com; click on company information and then investor relations.

Now turning to the results, fourth-quarter sales for Office Depot grew 3% to $3.8 billion when compared to the fourth quarter of 2005. But excluding the effect of the 53rd week from last year, sales increased 8% compared to prior year. North American Retail comps were up 1% for the quarter, which is the 12th consecutive quarter of positive comp sales.

Net earnings for the quarter on a GAAP basis were $135 million compared to earnings of $106 million in the same period of 2005. GAAP earnings per share on a diluted basis were $0.48 for the quarter versus $0.34 in quarter 4 of 2005.

We recorded charges in the fourth quarter of both years associated with the implementation of plans announced first in 2005 and subsequently disclosed in our SEC filings. Excluding certain items in both periods, which were primarily fourth-quarter charges and the effect of the 53rd week last year, net earnings as adjusted increased to $152 million in the fourth quarter of 2006 from $117 million in 2005.

Diluted earnings per share as adjusted increased 42% to $0.54 in the quarter from $0.38 in the same period last year.

Total Company operating expenses as adjusted improved 40 basis points to 25.9% of sales. EBIT, as adjusted, was $215 million in 2006 or 5.6% expressed as a percentage of sales, compared to the $188 million or 5.1% in the prior-year period.

Our as-adjusted effective tax rate for the full year was 29%, and 27% for the fourth quarter. For 2007, we currently expect a full-year effective tax rate of between 29% and 30%.

The fourth-quarter charges and other items had a negative effect on EPS in both years, $0.06 per share in 2006 and $0.04 per share in 2005, net of the effect of the 53rd week.

In addition to the charges in the fourth quarter of 2006, we recorded two other items. In anticipation of the completion of our new headquarters facility in 2008, we executed a sale leaseback in the fourth quarter of our current facility and realized a net pre-tax gain of $15 million. Unrelated to that, we recorded a separate charge of $16 million associated with the settlement of a legal matter. Fourth-quarter charges were $31 million, bringing the full-year amount to $63 million.

We anticipate charges of approximately $72 million in 2007 and $37 million in 2008. However, as always, future charges may change as plans are implemented.

We have provided a complete reconciliation of GAAP to non-GAAP results that you can access on our website at OfficeDepot.com, again, under company info and then investor relations.

Now highlighting our results for the year, sales for the full year increased 5% to $15 billion as we opened stores, increased our sales force around the globe, and completed our acquisitions. Excluding the 53rd week, sales grew by 6%.

GAAP earnings for fiscal 2006 were $516 million compared to earnings of $274 million in the same period of 2005. GAAP EPS on a diluted basis were $1.79 in 2006 compared to $0.87 in the prior year. As adjusted, diluted EPS for fiscal 2006 were $1.94, which was up 38% from the $1.41 level in 2005.

Our diluted weighted average shares outstanding declined by 9% in the year compared to the prior year, due to the impact of our ongoing share repurchase programs.

For the full year, EBIT, as adjusted, increased 26% from the prior year. EBIT margins expanded by 90 basis points to 5.5%. Our efforts to streamline our business have resulted in reduced costs and have been leveraged further with our higher sales numbers.

We're very pleased with the significant expansion that we have achieved in our return on invested capital. That expansion was 300 basis points in 2006 to 15.6%. We increased our return on equity by 730 basis points to 21.9%.

Now I would like to turn the call over to Chuck Rubin, who will take you through the details of North American Retail's performance for the quarter. Chuck?

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

Thanks, Steve. Good morning, everybody. Fourth-quarter sales in the North American Retail Division were $1.7 billion, about even with last year on a reported basis. However, sales increased 7% over the prior year after consideration of the impact of the 53rd week in 2005.

Comparable store sales in the 1,036 stores in the U.S. and Canada that have been open for more than one year increased 1% for the quarter, lapping a 5% comp in the year before. This represents our 12th consecutive quarter of positive comparable sales.

Year-round, our core shopper is generally a business customer. During the fourth quarter, however, we do see a heavier influence of personal consumers. During Q4 2006, we saw impacts to our business by a heavily promotional consumer sales environment, coupled with the lapping of 2005 hurricane recovery sales that helped boost sales in the fourth quarter of 2005. We expanded our private brand sales again, which negatively impacted comp sales but favorably impacted profitability.

By category, supplies were down slightly, with positive comp sales in core supplies like binders, filing, and paper. Technology grew significantly, with strong sales in notebook computers, cameras, GPS navigation systems, MP3 players, PC accessories, televisions, and warranties, even with an end-of-quarter drop-off in computer sales pre-Windows Vista launch.

Furniture continued to experience soft sales. Declines in furniture accounted for over 100 basis points of impact to our overall comp, as we believe overall softness in the housing market has negatively impacted our home office furniture sales. We remain, however, the number-one office furniture retailer in the U.S.

Beginning in the fourth quarter, our supplies of technology products as well as consumer demand slowed in anticipation of the January 30 Windows Vista launch. As a result, our pre Vista sales have been depressed. Post Vista, though, our comps have returned to normal levels. This may or may not impact the full first quarter depending upon the continual technology rebound as well as increased supply of computers and software from vendors.

