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ODP.OQ - Q3 2002 Office Depot Earnings Conference Call

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OVERVIEW:

Revenue increased slightly in 3Q. With a strong balance sheet, 3Q ended with $940m in cash. This will be invested in ODP's strategic growth initiatives, both domestically and internationally, particularly focusing on Europe. Q&A focused on forecast for the future, particularly overseas.

CORPORATE PARTICIPANTS

Bruce Nelson *Office Depot, Inc. - Chairman, Chief Executive Officer*

Eileen Dunn *Office Depot, Inc. - Vice President Investor Relations*

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CONFERENCE CALL PARTICIPANTS

Matt Kassler *Goldman Sachs*

Danielle Fox *JP Morgan*

Aram Rubinson *Bank of America*

Colin McClanahan *Sanford Bernstein*

Daniel Bender *Buckingham Research Group*

Jeff Black *Lehman Brothers*

PRESENTATION

Operator

Good morning, we would like to welcome you to Office Depot's third quarter 2002 earnings conference call. All lines will be on 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 Miss Eileen Dunn, Vice President of Investor Relations and Public Relations, who will make a few opening comments. Miss Dunn, you may begin, ma'am.

Eileen Dunn - *Office Depot, Inc. - Vice President Investor Relations*

Good morning, everyone. Thanks for joining us for today's earnings call. Before we begin today's presentation, I'd like to remind you that except for historical data, comments on this call should be considered forward-looking within the meaning of the Private Securities Litigation Reform Act. Forward-looking statements including projections as to revenues, core earnings and other statements related to expected future performance by Office Depot involve risks and uncertainties which may cause actual results to differ materially from those discussed on the conference call. Please refer to our filings with the SEC for further information. Before we begin, I want to remind you of our upcoming investor meeting here in Florida on November 5th. For those of you who are interested, please call our office at 561-438-1680. Now I'd like to turn today's call over to Office Depot's Chairman and Chief Executive Officer, Bruce Nelson.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Thanks, Eileen. Good morning to all of you. Joining me today from our Del Rey Beach offices are a number of our executive leadership team, including Charlie Brown, our CFO. Who today is celebrating his first anniversary as the CFO of Office Depot. So we start that this morning on a high note. Review with you briefly the press release that we issued this morning on our earnings.

Some highlights and I will go through the details by business unit and obviously at the end I will open it up for questions. We have very strong operating performance across all of our business segments. Our reported EPS was up 40%, excluding the non-recurring events in Q3 of '01, it was up 10% and exceeded consensus by a penny. Our reported operating profit was up 42%, again excluding the non-recurring quarter three events of last year it was up 13%. Our European business, which is the focus of our real growth outside the United States, grew 9% in local currencies, a strong performance in light of the economic conditions in Europe.

During the quarter, we did see acceleration in our North American delivery business. Particularly in the large account segment. Our North American regional comps were minus 2%, in line with our mid-quarter update. We have an extremely strong balance sheet. We ended the quarter with $940 million of cash after the redemption of $241 million of the 1992 alliance. On a sales basis, third quarter revenue increased 4%. Or highest growth percentage since the fourth quarter of 2000. Year to date revenue increased 3. Comparable worldwide sales were up 1% for the third quarter and flat for the first nine months of this year.

Worldwide e-commerce sales grew 35% to $543 million and we are on track to exceed over $2 billion of e-commerce sales this year. Virtually all of our customer service metrics across all of our businesses were better than last year and last year was a good performance. The weakening dollar did favorably impact third quarter sales by $33 million for approximately 1%, but on a year-to-date basis it was only impacted by 27. This is the first quarter this year we've had a favorable impact of a weakening U.S. dollar. On a sales growth basis, comp sales, as I said, were down 2% in our North America retail business, primarily reflecting a disappointing back-to-school season and continued weakness in furniture and technology sales.

North America retail transactions were flat for the quarter even taking into consideration the disappointing back-to-school season. The average retail ticket was down slightly, less than 1%. On a BSG [INAUDIBLE] sales grew 6% during the third quarter. Our contract segment, our large customer segment, grew more than 7. Our catalog businesses, Office Depot catalog and Viking remain soft, but sequentially improved over the second quarter. Our total international business grew 8% in local currencies, but 17% in U.S. dollars. As I said earlier, Europe grew 9% with local positive trends in the U.K., Germany, Netherlands, Italy and Ireland. Japan had negative comps, both in quarter three and negative year-to-date.

