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ODP.OQ - Q3 2004 Office Depot Inc. Earnings Conference Call

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OVERVIEW:

ODP reported GAAP EPS of $0.28, which is at the high end of Co.'s earlier revised guidance at $0.01 below last year's $0.29 per share. 3Q04 sales grew by 3% to $3.3b. Co. announced a $500m share repurchase program. ODP remains comfortable with the full year EPS guidance of $1.08-1.14. Q&A Focus: Retail business, Europe, contract business, pricing, and remodels.

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PRESENTATION

Operator

Good morning. We would like to welcome you to the Office Depot third quarter 2004 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 questions. At the request of Office Depot, today's conference is being recorded. I would like to introduce Mr. Sean McHugh, Director of Investor Relations, who will make a few opening comments. Mr. McHugh, you may begin.

Sean McHugh - *Office Depot, Inc. - Director, IR*

Good morning and thank you. Before beginning today's conference call, I would remind you that certain statements made on this call are forward-looking statements under the Private Securities Litigation Reform Act. Except for historical financial and business performance information, comments made on 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 26, 2004 and in our 10-Q filed with the SEC this morning. During portions of this call, our chairman and CEO, Neil Austrian, and other executives will refer to results of our third quarter 2004 which are not GAAP numbers. A reconciliation of non-GAAP to GAAP results is available on our website at www.officedepot.com. Now, I would like to introduce Office Depot's Chairman and CEO, Neil Austrian.

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

Thanks, Sean. Good morning, everyone. Joining me today on the call will be Charlie Brown, our Chief Financial Officer; Rick Lepley, our Executive Vice President of North American Retail; and Chuck Rubin, our executive Vice President and Chief Merchandising and Marketing Officer. Before I turn the call over to Charlie, I would like to quickly recap our third quarter. Third quarter sales grew by 3% to $3.3 billion. We recorded GAAP earnings per share of 28 cents which is at the high end of our earlier revised guidance and a penny below last year's 29 cents per share. North American retail posted its third consecutive quarter of positive comps despite a very challenging back-to-school environment. North American retail profitability improved, primarily due to improved comparable product margins and operating cost controls. Profitability improved in our business services group thanks to continued store and warehouse expense reductions. Sales challenges limited the performance of our international group. As we stated back in September, we're working diligently to improve the performance of our contract sales force in Europe. Our global eCommerce sales increased by 15% to $771 million for the quarter and we remain on track to record over $3 billion in eCommerce sales for this year.

And finally, we announced a $500 million share repurchase program. We think this clearly demonstrates our commitment to driving shareholder returns and affirms our belief in the future prospects of Office Depot. I'll have some additional comments and thoughts for you at the end of the call, particularly concerning my immediate priorities and goals. For now I'll let Charley, Rick and Chuck provide you with detailed insights on the quarter. Now, let me turn the call over to Charlie Brown, our Chief Financial Officer, to discuss the third quarter financial results.

Charlie Brown - *Office Depot, Inc. - EVP & CFO*

Thanks, Neil, and good morning, everyone. I would now like to share more insights into our third quarter and year-to-date performance. As you know, on September 14th we announced that we expected third quarter earnings per share to fall below the First Call consensus estimates. Our third quarter EPS was 28 cents, in line with our revised guidance of 26-28 cents. Total company sales for the first quarter grew by 3% to $3.3 billion compared to the third quarter of 2003. For the first nine months of 2004 sales grew 11%. Worldwide comparable sales in our 931 stores and 80 delivery centers were flat for the third quarter, but increased 1% for the first nine months of 2004. These results are in line with our lowered estimates reflecting sales softness across our business segments. Operating profit for the third quarter decreased by 5% to $135 million, but increased by 12% to $430 million for the first nine months compared to the same period in 2003.

In the third quarter, operating cost controls in retail and continued supply chain efficiencies were offset by cost increases in international and G&A, along with increased store pre-opening expenses. Improvements in retail product category margins were offset by retail product mix shifts towards technology items and by margin pressure in BSG. Additionally, we experienced disruption in a number of our stores and distribution facilities from the series of hurricanes that hit the southeastern U.S. during the third quarter. On a year-to-date basis, our profit increase primarily reflects the addition of Guilbert to our international group in June of 2003. Positive comp sales and continued improvement in expense controls in both our North American and BSG segments and, of course, positive foreign currency impacts. General and administrative expenses increased compared to the third quarter of last year. Contributing to the increase were employee-related costs and professional fees which were largely related to our Sarbanes-Oxley compliance effort, expensing certain systems development costs, and the negative impact of translating international expenses at weaker U.S. dollar exchange rates. We expect G&A spending in dollars to be in line with 2003 for the fourth quarter.

Third quarter GAAP earnings was 28 cents were diluted share compared with 29 cents for the same period last year. For the first nine months of 2004, GAAP net earnings were diluted share was 90 cents compared to 82 cents for the same period in 2003. Our first quarter 2003 results reflect the adoption of EITF 0216 which reduced diluted earnings per share by 8 cents for the first quarter, while the second quarter of 2003 included a positive 3 cent foreign currency effect on funds held in anticipation of our Guilbert acquisition. Results for the first quarter of 2004 included a one cent per share cost related to the settlement of an outstanding legal claim, while the second quarter included a 2 cent per share gain related to the settlement of certain claims associated with our European distribution system. We recorded a 30% effective tax rate for the third quarter. We expect that rate to remain relatively stable for the balance of 2004.

Turning to the balance sheet and cash flow metrics for the total company. Year-to-date free cash flow was $325 million with $247 million in capital expenditures. Inventory levels declined by $60 million from last year to $1.13 billion reflecting continued improvements in our supply chain. North American contract DSO were 43 days. That was flat with a third quarter of last year and an increase of one day over the second quarter of this year.