Comparable average ticket size continued to increase; and average sales per square foot were $246 for the quarter. We remain pleased with the results of our overall remodel efforts and, accordingly, accelerated the number and timing of the remodels, completing 63 remodels in the fourth quarter for a total of 176 during the year.

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 the brief remodel period from our comps to account partially for some of this disruption.

In addition to the remodels we also opened 39 new stores during the quarter, bringing our total for the year to 115. Two stores were closed during the quarter. The North American Retail Division generated an operating profit of $122 million for the fourth quarter of 2006, compared to $103 million in the same period of the prior year.

Gross profit expressed as a percentage of sales improved over the year before, 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. We also had lower payroll and related cost as a percent of sales, reflecting improvements in our store operating activities.

Remodeling and new store activities raised operating expenses by 30 basis points compared to the fourth quarter of 2005. Despite these cost pressures, operating profit margin improved 120 basis points to 7.1% in the quarter, from 5.9% in the prior-year period.

Our results continue to demonstrate the benefits realized from the continuation of a disciplined approach to our operations, which include strong execution from merchandising and store operations, and from expense leverage on increased sales.

Inventory per store was $935,000 as of the end of the fourth quarter of 2006. This is abnormally lower than the prior year and seasonal levels, due to winter storms in the western U.S. which impacted late-quarter replenishment efforts and a lack of computers pre the Windows Vista launch. At the end of this first quarter, we expect that inventory levels will return to be more consistent with that of the prior year.

During the fourth quarter, we opened 39 stores, bringing our total to 115 for the year. At the end of the fourth quarter, Office Depot operated a total of 1,158 office product stores throughout the U.S. and Canada. We estimate opening approximately 150 stores in 2007 and 200 additional stores in 2008. Over time, we believe we can roughly double our store count to approximately 2,000 stores in North America.

We will continue to be very disciplined in evaluating both individual new store openings and our overall execution strategy, based on our 13% hurdle rate.

In the fourth quarter, we completed remodeling 63 stores, bringing our yearly total to 176. As we stated last quarter, our goal is to remodel substantially all remaining stores within the next two years. As of December 30, we had roughly 500 of the 1,158 stores in our M2 format.

Our design, print, and ship business grew by double digits in 2006. Printing functionality improved as we enhanced our online submission process; added convenience for our customers with a file cabinet feature, allowing them to store their documents with us and retrieve them to print when needed; and began testing several new offerings that will continue to expand our service offering. We also continued to rollout newer printing technology in our stores that provide lower cost, greater speed, and smaller footprints.

We continued to expand the assortment of private brand products available to our customers as well, adding 950 new products within existing as well as new categories in 2006. For example, in the fourth quarter, we introduced private brand products in ergonomic seating, fine stationery, and office snacks.

In the last six months, we have been conducting tests to determine the potential of providing technical support services in our stores. Our tests with the Geek Squad are ongoing.

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 to new stores and the 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 1% compared to the fourth quarter of last year on a reported basis. However, sales increased 10% over the prior year after the consideration of the impact of the 53rd week in 2005. From a channel perspective, fourth-quarter 2006 revenue reflects like-for-like growth in the contract channel of 21%, including our recent Allied acquisition, which then more than offset expected decline from the direct channel from our brand consolidation, which deliberately reduced unprofitable business.

Contract sales growth was somewhat depressed due to reduced sales to our government customers from delayed budgetary approvals. Looking forward, we would expect to see a continuation of sales compression in the direct channel due to the previous brand consolidation efforts until we lap this consolidation during the second and third quarters of 2007.

The North American Business Solutions Division had an operating profit of $72 million for the fourth quarter of 2006 compared to $108 million for the same period of the prior year. Operating margins declined for the fourth quarter of 2006, reflecting temporarily higher expense levels that are associated with the integration of our Allied acquisition and continued investment in the expansion of both our contract sales force, which accelerated late in the fourth quarter of 2005, as well as the expansion of our telephone account managers and the implementation costs associated with the new delivery initiatives. These expenses, which significantly raised operating costs in the fourth quarter, were the primary contributors to margin erosion and are expected to moderate over the next few quarters.

For example, we'll lap the accelerated levels of investment in our contract sales force; and we should see reduction in the costs assisted with the telephone account management program expansion; as well as benefits from the fully-integrated Allied acquisition, as those activities were substantially complete at the end of 2006.

The Business Solutions Division continues to expand its market share by targeting existing and potential profitable customers. We have continued to increase our sales force in order to effectively pursue new, profitable contract customers. We have also significantly expanded our use of telephone account managers to drive additional revenue growth from existing accounts. We found telephone account managers to be a very cost-effective and efficient way to grow our share of wallet.

For example, we're able to quickly and effectively introduce new products and service offerings to targeted customers without incurring significant additional costs.

We continue to focus our selling resources on profitable service initiatives like our design, print, and ship offering. We have dedicated some of our sales force to driving this business; and the resulting revenue growth in our contract channel has been tracking well into double digits.

The office products industry is still highly fragmented, and we're pursuing new, profitable customers through both organic means as well as possible tuck-in acquisitions like we did in 2006 with Allied. Our Internet sales continued to grow in 2006 with annual sales climbing to $4.3 billion from $3.8 billion in 2005.

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

Okay, now let's turn the discussion to focus on our International Division. The International Division's fourth-quarter sales increased 13% in U.S. dollars compared to the fourth quarter of 2005. Local currency sales also increased, but by 13% over the prior year, after consideration of the impact of the 53rd week in 2005. Importantly, all channels contributed to positive growth, and the division has realized its fourth straight quarter of sales growth in local currencies.

Division operating profit was $77 million in the fourth quarter compared to $57 million in the prior year's fourth quarter. Operating profit margin expanded by 120 basis points to 7.6% in the fourth quarter from 6.4% in the prior year, as modest gross margin pressures experienced from shift in sales mix were more than offset by continued improvements in operating expenses, as well as leverage achieved from higher sales. As expected, the acquisitions which we completed during the year did not contribute significantly to operating income, but also were not dilutive.

During the fourth quarter, we acquired a majority stake in Asia EC, one of the largest office supply companies in China, and our second acquisition in the region, following the Best Office acquisition in the second quarter. To support our expanding Asian presence we also established a regional headquarters in Hong Kong. We expect to continue to evaluate new market entries and tuck-in opportunities in the region.

Sales on an annualized basis for all of our international acquisitions in 2006 aggregate to approximately $300 million.

In the fourth quarter, the International Division increased the size of its contract sales force across Europe, Asia, and Latin America. We also increased the use of telephone account management to drive our share of wallet with existing customers. We plan to further increase our sales force and telephone account management to profitably grow sales during 2007.

In Europe, we introduced new sales vehicles focused on targeted customer groups. In the third quarter, we introduced our Green Book containing office products from environmentally sustainable sources. In the fourth quarter, we began distributing our work and life trends catalog, which is a seasonal publication focused on the needs of busy professionals whether at work, on the road, or at home.

We also launched a virtual technology sales model under the Tech Depot brand in Europe, providing our existing business customers with technology solutions without the use of bricks and mortar.

Also during the quarter, we established our global sourcing office in Shenzhen, China. This office will provide the global hub for our private brand and direct import activities, another of our stated strategies to further improve our overall cost structure and provide even greater value and innovation for our customers.

From a cost management perspective, we have continued the rationalization of our marketing and merchandising operations. We centralized our European postage contract and renegotiated our catalog print contracts. We also have standardized our merchandising contract procedures and extensively used e-auctions to leverage our global scale and reduce our purchasing costs. We have continued consolidating our warehouse and supply chain activities acquired through previous acquisitions; and we have grown our private brand penetration.

In the fourth quarter we implemented new automation tools in our customer order processing operations that not only reduce costs associated with processing incoming orders, but also reduce the number of processing errors. Finally we have reduced our G&A through tight expense controls.

Now, Pat, if you will take over and take us through the cash flow and balance sheet.

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

Sure. For 2006, free cash flow before share repurchases was $484 million versus $375 million in the prior year. This 29% year-over-year increase is attributable primarily to improved profitability as well as working capital improvements. Cash provided by operating activities was $827 million.

Depreciation and amortization totaled $279 million for the year, up from $268 million in 2005. Adjusted EBITDA was $1.1 billion, an increase of 19% when compared to adjusted EBITDA in the prior year. Capital expenditures for 2006 were $343 million, down from the previous estimate due to revised timing of spending and absolute reductions in previously planned spend.

We will continue to identify and execute on investment opportunities that drive returns above our cost of capital. Previously, we stated that we expected capital expenditures in the next two years to be between 600 and $700 million. After refining our plans further, we now expect 2007 CapEx to be in the range of 550 to $600 million, and 2008 CapEx to be between 600 and $650 million. Again, we continually monitor and evaluate our capital-based projects to ensure they meet our hurdle rate criteria. Consequently, we may refine these estimates over time.

During the quarter, we repurchased approximate 2.4 million shares of our common stock at an average price of $41 for $100 million. At the end of the quarter approximately 200 million remained authorized for future repurchases under repurchase programs previously approved by the Board of Directors. In 2006, we have repurchased approximately 26 million shares of our common stock for $971 million at an average price of $37 under these approved plans. In the future, we will continue to repurchase shares with excess cash flow.

Now on to the balance sheet. We ended the fourth quarter with $174 million in cash and short-term investments. Our investment in inventory totaled $1.6 billion globally. Our fourth-quarter inventory balance includes improving in-stock positions across all channels and recent acquisitions. We ended the fourth quarter with average inventory per North American store of $935,000, lower than the fourth quarter of 2005 and normal seasonal levels.

Working capital declined by 11% as compared to the fourth quarter of the prior year. This was driven by an increased accounts payable to inventory ratio of 100%, an improvement from the prior year's level of 97%. We continue to work on initiatives to drive improvements in working capital.