As a result, our cash and short term investments exceeded $1.2 billion at the end of the third quarter, an increase of about 200 million from the second quarter and 400 million from the prior year. Now, I'll move to our individual business segments.

First our North American retail business. Total sales increased 3% to $1.5 billion in the quarter. Comparable sales increased 1% for the quarter. Although below our expectations, we are pleased to report three consecutive quarters of positive comp sales, a trend we expect to continue into the fourth quarter. Despite our lowered expectations, we still expect fourth quarter comps to be the best of the year. The increase in comparable sales were attributable to strong sales of technology products, somewhat offset by softness in supplies and furniture. Comparable technology sales increased in the double-digit range for both the quarter and year-to-date. Our aggregate furniture and other category reported a comp sales decline of 3% for the quarter and 1% year-to-date. Core office supplies declined 3% for the quarter and 1% year-to-date largely due to disappointing back-to-school sales and strong sales in 2003 from the launch of Ink Depot. Excluding computers, back-to-school sales declined 6% versus 2003.

Average transaction size increased for the third quarter and first nine months because of the mix shift towards technology products, while comparable transactions declined in both periods. During the quarter the company opened 24 new retail stores, closed two stores and relocated 6 stores. At the end of the third quarter we operated a total of 923 office products superstores throughout North America. Margins increased in both supplies and furniture for the third quarter but were mostly offset by a higher mix of lower margin technology sales. The attachment rate of supplies with technology sales were below expectations putting some pressure on overall margins. A strong focus on managing operating costs as well as targeted efforts at improving underperforming stores continues to improve profitability as operating expenses trended at favorable levels in the third quarter, declining by 30 basis points compared to last year. Payroll savings contributed over 80 basis points largely because of a more flexible staffing and lower wage rates associated with an increasing mix towards part-time staff.

Advertising, principally driven by the summer Olympics, was higher than in 2003 and largely offset the payroll savings. Overall segment operating profit increased 7% in the third quarter and 10% year-to-date compared to the prior year. Additionally, our decision to delay new store openings to allow us to incorporate our new M2 format resulted in higher-than-expected pre-opening costs in the third quarter. We expect to also incur higher pre-opening costs in the fourth quarter. For our North American business services group, total sales increased by 2% in the quarter and for the first nine months of 2004 compared to the prior year. Contract sales increased 2% for the quarter and 3% year-to-date. While results so far this year have been below our expectations, we remain confident in our sales force re-alignment and continue hiring additional resources in this area. We are also making investment in resources targeted to smaller contract and commercial customers. Commercial sales increased 3% for the quarter versus the prior year, slightly better than second quarter trends.

Increases in Office Depot catalog sales were largely offset by declines in Viking sales. Domestic eCommerce sales, which are included in our various business segments, grew 12% during the quarter and for the first nine months of 2004. We expect our worldwide eCommerce sales this year to exceed $3 billion. This is an important component of taking costs out of our business while adding value for our customers. BSG's gross margins declined about 80 basis points in the second quarter. Competitive pricing pressures, increases in the cost of paper and promotional activity in our catalog business contributed to the decline in margin. Our North American warehouse costs continued to improve in the third quarter compared to the prior year, dropping by 35 basis points. Warehouse costs have now declined for 15 consecutive quarters, evidence of a continuing focus on execution and driving out costs. Use of third-party delivery and labor efficiencies are again the primary contributors. Combined these results generated a 5% increase in segment operating profit for the quarter and 3% year-to-date compared to the prior year.

International group sales grew 4% in U.S. dollars but declined 5% in local currency during the third quarter compared to the prior year. The United Kingdom, Germany, France and the Netherlands all posted local currency declines. Positive local currency catalog sales growth in the U.K. was more than offset by catalog declines in the other major countries. Contract sales in local currencies declined in the double-digit range, with declines in all the major European countries. While we have successfully achieved the purchasing synergies expected on the Guilbert acquisition, performance of the sales force continues to be challenging and is our top priority in Europe at this time. Retail comps in Europe were up 8% for the quarter in local currencies with a very strong performance in France, the result of a sustained focus on improving product assortment and service levels. We opened two retail stores in France and three in Japan during the quarter, bringing our wholly-owned international store count to 76.

International gross profit as a percentage of sales increased by about 70 basis points in the third quarter. Continued purchasing leverage largely due to the Guilbert acquisition was partially offset by increasing competitive pressures. Total store and warehouse operating and selling expenses increased as a percent of sales in the third quarter, principally because of deleveraging on lower sales in local currencies; but actually declined as measured in local currencies. International segment operating profit benefited from foreign exchange rates by $9 million for the quarter and $29 million for the first nine months of 2004 compared to last year.

In summary, our sales growth was disappointing this quarter. However, we remain confident that we are investing in the right strategies to drive future growth including expanding our retail and delivery presence in the northeast, remodeling the older stores to the M2 format, expanding our contract sales force in both North America and Europe, bargaining resources into small contract customers and implementing merchandising systems to improve execution at the store level. At the same time we're investing for growth, we intend to aggressively take costs out of the business. We have implemented a more flexible retail staffing model. Supply chain execution and cost reduction efforts continue to deliver savings while maintaining service levels. We've successfully taken the costs out of some of our support functions, but we're looking to aggressively accelerate those efforts. At this time we remain comfortable with our full year EPS guidance of $1.08 to $1.14. This is driven by low to mid single-digit comps in North American retail, low to mid single-digit comps in BSG. And finally, negative to flat local currency sales in international. Furthermore, we expect no significant increase in inventory levels despite 80 new store openings. CapEx in the 375 to $400 million range and free cash flow generation of 275 to 325 million. At this point I'd like to turn it over to Rick Lepley who will provide greater insight into the trends and initiatives in our retail division.