Our long-term debt at the end of the fourth quarter was $571 million. Our debt to total book capital ratio was 17.9%. Our outstanding 2013 Senior Notes are rated investment-grade by both Moody's and Standard & Poor's. Our balance sheet remains very strong and we are pleased that Standard & Poor's recently reported a change to a positive outlook with regard to our credit rating.

Return on invested capital, adjusted for charges, increased 300 basis points to 15.6% from 12.6% in the prior year and 11.2% just two years ago. Our return on equity, adjusted for charges, for the trailing four quarters improved 730 basis points to 21.9% as compared to 14.6% for fiscal 2005.

As a reminder, we continue to review our internal financial reporting measures and modify our external disclosures as appropriate. Beginning with our discussion of first-quarter results, we anticipate presenting distribution costs as a component of cost of sales.

Now I would like to take a moment and talk about our overall business model. As you know, we don't give specific earnings guidance; and one possible unintended consequence is that forecasts may become too bullish, thereby setting up a disappointment even in a terrific quarter. We wanted to make sure that people understand our business model so this doesn't happen.

While we have achieved 38% EPS growth in 2006 and nearly 30% EPS growth for the past two years, clearly straight-lining EPS growth at this level may not be sustainable. We believe we can deliver mid upper single digit top-line growth with very low single digit North American Retail comps. Category management in private brand efforts should allow us to deliver some margin expansion each year, and cost containment efforts should also allow some annual cost leverage.

Excess cash flow after investment for profitable growth may be used for share repurchases as long as we believe it to be accretive. Barring unforeseen circumstances -- for example, large shifts to lower-margin product mix, or customer segmentation, and/or irrational competitive activity -- this model should contribute solid mid to upper teens EPS growth.

Upsides to this model also exist from category management and marketing efforts, higher real estate expansion, sales growth from global investments in our contract sales force and telephone account managers, margin expansion from private brand and direct sourcing acceleration, and leverage from our supply chain cost control efforts.

We also believe our ongoing cost-reduction projects can continue to bear fruit in coming years. If the upsides transpire there is a possibility of exceeding our base model in some quarters over the next few years, but not every quarter.

We are pleased that we have a business model that is capable of robust growth. You should not count on our ability to minimize downsides and optimize the upsides every quarter, but we will do our best. That concludes my remarks. Now I would like to turn the call back over to Steve.

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

Thanks, Pat. During 2006, we focused on expanding our relationships with the existing customer base as well as acquiring new customers. We also continued to execute against our plan to streamline our operations. We believe that substantial progress has been made in each of these areas, but we also believe that there are significant opportunities for continued improvement. I would like to highlight some of the achievements in 2006 and then comment on some areas of future focus.

In 2006, our sales were $15 billion, which is a 6% increase over the prior year. North American Retail reported 2% comps for the full year, culminating with the fourth-quarter positive comp performance, making the 12th consecutive quarter of positive comps. We opened 115 stores in North America in 2006 alone, and we see plenty of opportunity for future new store openings. We have 150 planned for 2007 and 200 planned for 2008.

Our North American Business Solutions Division increased sales on a like-for-like basis by 9% for the year, successfully integrating the Allied office supply business, and continuing to add to its sales force.

Our International Division reported growth on a like-for-like basis of 7% in the year, also adding to its sales force and making progress implementing operational efficiencies and executing a number of acquisitions.

Adjusted EBIT margins increased 90 basis points, and ROIC expanded by 300 basis points to 15.6%, while ROE expanded by 730 basis points to 21.9%. All of these achievements helped to drive an adjusted earnings per share on a diluted basis of 38% compared to the prior year.

Now I would like to remind you that we have three key strategic priorities for growth. First is North American Retail. We want to continue to improve our store productivity, and we have accelerated our store expansion and remodel plans. We now have plans to substantially refresh the rest of our chain over the next few years. We opened 39 stores during the quarter, bringing our total to 115. But as Chuck talked about, we have had a tough comp environment in the fourth quarter due to the heavy promotional holiday season and we were lapping a tougher comp environment from the prior year.

We could continue in the first quarter to have a tougher comp environment due to the transition period associated with the launch of Microsoft Vista and continued softness in the furniture sales.

Second, North American Business Solutions. We plan on profitably growing our market share through new customer acquisitions, and new product and service offerings, and supplementing with tuck-in acquisitions. We have not only grown the sales force but devoted more of our existing sales resources to acquiring new customers. We have expanded our outbound sales and customer retention calls with our telephone account management group; and we have supplemented growth with recent acquisitions that we have discussed. We have enhanced our e-commerce site's content and functionality.

But we're going to have to lap the merger of our brands in the direct catalog business during the second quarter. So the comparisons in the first and second quarter still will be tough in this segment.

Then finally International. We continue to make progress in profitable market share growth in Europe and increase our geographic reach. Our management team in Europe is making great progress, achieving a fourth consecutive quarter of growth and improving profitability. Our new management team in Asia is establishing the sourcing office to allow us to globally source a greater percentage of our private brand products, which will increase our margins.

Finally, we completed acquisitions, as you know, reflecting our confidence in the ability to expand our reach in emerging markets. We still need to complete our pan-European supply chain and organizational restructuring over the next two years, especially in Europe.

So we have a business that generates substantial cash flow year in and year out. We can use our cash flows to profitably grow our business by opening new stores, opening new geographic markets, making necessary investments in our core businesses, like store remodels and distribution facilities. We can acquire assets or businesses in our key priority areas. And we can continue to repurchase stock, as long as we believe it is accretive.

So we are really pleased with the success that we have had and the significant progress that we have made relative to our growth and cost-management initiatives. But we remain very excited and confident about the opportunities that lie ahead of us. We believe that the base business model that Pat described can deliver a solid to mid upper teens growth; but that we have potential for further upside from that level depending on the quarter.

We have established an environment that ensures that our team has every incentive to optimize these results for our customers, employees, and shareholders over time. We're building a strong track record of delivering winning solutions both within the organization and to our external stakeholders, and that we believe that we are well positioned to continue on this course. Now, I would like to open up the call for questions.

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

We're waiting now for -- if we could have the operator come on to open up the call for questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS) Colin McGranahan.

Colin McGranahan - *Sanford Bernstein - Analyst*

I wanted to focus on the BSD business first. I guess three questions. First, can you talk about the organic growth in the fourth quarter, ex-Allied and adjusted for the 53rd week? So just to try to get an understanding of what the underlying organic growth rate on an apples-to-apples basis was in the quarter.

Secondly, if you could talk more specifically about the performance of Allied and what kind of integration costs you incurred.

Then more broadly, what you mean by this new delivery initiative and the costs or the expense pressures we saw in the quarter, and why you think those will be temporary, and to what degree this was really an anomaly versus a lower-margin outlook.

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

Sure, I would be happy to take that. The organic growth, if you exclude the 53rd week in total, the BSD business grew by 10%. If you exclude Allied, that takes off a few percentage points from that. So we had very good, solid mid single digit growth in the organic business.

We did take the opportunity to invest heavily in this business, and those results were impacting the margin for BSD in this quarter. Those investments included the final transition of the Allied facilities, the distribution facilities, into the Office Depot facilities; the closure of the office; and the transition of the back office activities. So all of the Allied transition costs now are complete as occurred in the quarter.

The delivery initiative is an investment in moving to a third-party delivery process for our furniture products, which allow us for the first time to significantly improve furniture delivery and reduce the customer issues in that business. Whereby we provide two-man teams through this third party and they deliver the furniture, scheduled in a tighter time frame, take away the old furniture. So this is a really big improvement.

So the costs that -- oh, the final thing was, Colin, the investment in the sales force, which ramped up starting at the end of 2005, but we have added hundreds of salespeople.

So we will continue to see a little bit of margin pressure from those investments in the first quarter. They should start to ameliorate and will get back to normal in the second and the third quarters. So I think it is a really appropriate investment back in the core business.

Colin McGranahan - *Sanford Bernstein - Analyst*

Can you quantify at all the Allied costs, the transition of the Allied DCs, and the transition of the back office?

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

You know, we haven't laid that out, but it is about 50 basis points.

Colin McGranahan - *Sanford Bernstein - Analyst*

Okay. Then you said you have added hundreds of salespeople. That is over the last year?

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

Over the last -- yes; since the beginning in December of 2005, we have added many hundreds of salespeople. For competitive reasons, I prefer not to give the exact number.

But we are very pleased with the productivity of the salespeople. We started at that point and tested it to see whether we could add them productively. We can. They have ramped up very well and they are paying out. So we accelerated that again in the fourth quarter.

Colin McGranahan - *Sanford Bernstein - Analyst*

Okay, so in 4Q '06, you continued to add significant number of contract salespeople?

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

That's right. Remember, also, last year we had the 53rd week, which is about 50 to 60 basis points.

Colin McGranahan - *Sanford Bernstein - Analyst*

Right, okay. Thank you.

Operator

Matt Fassler.

Matt Fassler - *Goldman Sachs - Analyst*

I would like to begin with just a couple of detailed financial questions on the income statement. If you could talk to us about the allocation of the charges among the different divisions; and then also if you would be kind enough to give us the unallocated G&A number. I guess we would typically find it in the Q or the K. But if you have that number, it would be extremely helpful.

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

Pat, do we have that unallocated G&A number?

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

Yes, let me grab it; it will just like take me a moment.

Matt Fassler - *Goldman Sachs - Analyst*

I can ask a follow-up if I may. But my follow-ups relate to the technology business, and I guess it is two different parts. The first was you talked a bit about the consumer environment and promotional dynamics in the fourth quarter. Presumably some of that relates to TVs; and certainly we have heard similar comments from lots of different retailers. Did your experience this fourth quarter lead you to reconsider the way you're thinking about that consumer business? Specifically with regard to technology and how you might come at it, particularly over the next holiday season.

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

No, we added some flatscreen TVs in the fourth quarter here. But that is predominantly for business purposes. In all small businesses and so forth that -- using those monitors and so forth. We have sold TVs profitably. It is not a big part of our business, but it was a good add and we managed the end of life very well. Our challenge has been to try to get the supply of computers and laptops in pre Vista. Chuck, you may want to talk about that.