Rick Lepley - *Office Depot, Inc. - EVP, North American Retail*

Thanks, Charlie and good morning, everyone. I'd like to begin by giving you an update on our real estate activities. We made progress during the third quarter on our Kids 'R Us transaction. To remind everyone, back in March we announced our agreement with Toys 'R Us to acquire 124 of their former Kids 'R Us locations for $197 million in cash plus the assumption of lease obligations. Shortly thereafter we also announced our agreement with Petco to sell 20 sites for approximately $45 million plus the assumption of certain lease obligations. By the end of the third quarter we had closed on 82 of the properties, 19 stores have been removed from the transaction by mutual agreement with Toys 'R Us, bringing the deal site count down to 105; and we expect to close on the remaining stores by the end of the fourth quarter. We plan on converting approximately 50 of these sites into Office Depot stores. As of today, we have closed on 43 of those 50 KRU sites, 7 are currently open for business and 10 will open in the next two weeks. And by the end of the fourth quarter, I expect that 35 to 40 of these stores will be operational. Of course, we are actively marketing the excess sites. In the third quarter we remodeled 3 stores and we plan on remodeling about 15 stores in Q4, and more on that in just a minute. During the third quarter we also opened 24 new stores, we closed 2 stores, and we relocated 6 stores to bring our North American retail total to 923. And in the fourth quarter we expect to open approximately 50 new stores.

Now, let me update you on the M2 store program. At the end of the third quarter 33 M2s were open for business. That is a combination of 24 new stores, 6 relocations, and 3 remodels. Our very small remodel sample size of only 3 stores is simply too small to allow us to draw specific conclusions on the program's investment performance. And to remind everyone we limited our remodel program in Q3 to avoid sales disruptions during the back-to-school period. If the fourth quarter we expect to remodel an additional 15 stores and will continue to closely evaluate the performance of the M2 remodels. Decisions regarding a broader remodel rollout will likely be made by the second quarter of 2005. New stores with the target M2 footprint, that's the footprint greater than 15,000 square feet, are currently tracking above our internal pro forma sales projections. On a productivity basis the new stores have higher average sales per square foot versus a comparative new store group in the prior year. Now we don't have deep financial history on any of these new stores yet, but we will provide you with periodic updates as we continue to open new stores going forward.

Finally, here are some other highlights on the quarter. Our focus on profitability continues to deliver results. In the third quarter our store and warehouse expenses were down about 30 basis points as compared to last year. And this was primarily due to better management of our payroll expenses. We have established greater pay rate consistency for given positions across the chain. Also, we continued to manage our work force mix towards a better balance of full-time versus part-time employees, all without sacrificing customer service. Our underperforming stores task force continues to deliver results as well. Year-to-date we have elevated this overall group of stores to a cash flow positive status. We will continue to invest management time to drive further improvement in this store group.

I'm very pleased to announce two enhancements to the stores leadership team. First, George Hill was recently promoted from Regional Vice President to Senior Vice President-Regional Operations. In this role he will manage 6 regional vice presidents, drive consistent execution across the six regions and improve our focus on training and developing personnel. Prior to joining our team, George was a regional vice president for Home Depot. Second, I'm happy to note the hiring of Bob Osborne as our Vice President of Real Estate. Bob joins us most recently from Mitsubishi

Motor Sales of America and during his 14 years at Mitsubishi one of the responsibilities included the oversite of real estate site election in the eastern portion of the United States. Bob will be responsible for our real estate strategy and I'm confident that he will help us to further develop our quantitative and qualitative site selection capabilities as we continue our store expansion program into next year. With that I'd like to turn the call over to Chuck Rubin, our Chief Merchandising and Marketing Officer.

Chuck Rubin - *Office Depot, Inc. - EVP & Chief Merchandising/Marketing Officer*

Thanks, Rick. Good morning, everyone. Let me address retail stores performance first and add some depth to what Rick mentioned. Despite a disappointing performance to our sales plan, we did achieve our third consecutive positive comp sales quarter, as you've heard, after 15 negative quarters. We believe this is evidence that some of our merchandising initiatives intended to turn around our performance have begun to take hold. Overall, compared to last year we posted a 1% sales comp with a slightly higher gross margin rate and slightly higher gross margin dollars. In addition, inventory turn improved as well. The technology group led the comp sales group. For the quarter, technology sales were up double-digits. Computer sales drove this performance. Notebooks, desktops and our best-in-class build-to-order all performed well. Notebooks, which deliver higher margin, had comp sales growth of over 225% and outpaced desktop growth. This is in line with our focus on mobility for our core business customer segment. Also posting positive comp sales were technology services, wireless accessories, drives, memory and networking.

Initiatives to boost the sales of higher margin technology products as well as to improve the attachment rates of supply items continued. Our technology remerchandising initiative was completed in the scheduled 635 retail locations. Attach rates showed some improvement versus last year and we remain optimistic about positive future growth. Sales and center programs were tested and will continue where appropriate. We also piloted a first of its kind technology recycling program. The campaign ran as scheduled through the back-to-school period and was received with strong customer acceptance. We are currently reviewing options to reactivate the program.

Turning to our other product categories, our furniture group comp sales were negative due to significant clearance activity last year; however, overall gross margin dollars and rate were significantly higher year-over-year. The Christopher Lowell furniture collections continue to perform well. We will be introducing a new collection and new business oriented pieces in November and due to our tight inventory controls and vendor partnerships the transition will occur with virtually no end of life inventory liability. Supplies experienced disappointing comp sales but achieved higher gross margin dollars and rate compared to last year. Our overall back-to-school selling results were disappointing despite improving during the last few weeks of the season. Despite those lower sales, we did achieve higher gross margin rates in dollars for back-to-school product as well, compared to the year-ago period. Even with the lower-than-planned sales, our end of life inventory was well controlled and we achieved an out of stock date significantly earlier than last year's back-to-school time frame.