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

Yes, to that point, Steve, we did manage I think our technology business well from a inventory standpoint. So as Steve said, we made money on TVs, which you called out. We did see our PC sales slow towards the end of the fourth quarter, partially due to supply and I think customers also waiting for the launch of Vista. We think this is a temporary issue, and post Vista we are selling back at the levels that we have been expecting and seen in 2006.

Matt Fassler - *Goldman Sachs - Analyst*

So to the extent that, Steve, some of your comments suggested that some of that could continue into the third quarter, the first quarter as well, rather, that was primarily January you were discussing, before the Vista release?

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

Yes, Vista launched January 30, which was well into our first quarter, and we saw some issues on supply of computers during that time. But post the Vista launch -- understand Vista gets a lot of play as a software package for people buying the software itself. But understand there was a significant transition in the hardware that was timed to coincide with that January 30 date. So since January 30, what we are seeing in terms of sales is living up to what we expected and had seen in previous quarters.

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

I think it is important to point out that the vast majority of the installed base of computers will not run Vista with full functionality. So what we had to do is run down all the supplies in all of our systems, in the stores and throughout the distribution system, and replenish it in anticipation of the January 30 launch.

But the good news is that now every computer sold is with Vista; and going forward, every computer practically in the entire world is going to have to be replaced in order to run Vista. So in the medium to long term here, this should really benefit our technology sales.

Matt Fassler - *Goldman Sachs - Analyst*

Understood. Then just on that G&A number from Pat?

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

Yes, that is $67 million for the quarter.

Matt Fassler - *Goldman Sachs - Analyst*

If I were to compare that $67 million with the prior year, it looks like that would have been around $88 million. So is there anything behind that significant decline? Anything particularly noteworthy?

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

Well, I think last year you will remember that we had some contributions that we had done as part of our year-end process; as well as I think there's some cost savings that we have been implementing this quarter as well.

Matt Fassler - *Goldman Sachs - Analyst*

Got you. Okay, thank you very much.

Operator

Bill Sims.

Bill Sims - *Citigroup - Analyst*

I have two questions. First, Steve, can you comment on the replenishment disruptions you saw at the end of the fourth quarter? Did it have any impact on your fourth quarter sales, or should we expect any (indiscernible) issues impacting your first-quarter sales?

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

Yes, there's a couple aspects to our replenishment. First of all was the shortage of supply of computers, which started in December and continued into January.

The second piece were the weather disruptions from all of the storms. That kind of stuff we deal with all the time, but it did disrupt us a little bit in there. We are back in-stock now on computers here post Vista and things are going strong. But yes, Bill, it did impact December and into January.

Bill Sims - *Citigroup - Analyst*

Then my second question is one of your largest suppliers indicated they were going to push through large price increases in 2007. How are you responding? Is this just an automatic -- you are passing these prices on to your customers? Or is there more a shift into private label products to offset some of the national brand price increases?

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

I'm not sure which supplier you are talking about.

Bill Sims - *Citigroup - Analyst*

(inaudible) [Adco].

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

Adco? Chuck?

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

Bill, I'm not sure that we are expecting to have any pressure on cost increases through Adco.

Bill Sims - *Citigroup - Analyst*

Okay, very good. Last question. Can you comment on HP's move to try to squeeze own brand ink out of some of the retail stores? You have chosen to maintain the no-brand strategy in addition to HP. Can you give us an idea of your philosophy on the strategy you are pursuing?

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

Well, we think it is critically important to provide choice for our customers. Our strategy is to provide a good, better, and best range of products. Of course, HP is represented well in our stores and continues to do well. We also provide our own private brand because we think that is an important part of our offering.

We also have -- in a few hundred stores, we have ink refill stations; and we have plans to expand that in the future. We don't think it is in the best interest of consumers or business customers to limit choice, and we think it would be a mistake for anyone to do that.

So our strategy is to always provide the consumer choice and give them what they want. This has worked very well for us, and we have seen a pickup in our business because of it.

Bill Sims - *Citigroup - Analyst*

Thank you.

Operator

Michael Baker.

Michael Baker - *Deutsche Bank - Analyst*

Just a couple. One, so the supplies business was down but the core supplies are up. So just, A, curious (inaudible) core supply.

Then (inaudible) the whole supply business being down is a little bit of a change in trend from the third quarter. Is that a macro issue or is that an issue of cycling the hurricanes from a year ago? So, how does that look into the first quarter?

Then my second question -- would you speak on the CapEx? It looks like you pulled it back a little bit. Maybe some projects that didn't quite hit your hurdle rate? Is that the correct to read there? If so, what were those projects? Thanks a lot.

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

Michael, this is Chuck. I will take the first part of the question. On our supplies business, yes; during the fourth quarter there was some hurricane impact from the rebound of 2005, as businesses in 2005 had to go out and replenish everything.

But the other part that we classify as part of our supplies product grouping is desk accessories. As we have talked about with our furniture business, the challenges facing that, that trickled over to everything that you would use with furniture. So it trickled over into lighting, it has trickled over into desk accessories. So that was the biggest contributor to our challenge in our supplies business.

But the core component of supplies for the fourth quarter, as we called out a couple of examples, was pretty stable. As far as the CapEx, I will turn that back to Steve.

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

Yes, in the last conference call we were trying to help out with people's modeling, and we issued some numbers in the 600 to $700 million range just to give some guidance. Since that call, we have finalized our 2007 specific CapEx plans, and we have refined that to 550 to $600 million for 2007.

So it was more of a refinement, Michael, than anything else. But we will not spend CapEx unless we have discounted cash flow analysis that says that it will hurdle our IRR requirements and that it will be accretive to our ROIC. We will not waste capital.

So as we go forward, we're going to continue to refinement that. So even though we said we are going to open up 150 stores this year, if we can't find 150 stores that we think will make us money we won't open them. Because we just simply are not trying to chase unprofitable growth. We will not chase unprofitable growth.

That is part of our real estate strategy. It's also part of our comps strategy. We don't want to just drive comps they don't drive results. We want profitable growth in this thing. So.

But we think that we can find 150 sites and we can find 200 next year that hurdle, and so we will continue to open that. So it is a refinement in our budget, but that does bring our cash flow number up from a lower CapEx use.

Michael Baker - *Deutsche Bank - Analyst*

Okay, thanks.

Operator

Mitch Kaiser.

Mitch Kaiser - *Piper Jaffray - Analyst*

I was hoping you could give us the buckets on CapEx between kind of new stores, remodels, and then any systems that you might have. Because when I kind of go through my model and have an understanding of what CapEx is per stores, there is a pretty significant delta. Could you give just a little more color on that?

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

I think we have characterized the new store openings as taking between $1 million and $1.5 million a store. We characterized the remodels as being around $250,000 per store, and it depends on how many remodels that we get done.

We also are in the process of working through our IT systems and replacing many of our IT systems, especially as we now finish our streamlining in Europe and move to one consolidated ERP system with Oracle. We are currently running, as you may or may not know, we are running SAP in parts in Europe. So we have got all these systems that we have got to replace; and we have got that planned for this year.

Then finally, we're replacing a couple of our distribution centers. We are out of capacity in a couple of places. Those projects have very good IRRs, as we are consolidating facilities and adding some square footage. But that hits us exceptionally this year.

So that is probably -- IT and supply chain are probably the two areas, Mitch, that account for the delta.

Mitch Kaiser - *Piper Jaffray - Analyst*

Okay, so that could be almost half. Those collectively could be almost half of the CapEx this year; that's right, correct?

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

It is a big chunk. I would have to think about whether it is half.

Mitch Kaiser - *Piper Jaffray - Analyst*

Then with Geek Squad you said that those tests are ongoing. Could you just refresh us where you are at with that; and then maybe anything that you could share in terms of how that is going?

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

Mitch, this is Chuck. We are offering tech services through a variety of partners. Geek Squad is one of those. We are currently in market in Orlando as well as in Denver offering Geek Squad services. There's different components of the tests in those two markets. The tests continue, and we are committed to offering our customer the services.

As far as specifics on the Geek Squad, we would not provide that just yet, as it is still in a test. But as I say we are in those two markets. We started with Orlando and we moved it to include Denver.

Mitch Kaiser - *Piper Jaffray - Analyst*

Okay, when does Denver start?

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

Denver is up and running now. It is a different format than we are doing in Orlando, but it is operational now.

Mitch Kaiser - *Piper Jaffray - Analyst*

Okay, thank you.

Operator

Danielle Fox.

Danielle Fox - *Merrill Lynch - Analyst*

I just have a follow-up question on inventories. On a total Company basis, it looks like inventories were up 15% versus, I guess, on a like-for-like basis sales up 8%. In your comments you mentioned a number of times that retail inventories were low. So what accounts for the difference between the 8% and the 15%? Is that primarily acquired inventory from some of the acquisitions?

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

Yes, first of all, if you look at inventory on a per-store basis, our inventory per store dropped year-over-year. So that is one good way to look at it. The rest of the delta is due to acquisitions and foreign exchange, which will ameliorate itself. Do you want to --?

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

Yes, so if you take into consideration that all of the acquisitions were not completed as of the beginning of January, so when you take a look at the full-year effect of the acquisitions, you're going to get a little bit more disproportion in terms of the influence of the acquisitions on the inventory related to sales.

Then FX again moved by about 9% or so for the year end. So that is part of -- as you take a look at our European inventories, it will have some impact as well. It is really a combination of those things. If you peel those back, Danielle, you get what you would expect in terms of the overall performance (multiple speakers) year over year.

Danielle Fox - *Merrill Lynch - Analyst*

Okay. That is helpful.

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

Inventory is a very high focus for us. We gear it, other than that exception, we gear it towards the number of stores to make sure that we are controlling it. There is a very high focus to make sure inventory is in control. We do not have inventory issues.

Danielle Fox - *Merrill Lynch - Analyst*

Okay, then just one other question. You provided some high-level guidance. There is actually a little bit more detail than I think we have heard before in terms of moving from this 30%-plus EPS growth rate to something in the range of the mid to high teens.