Ink and toner experienced slightly negative comp sales as well as we continued to comp a strong launch of Ink Depot. Let me turn to BSG segment's performance. BSG sales increased 2% for the quarter, with sales improving across most major product divisions. Contract sales increased 2% while commercial sales, including 4SURE, increased 3%. Growth in the OD brand in 4SURE was partially offset by a decline of the Viking brand. Furniture and supplies both delivered good comp increases. In fact, all supply departments were up in the contract group and many were positive in our commercial business. Categories that were particularly strong include ink and toner along with writing instruments. BSG gross margin dollars declined slightly in the third quarter compared to last year due to us absorbing higher paper costs along with a continued competitive promotional environment in both our catalog and Office Depot eCommerce channels.

Let me give you a brief update on a couple of our key merchandising initiatives. First, private brand penetration as a percentage of sales increased for the year-to-date period to 13.5% of our total sales and, in fact, penetration reached 15.5% during the last month of the quarter. We continue to expand our successful Christopher Lowell collection in both furniture and accessories. Our writing instrument brand, Foray, which was launched during the third quarter, continues to meet sales expectations at a gross margin rate of 70 points and above. Private brand penetration will continue to accelerate through the balance of this year and into 2005. On the global purchasing front we continue to work closely with our international counterparts. Through a combination of conventional bids and eAuctions, we continued to lower costs on all product categories addressed thus far. Through Q3, 14 product categories have been reviewed with an additional 7 categories to be reviewed in Q4, and this program will continue into next year.

In the area of pricing we continued our North American retail category pricing review. This review is intended to ensure that we remain competitive in the marketplace while optimizing our margin expansion opportunities. This initiative contributed, along with other margin enhancement efforts, to our Q3 financial performance by delivering higher margin rates in many of our product categories. We will continue this program as well into Q4 and into 2005 as a core component of our profit improvement initiative. We also implemented during Q3 new operational processes and strengthened our organizational structure. Examples include the establishment of a new merchandise planning group and the implementation of a new standardized assortment planning process. These, along with other improvements, will help us achieve and sustain improved execution of the key initiatives.

Moving on to our Magellan project, over halfway into the project we remain on track and on budget. Modules now in place across the chain include forecasting and planning, pricing, assortment planning and improved merchandise reporting. During the quarter we also began the 2005 planning process with the new preseason planning module.

Let me quickly recap a couple of our advertising initiatives. We continued our aggressive approach of rationalizing our overall marketing spend by focusing our spend on those vehicles driving incremental sales and incremental margin dollars. As you hear, the third quarter spending level was up slightly versus last year, as planned, due to our support of the summer Olympics in Athens. Despite this we continue to expect our overall 2004 spending rate to be lower than 2003 levels while still achieving our financial performance goals. During the quarter we realigned our marketing group to improve collaboration with merchandising and other functional areas. The new structure will provide a more integrated team focus and ability to understand and act quickly upon customer insights. We continue to refine our insert strategy in terms of content, creative and distribution. We are pleased with the initial results of this more analytically derived approach.

Another key enabler to improving our marketing investment spend is the advantage loyalty program. This program now has over 1.9 million members, which is slightly ahead of our plan, through the end of the third quarter. Our analysis of these customers confirms that they visit Office Depot channels more frequently, spend more per visit and are more loyal to our brand than our other customers. During this past quarter, we began to directly market to them. Our drive to expand our membership base and effort to individually market to them will continue for the balance of the year and into next. As we look forward we believe we will achieve our Q4 sales comps through the following: an improved organizational structure, new processes in merchandising and marketing enabled by the Magellan project, a continued customer-centric focus, a continued analytical decision-making approach, and finally a heightened focus on execution and accountability throughout merchandising and marketing. With that I'll turn the call back to Neil.

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

Thank you, Chuck. Before we move into the question-and-answer portion of the call, I'd like to share just a few thoughts. As I mentioned earlier I have, really, two or three main goals during my tenure as CEO. The first is to instill greater alignment and accountability to drive both the speed and quality of execution of our key strategic initiatives. As I said when I accepted this job, I didn't come into it as a caretaker and intend to perform as a very active Chief Executive Officer. And, secondly, really assist in the identification selection and hiring of a permanent Chief Executive Officer for the Company. At a more operational level, I'm focused on three keep priorities: Improving our North American retail profitability while aggressively rolling out new stores in the northeast, increasing our market share within the Company's North American Business Services Group and fulfilling the promise of profitable contract sales growth in Europe.

These priorities will be carried out with a sharp focus on proper fiscal management and capital discipline. For example, just yesterday we announced our decision to place on hold, indefinitely, the development of a new global corporate head quarters in south Florida. We have pressing issues to address in all of our business units and limiting our managerial and financial focus to areas that directly influence these results will best serve our shareholders at this time. In addition, we're currently conducting a thorough review of our overall cost structure to enhance our financial performance while remaining competitive in the marketplace. I plan to share with you the outcome of this review over the next several months. We will be hosting our investor meeting next month in Washington, D.C. At the meeting I hope to expose everyone to a deeper portion of our management team, to set high-level expectations for fiscal 2005 and communicate our key plans and actions to drive the business going forward. After being on the job for just over two weeks, I can say that I really am pleased with our current plans and our employees commitment to execute against these plans. I look forward to meeting many of you in Washington in November and now, operator, I'd like to turn the call over to you for questions.

QUESTIONS AND ANSWERS

Operator

[Caller Instructions] Thank you. Our first question comes from Matt Fassler with Goldman Sachs. Your line is open.

Matt Fassler - *Goldman Sachs - Analyst*

Thanks so much and good morning. I'd like to ask a couple questions. The first one would be just to get a bit more of an explanation of what's happening in Europe. Clearly, from a sales perspective you don't have the traction on the contract side that you expected. That's something that we haven't heard a whole lot about in detail in terms of the progress of the Guilbert integration and what might be going wrong there. So if you could shed a little bit of light on that I'd appreciate it. Then I have a brief follow-up.