I am wondering if this is also the beginning of a shift in relative emphasis from more operating margin driven growth to more top-line driven growth. Essentially should we start to see more of a balance? Because it sounds like a lot of the drag -- well, there were some drags in the quarter that were related to investments for future top-line growth. So should we start to see more of a balance between top line and margin?

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

Yes, that is a good question. What we're trying to do is to make sure people really understand our strategy and the business model. So what we have tried to do is characterize a base business model, saying -- this is a great business model that can produce, with the kinds of numbers we talked about, it can produce mid to high teens kind of growth. But that on top of that, we still have opportunities for cost savings, margin expansion through private brands, top-line expansion through all the things we have talked about. I won't repeat it.

So therefore, we can continue to, we think, over time to beat that base model. It may not be every quarter. So we are just trying to make sure that people don't get their estimates out ahead of ourselves, straight-lining a 38% EPS growth, which is what we have had, and 30% over the past two years.

So it is not signaling anything other than to remind people that we really had an exceptional period of time. We think great opportunities for the Company going forward, but let's be careful not to straight-line these numbers.

We will not chase unprofitable growth, period. We will not chase it. So we will invest where we believe that there will be high returns on that investment, which is what we talked about in the fourth quarter for the BSD division and going forward.

So we definitely need to have profitable growth. We definitely think, though, that there is continued room for margin expansion through our cost efforts.

Danielle Fox - *Merrill Lynch - Analyst*

Thank you. Very helpful.

Operator

Daniel Binder.

Daniel Binder - *Buckingham Research - Analyst*

Just a couple questions. Just on housekeeping, first. Could you give us an idea of what the organic growth in the International Division looked like, excluding acquisitions, obviously? And then what the traffic number looked like for North American Retail? That is my first two questions.

The third question was related to the acquisitions that you have done, in Europe in particular. What would be a reasonable expectation in terms of organic growth for those acquisitions going forward? Maybe you can include in that discussion really all the acquisitions you have done in the last year.

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

That is a lot of housekeeping, Dan.

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

You must have a big house.

Daniel Binder - *Buckingham Research - Analyst*

Well, the housekeeping was the traffic and the organic growth. The other one was more of a modeling question.

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

Well, the North American Retail traffic was positive in the quarter. Actually both components were positive, but it was a modest positive.

In International, our fourth-quarter sales increased 13%. Local currencies increased 13%. Organically, it was about 4%, excluding all the acquisitions and cleaning it up for the 53rd week and so forth.

Daniel Binder - *Buckingham Research - Analyst*

That's local?

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

Yes.

Daniel Binder - *Buckingham Research - Analyst*

Okay.

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

That's correct.

Daniel Binder - *Buckingham Research - Analyst*

Then with regards to the acquisitions, I guess I am just trying to figure out how -- they are all relatively small businesses, I guess, with the exception of Allied, I suspect in their early growth.

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

Yes, we characterized the International acquisitions as being about $300 million on an annualized basis, spread across, I think, five or six different countries. The good news is there that the acquisitions were not dilutive even in their first partial year.

So these have been the kinds of acquisitions that we really like to do. Acquisitions of good businesses that are producing cash flow already, that give us a base of operations from which to expand our global operations and leverage global customers. So we can continue to leverage then our existing business, then, in those countries. So these are really strong acquisitions.

Then the U.S. acquisition of Allied added annually roughly was characterized at about another $300 million. So those are the kind of acquisitions that I think you can expect for us on a base basis going forward.

Daniel Binder - *Buckingham Research - Analyst*

I guess I was just thinking about just from a modeling standpoint a lot of these are smaller companies that are probably in more hypergrowth stages. Are we looking at more like solid double-digit, like 20, 30% type growth out of those acquisitions going forward, given their relative small size? Or something lower?

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

You know, we're not actually sure. We hope so. The question is how much can we leverage from our existing customers in those areas. But you're right, they are small, and that is probably not a bad number.

Daniel Binder - *Buckingham Research - Analyst*

Then a final question on store labor. You mentioned it was lower. I was just curious how much of an offset that was on the expense side in terms of basis points.

Then I'm also just trying to reconcile the reduced labor with the improvement in print services. That seems like that is a little bit more labor-intensive. I am just kind of curious what you have been able to do with the labor model to afford an improving business there, which requires higher labor and keeping service levels up overall.

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

Yes, no, no. Our labor has been really stable in the last couple of years. Our part-time/full-time ratios have been stable. What we have tried to do is reorganize the work in the stores in order to drive the labor hours to the copy and print business that we talked about, as well as to tech, and away from the non [task] kinds of things.

We are getting some leverage on it. But our labor hours in our models are still very strong. So what we have been working through are the -- and standardizing operations across the country, which we didn't really do very well before. So I would characterize it as a remix of where we are focusing the labor to the exact places that you just mentioned.

Daniel Binder - *Buckingham Research - Analyst*

Great, thanks.

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

With that, I guess, I think we are out of time. We would like to thank everybody for joining us today, and we look forward to talking to you in the future.

Operator

Thank you. That concludes our call.