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

Yeah, let me try, Matt. I think when we acquired Guilbert there were two keys to that acquisition. The first was to really see if we could drive purchasing and operational efficiencies throughout the two organizations, which we did achieve; and, frankly, we're on target for that. When we acquired Guilbert we knew that the corporate cultures of the two companies were vastly different. We had a very aggressive sales force very committed to prospecting, acquiring new business. I can't say that they milked the business but they were basically in a status of basically caretakers and basically sitting on their accounts and not being as aggressive as we would have liked. And I think we probably underestimated what it would take to integrate the sales forces and change that kind of culture. Charlie and I plan to spend a good several days in Europe in the next two weeks and meet with Rolf and his management team to go over how they plan to make these changes which are underway at this point in time.

Matt Fassler - *Goldman Sachs - Analyst*

And Neil, have you lost sales people, has there been turnover to the extent that you're seeing local currency declines at this point?

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

I think there has been turnover. Mostly, from our standpoint, on a positive basis in terms of the people that really couldn't compete with our people and we're in the process of hiring and replacing those. We haven't lost as many people as you might expect just due to the merger that we wanted to keep.

Matt Fassler - *Goldman Sachs - Analyst*

Gotcha. My second question is directed towards Rick at least vis-a-vis the retail business. Just to play devils advocate for a moment on your move to more part-time sales people. Obviously this is an issue I'd imagine that the Company had thought about from time to time and contemplated industry best practices. You know, sometimes when that happens you tend to see dilution over time in customer service. I know you discussed the notion that customer service won't be sacrificed. But if you can discuss how you're compensating for the reality of having some less seasoned people, I guess, and people who are going to be more part timers in the store. And also if you could try to quantify the change in the mix for us.

Rick Lepley - *Office Depot, Inc. - EVP, North American Retail*

Yeah, Matt the primary way that we're trying to do this is when we're opening new stores we're trying to move full time employees from surrounding stores into the new store to change the mix in both stores. Obviously we are focused on customer care and the quality of service that we're delivering. We are trying to do it in such a way that that's not affected. We've also done quite a bit of it through attrition.

Matt Fassler - *Goldman Sachs - Analyst*

And can you talk about the magnitude of the full-time versus part-time numbers chainwide?

Rick Lepley - *Office Depot, Inc. - EVP, North American Retail*

Yeah, a lot depends too on the mix of hours. Our full-time employees are working about 40 hours a week and our part-time employees are working considerably less. I don't really have a number on that right now but that's a big part of how we're achieving the mix as well.

Matt Fassler - *Goldman Sachs - Analyst*

Okay, thank you.

Operator

Thank you, next question. Aram Rubinson with Banc of America, your line is open.

Aram Rubinson - *Banc of America - Analyst*

Thanks, yeah. Two lines of questioning, I guess. The first, I really want to understand the mix of PCs at your retail stores this quarter versus last for starters.

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

Chuck, do you want to answer that?

Chuck Rubin - *Office Depot, Inc. - EVP & Chief Merchandising/Marketing Officer*

Yeah, in terms of notebooks to desktops you're saying?

Aram Rubinson - *Banc of America - Analyst*

I don't know, just computers as a percent of the mix as hardware preferably if you can give us.

Chuck Rubin - *Office Depot, Inc. - EVP & Chief Merchandising/Marketing Officer*

The -- well, we still sell more desktops than we sell notebooks. Notebooks is growing at a much faster clip than desktops. In terms of our mix of the hardware versus the others I'm not sure that we break that out so--

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Aram Rubinson - *Banc of America - Analyst*

Can you ballpark it? Like it's not ten, right? I mean --

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

I think from a competitive standpoint I'd really prefer not to break that out at this point in time.

Aram Rubinson - *Banc of America - Analyst*

Alright, so let me ask the question a different way. You said that your technology comps were up double-digits. How much did that add to the total comp?

Rick Lepley - *Office Depot, Inc. - EVP, North American Retail*

How much did that add to the total comp? Our technology area comped positive in the double-digits. Our overall comp was a--at retail level now I'm speaking--our overall comp was 1%. So to the -- at the highest level technology accounted for our comp increase. Supplies and furniture are the other two major groups that we -- within our product hierarchy actually experienced negative comps. So technology was the driver.

Aram Rubinson - *Banc of America - Analyst*

Okay, I'm just curious if those other categories were, you know, down three, down five, down whatever.

Charlie Brown - *Office Depot, Inc. - EVP & CFO*

This is Charlie. I think we talked about supplies were actually down three.

Aram Rubinson - *Banc of America - Analyst*

Okay. And then tell me the second line of questioning is when you do have kind of a future plan for-- with the new CEO in place and such, is it going to be the type of thing in your mind that you need to infuse new investments to jump start the Company? Or is it the kind of plan where you hope to reap investments that you have already made?

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

I think it is the latter. I mean, I think as I said when I accepted the job and where I feel very comfortable today. It's really a question of execution. I don't see any change in strategy at this point. I don't see that we have to make any additional investment other than what we've already talked about, which is really the new store openings on retail side and the hiring and adding to our sales staff domestically here at BSG.

Aram Rubinson - *Banc of America - Analyst*

Okay. Well, we'll look forward to seeing you in D.C. Thank you.

Operator

Thank you, the next question, Dan Binder with Buckingham Research. Your line is open.

Dan Binder - *Buckingham Research - Analyst*

Hi, a couple questions. First, based on the remodel activity that you've given us this quarter and next quarter, it looks like maybe the remodels for the year are down a bit and you're talking about, sort of, reviewing that in the second quarter of next year in terms of ongoing plans. I'm just curious what's going on in that front and if I'm correct on the remodels for the year coming down, what has prompted that is my first question?

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

I think -- you are accurate. I think what we want to do is have enough of a test sample group of remodels to ensure ourselves that the investment that we're making in remodels is going to pay off. I think we're very happy with the M2 stores themselves. As Rick said, they're tracking above our internal pro formas, but I guess we're at a point where we'd like to test a few things and make sure we're on track and see if the remodeling expense is justified. And we'll have a better sense of that by the second quarter of next year.

Dan Binder - *Buckingham Research - Analyst*

Does that take assessment take into consideration that if those that are not remodeled that they may actually lose share versus just looking at it an absolute sales lift.

Rick Lepley - *Office Depot, Inc. - EVP, North American Retail*

No, there's no indication at this point that we would lose share as a result of remodels. I've characterized it further by saying that we're looking at three different levels of remodel. One that, as you know, and we've already told you costs about 250 to 275 and then two other remodels slightly less than the first and then another one that is quite a bit less than the first that would give it the look without changing a whole lot of fixed assets. So we'll be testing that. We're also testing three different labor models. In the three remodels that we've done, we have actually three tests going on; obviously one in each store, for three different labor models right now. So we'll learn a lot more about these. If we get a total of 18 or 20, let's say they're open for 3 or 4 or 5 or 6 months then we'll have a much better sense of which way we want to go with this to optimize return on investment.

Dan Binder - *Buckingham Research - Analyst*

Okay, then second question was on your announcement yesterday with regards to putting on hold plans for the global headquarters. I guess how far down the path should we expect any kind of charges to unwind, any contracts that may have been in place? And then the last question is with regard to your retail comp outlook I guess I suspect that me, and maybe others on the call, are a bit surprised that you're still looking for your highest comp of the year out of Q4. Can you give us some color on what you've seen so far to give you that confidence?

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

Sure, let me try. To answer your first question it's our guess that we will probably have a fourth quarter charge, which was not reflected in Charlie's comments, of between 4 and $6 million; which reflects permitting, some legal costs and things we've done. At the same time I would have to say that land values down here have increased in value and we have not taken that into account which we'll only do at such time as we either sell or dispose of the property. As relates to your comps and--your question on comps in the fourth quarter, all I can say is that what we're seeing right now for the first three-plus weeks in October. One is very exciting for us. But two, more importantly, if that holds, which we fully expect it will at this point, it will be our highest level of comps for the year.

Dan Binder - *Buckingham Research - Analyst*

Okay. Thank you.

Operator

Thank you. The next question, Colin McGranahan with Stanford Bernstein. Your line is open.

Colin McGranahan - *Sanford Bernstein - Analyst*

Yes, thank you. First just like to follow up on Europe. Can you comment a little bit on maybe who you're losing share to in the contract space there? And any additional commentary you can give us on, you know, what your initial thoughts are on how to integrate that sales force a little better and how you can change that culture?

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

Specifically I don't know. I think it's probably across-the-board. And in terms of what we intend to do, as I mentioned earlier, we're going to spend some time in Europe in the next week or two. And I really think it gets back to what I thought I had said earlier is that when you put two different cultures together, which this was, I think we underestimated how difficult the transformation was going to be from taking a sales force that basically were just farmers and were just harvesting what they had to turning them into hunters. That's the best I can answer it at this point.

Colin McGranahan - *Sanford Bernstein - Analyst*

Okay. Thanks. Second question on the contract business. It sounded yesterday when Boise reported that they're looking for lower margins in their contract business. I know in your release you commented on the competitive environment in the overall BSG business. Can you just comment on what you're seeing in terms of acquiring new contracts, maintaining and keeping existing contracts in terms of the competitive environment currently.

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

Let me have Cindy Campbell, who runs our BSG business, comment.

Cindy Campbell - *Office Depot, Inc. - EVP, Delivery Sales*

I think it depends upon which segment we're looking at and the mix of business that a contract customer or contract stationer would have. It's highly competitive at the very highest end. There is margin opportunity in the mid to small markets.

Charlie Brown - *Office Depot, Inc. - EVP & CFO*

One of the others problems we've had Colin currently is, again, some of our pressures have come around paper costs and in the contract business it's more difficult to pass those along as quickly as you can in retail.

Colin McGranahan - *Sanford Bernstein - Analyst*

All right. Okay. Final question, Neil, can you just comment on any progress you're making with the CEO search and then any comments on the share repurchase strategy as well?

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

I met with Heidrick & Struggles last Friday in New York and team that they have put on this assignment. They are coming down here to Del Ray tonight, will meet with the full board tomorrow, and that's as best as I can do at this point. We don't have any specific names, we haven't interviewed anybody and that will happen over the next several months. As to the repurchase strategy we have a meeting tonight, I believe it is, or early tomorrow morning with our finance committee where we will lay out our recommendations for implementing the $500 million share repurchase. And at such point as we have any details we'll certainly make an announcement.

Colin McGranahan - *Sanford Bernstein - Analyst*

Good. Look forward to that, thank you.

Operator

Thank you. Next question, Danielle Fox with Merrill Lynch. Your line is open.

Danielle Fox - *Merrill Lynch - Analyst*

Thank you, good morning. Neil, could you give us little bit more detail on what your objectives are with the extensive review of ODP's overall cost structure. The historical trend seems to suggest that Office Depot has been able to protect, and in some cases, expand margins even in a negative comps environment for the stores. So I'm wondering where you see the largest inefficiencies.

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

I don't know where the largest are at this point after nine days. What I can say is that any organization as large as ours with $13.5 billion in sales can always benefit from business reviews and a relook at how we do business. We've got a very large G&A account, and as I go if with our key management and have these kind of detailed reviews, I fully expect that we'll find both some cost savings and some ways to execute better so that we can get margin improvement.

Danielle Fox - *Merrill Lynch - Analyst*

Okay. I guess and the second question would just be, you mentioned in the closing comments that your goals, besides accountability and capital discipline, were improving North American retail profitability with an aggressive rollout of new stores. I guess I'm wondering why continue to roll out new stores so aggressively? I can understand relocations but, you know, what is the rationale for aggressively rolling out new stores?

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

Well, I think there's two pieces to the rush. The first is that we were very nonaggressive over the past several years in terms of opening new stores. And we think we see a unique opportunity in the northeast that we've left to Staples, basically by themselves, and we think the customers deserve a choice. And we, frankly, think that we have that kind of opportunity which was evidenced when we acquired the Kids 'R Us stores and we intend to exploit that.

Danielle Fox - *Merrill Lynch - Analyst*

Thank you.

Operator

Thank you. The next question, Bill Sims, your line is open with Smith Barney.

Bill Sims - *Smith Barney - Analyst*

Good morning. Thank you I have two related questions. In the contracting commercial business can you comment of whether it was average ticket or number of transactions that drove sales? And related to that any comment on the business spending environment? Have we seen a pick up or is it still anemic? Thank you.

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

I'm sorry. Could you repeat that? We couldn't understand it at this end. I'm sorry.

Bill Sims - *Smith Barney - Analyst*

In the contracting commercial business, I was wondering if you could point to was it average ticket or number of transactions that were driving the sales growth in those two segments? And comment on the overall macro environment in terms of business spending, have you seen a pickup or does it remain anemic?

Cindy Campbell - *Office Depot, Inc. - EVP, Delivery Sales*

This is Cindy Campbell. The average transactions have actually increased. That would be the cause for the growth.

Bill Sims - *Smith Barney - Analyst*

Okay, and has average ticket turned positive, or does that still remain negative?

Cindy Campbell - *Office Depot, Inc. - EVP, Delivery Sales*

It's positive, absolutely.

Bill Sims - *Smith Barney - Analyst*

Thank you. Can you just make a macro comment on the environment that you're operating in?

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

I still can't understand you. I apologize. We're having a problem at our end understanding what you're saying.

Cindy Campbell - *Office Depot, Inc. - EVP, Delivery Sales*

It's cutting out a bit. I think the business environment--if I heard you, I think you're questioning-- is the business environment positive or negative. Is that, correct?

Bill Sims - *Smith Barney - Analyst*

That's correct.

Cindy Campbell - *Office Depot, Inc. - EVP, Delivery Sales*

I think it's neutral at this point. We haven't seen a substantial shift in any -- in either direction. It's been that way sort of throughout the year at this point.

Bill Sims - *Smith Barney - Analyst*

All right, thank you.

Operator

Thank you. Next question, Mark Rowen with Prudential. Your line is open.

Mark Rowen - *Prudential - Analyst*

Thanks. Good morning. A couple of questions. First you mentioned that the attach rates on your technology sales weren't up to your expectations. I wonder if you could just give us a little bit more detail on that? Do you think that you just didn't execute well or do you think that the kind of technology products you were selling just didn't lend themselves as well as you thought to attaching, either warranties or accessories? And then I have a follow-up after that. Thanks.

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

Chuck?

Chuck Rubin - *Office Depot, Inc. - EVP & Chief Merchandising/Marketing Officer*

I think it's a little bit of both. I think that as we continue to refine our assortments and get them focused that attachment items, and this isn't just to technology although that's a core driver. The types of attachment items that we carry and how we merchandise them will improve. On the execution side, we can merchandise them much better. Merchandise them both in terms of how we advertise them and position them in our ads, merchandise them in stores, and also how our sales people in the store work with customers. So, as I mentioned in my comments, we've seen improvement but it is a key opportunity that we think is ahead of us for much better results.

Mark Rowen - *Prudential - Analyst*

Okay. And then, Neil, I just kind of have a broad question for you. It seems like you've got a lot of things to fix in the business. The European business isn't doing well, North American contract seems to be under tremendous competitive pressure, you're opening a lot of new stores for the first time in a number of years, you're remodeling a bunch of stores. Do you think you've got too much going on and how do you focus the organization on all of those things? Do you think you might need to put off-- sort of following up on Danielle's question-- do you think you might need to put off some of those things and focus on one at a time and fix them, or do you need to fix them all at once to make this work?

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

Actually, if you had seen the list of priorities that was on my desk when I got here we probably cut 150 of them out. I think we're very clearly focused on three, I don't think this is a bandwidth problem at all at this point. I think the organization-- and you'll talk to these folks in November. They understand very clearly there are three key priorities and I don't think that's a lot for a company this size. I think that we've got the management talent to do it. I think we've got the management depth to do it. And clearly as you talk to our people, you'll see that they clearly understand what we have to do and what everything is going to be focused on this coming year.

Mark Rowen - *Prudential - Analyst*

Okay. Great, thanks.

Operator

Thank you. Next question, Michael Baker with Deutsche Bank. Your line is open.

Michael Baker - *Deutsche Banc - Analyst*

Hi. Thanks. I was kind of breaking up earlier so hopefully this question wasn't already asked. If so, I apologize. But just to comment on the pricing environment, particularly in contract, reading between the lines on some of your comments. It sounds like getting a little bit more aggressive across the board is that being initiated by you guys or competitors or what's the situation there?

Cindy Campbell - *Office Depot, Inc. - EVP, Delivery Sales*

I think that it's a historical situation. One that we, frankly, chose not to respond to for a period of time. It is highly competitive. Our competitors are worthy competitors. And they are looking at their pricing mechanisms by taking advantage of all the assets they have, including marketing and that sort of thing. Typically we haven't gone that route. And we sustained a fairly clean approach to pricing, one which is still the path that we're on.

Michael Baker - *Deutsche Banc - Analyst*

So when you say you initially chose not to respond, so are you now responding or are you still maintaining your pricing?

Cindy Campbell - *Office Depot, Inc. - EVP, Delivery Sales*

I think we're responding in a different way than our other competitors perform. We have are having to respond, of course, to win business but we're choosing not to show the elements of our pricing perhaps the same way some of our competitors are.

Michael Baker - *Deutsche Banc - Analyst*

Okay. And retail-- pricing at retail, is there anything going on there or is that more benign?

Chuck Rubin - *Office Depot, Inc. - EVP & Chief Merchandising/Marketing Officer*

It continues to be a competitive environment out there. As I mentioned in my comments, we have done a good amount of work between the merchandising marketing group and store operations group. That work continues to ensure that we remain competitive on very identifiable products but we optimize our margin opportunities on other products that aren't quite as visible.

Michael Baker - *Deutsche Banc - Analyst*

Great. Thank you.

Operator

Thank you. Next question Gary Balter of UBS, your line is open.

Gary Balter - *UBS - Analyst*

Two questions. One is the corporate expenses keep on rising. Looks like it is now 4.9% on the. [INAUDIBLE] Why is that going up so high? Is that just you haven't allocated expenses? And if you haven't, where did that go? And if you have then why is corporate so high?

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

I'm sorry, we could not hear anything that was said on that call. You're breaking up totally.

Gary Balter - *UBS - Analyst*

Can you hear me now?

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

No.

Cindy Campbell - *Office Depot, Inc. - EVP, Delivery Sales*

Operator?

Operator

We're trying to adjust the line. One moment, please.

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

Thank you.

Operator

Go ahead, please.

Gary Balter - *UBS - Analyst*

Hello?

Operator

Yes, go ahead, sir.

Gary Balter - *UBS - Analyst*

Could you hear me now?

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

A little bit better.

Gary Balter - *UBS - Analyst*

Okay. Well, we'll try. Question was on margins. Your operating margin, I believe, is about 4.05 this quarter. If you add back the corporate, the corporate's about 4.9. Why is that such a high number and what's -- why is it growing so much and why is that not allocated to different divisions and what would that imply for the divisional profits if it was properly allocated.

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

I'm sorry I cannot hear that, I apologize we have to see if we can answer that later or offline because I can't hear the question.

Operator

Thank you. One moment for the next question. David Katz with Matrix your line is open.

David Katz - *Matrix - Analyst*

Hi. I'm just trying to get a little color on the M2 store remodels. It seemed like prior to today's call you were very upbeat about the cost-effectiveness of it and is today taking a step back more related to a new CEO and just a fresh outlook or the fact that the store sales are not coming through as you had anticipated?

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

No, we're still optimistic. I'll let Rick talk. I just feel, as does the management group, what we'd like to do before we spend a significant amount of capital to test to see whether or not we get the kind of lift that justifies this kind of investment. We're very happy with M2 at this point. Rick do you want to add anything?

Rick Lepley - *Office Depot, Inc. - EVP, North American Retail*

The only thing I would add is that the same people who are in charge of the remodels are the same people who are in charge of opening the new stores. And our original plan called for closing on the KRU stores much earlier than it's turned out that we could close on those stores. And the result is, as you could see from the numbers I reviewed with you, 50 new store openings are now in the fourth quarter. So I think it's prudent to do these the right way, to study three different levels, to look at the three different labor models that we'e putting into these stores and if some of these remodels take place in the first quarter that's just fine with me.

David Katz - *Matrix - Analyst*

Thank you.

Operator

Okay. Again, Gary Balter, your line is open.

Gary Balter - *UBS - Analyst*

Can you hear me now?

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

Yes.

Gary Balter - *UBS - Analyst*

Okay. Great. Two questions. One is -- one's a relatively easy one just with the number of members you're signing up, what we've seen at other companies is when they have some type of discount program, like Best Buy being a good example, there's gross margin pressures; and that's not one of the comments that you mentioned in North American retail or the contract area. Why are you not seeing margin pressure from the members?

Rick Lepley - *Office Depot, Inc. - EVP, North American Retail*

The advantage program.

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

The advantage program you're talking about.

Gary Balter - *UBS - Analyst*

Right, on the advantage program.

Chuck Rubin - *Office Depot, Inc. - EVP & Chief Merchandising/Marketing Officer*

Is that correct, Gary, this is the advantage loyalty program?

Gary Balter - *UBS - Analyst*

Yes.

Chuck Rubin - *Office Depot, Inc. - EVP & Chief Merchandising/Marketing Officer*

The offers that we're providing to advantage members, the cost of those offers have actually been offset by reductions of other types of promotional pricing that we had done in years past. So we're actually seeing good control of other offers that we have out there and that's how the math has worked out.

Gary Balter - *UBS - Analyst*

And then when we look at the overall operating margin which is about 4.05, right on top of that is about a 4.9 corporate expense and that keeps on growing. Can you talk about what's in there, why does it keep on growing and should it be -- is there a point it's going to be allocated and what does that imply for the segment operating profits?

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

I think you're referring to G&A costs.

Gary Balter - *UBS - Analyst*

Right.

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

And the G&A costs are under review right now and I hope that we'll be in a position at the investor conference to share some things with you in terms of some of the changes we're making and some of the reductions that you'll see in G&A going forward.

Charlie Brown - *Office Depot, Inc. - EVP & CFO*

Gary, this is Charlie. One of the other things that influences that number this quarter is foreign exchange. We've added the Guilbert numbers and, of course, to the pot and we're translating those at higher exchange rates. So that drives up part of it.

Gary Balter - *UBS - Analyst*

Okay. Thank you very much.

Operator

At this time we have no further questions.

Neil Austrian - *Office Depot, Inc. - Chairman & CEO*

I'd like to thank everybody very much for participating in the call. I hope we've been able to answer most of your questions and we look forward to seeing those of you who are coming to Washington November 14th or 15th. Thanks again.