On a consolidated operating profit basis, our reported operating profit increased 41% to $142 million. Excluding the non-recurring events in the third quarter of last year, operating income increased 13%, on the sales increase of 4%, continued evidence of Office Depot's ability to find ways to improve our operations, take costs out of our business and improve processes to drive shareholder value. Our North America retail operating profit margins reached 8.4% of sales despite negative comps. The operating profit in BSG for the quarter was up 14% to a record 10% of sales, up 28% year-to-date. I will have comments about that when I talk about BSG.

International's operating profit was up 10%, excluding the gain we recorded last year on the sale of our London warehouse. Our gross margins on a consolidated basis grew 63 basis points. The key drivers of the operating profit expansion were retail gross margin improvements, and continued improvements in our BSG North American operating costs. G&A costs were slightly negatively impacted by higher incentive pay accruals across the Company and our strong strategic growth initiatives in Europe. We opened two new countries in Europe this year. We've launched three new contract businesses in Europe this year and that's investment for the growth.

Our year-to-date operating profit increased 44%, up 36% when you exclude the non-recurring events that we recorded year-to-date in 2001. Our EPS basis on a fully diluted GAAP basis, we reported an increase of 40% to 28 cents in the quarter compared to 20 in the third quarter last year. This did exceed estimates by a penny, despite the inclusion of an additional $3 million accrual for the anticipated settlement of the class action litigation in the state of California that we commented last quarter. Excluding the non-recurring events in quarter three of 2001, EPS was up more than 10% for the quarter and more than 34% year to date. After-tax income from Australia, which is now treated as a discontinued operation, was just slightly over $1 million and when fully added back to diluted earnings, as I said earlier, the EPS of 28 cents exceeded the consensus by a penny.

Now to talk about the business units. North American retail, third quarter sales were down 1% and flat for the year. Comps down 2, as I said earlier, impacted by a weak back-to-school season and continued weakness in furniture and technology sales. Core office supply comps were positive. Furniture was down 9% in the quarter versus down 1 in the second quarter. Technology still down was down less than it was in quarter two. Technology hardware sales were down 5% in the quarter compared to 12% in quarter two. We did see some pickup in technology sales, and in particular we saw a pickup in back-to-school technology sales in an offering we had called Computer In A Box for back-to-school. Our software was up 2% in the quarter. The average ticket as I commented was down slightly, reflecting furniture and technology still being down. Comp transactions were essentially flat for the quarter.

Our customer service indexes across retail were all up. An indication that we're serving customers today better than ever before, and we're giving enormously positive comments from our customers, albeit we still do get complaints when you operate a chain of 870 stores in North America. On a North America retail operating profit, we reached an industry-leading 8.4% of sales in Q3. It's our best performance since Q2 of 1999. This is in spite of negative comps. Retail gross margins improved 129 basis points over last year. This comes from the benefits we continue to receive from global sourcing,. Global sourcing of back-to-school products did help margins. We get continuing remerchandising benefits and better SKU management. Our in-stock position is higher. We have less shrink of markdown than ever before, because we have the industry's best supply chain. And we have the benefit of the continuing mix shift away from technology. Our store operating costs excluding the California litigation costs, were essentially flat to last year, and this is in spite of substantial increase in benefits to our store employees, and pay increases. And this is the result of our payroll model, which is allocating hours more properly to stores and when we've taken hours out of our stores, we've improved our customer service indexes, and that's what we said we would do with our payroll model.

We have improved customer satisfaction, fewer complaints than last year. In the quarter, we had 861 stores at the end of the third quarter, we opened eight this quarter. New stores in North America. And we relocated three stores.

Now turning to BSG, sales in this segment increased 6% for the third quarter and on a year to date, 4%, indicating the acceleration I talked about earlier. Our contract division had high single digit growth in the third quarter, reflecting share gain in large national accounts, an area we said we'd begin to emphasize. Our western region, which has had basically negative sales growth through the first half of this year, was basically flat. We've now anniversaried the worst comparisons we had with the technology era, we're at a strong position in Northern California. We still expect our contract division to continue improving for the remainder of this year.

Our average order size continued to show some improvement in this business segment. That's a healthy sign to us, indication that customers were earning more of our customer share [INAUDIBLE], which is one of our primary goals. As I said earlier, domestic e-commerce sales grew 34% for the quarter and 35 year to date, expanding our worldwide lead position in e-commerce sales. Our warehouse customer service indexes were all up, reflecting better on-time performance in our warehouses. Our on-time delivery performance for the quarter just ended was 99.4%. It's a record high for Office Depot. And that's an indication of the kinds of service we're giving our customers. Our business service group operating profits increased 70 basis points from 9.4% last year to 10.1 in this quarter. In quarter three of 2000, just two years ago, the operating profit in this business was 5.8% of sales. That's the indication of the significant improvements we've accomplished in this business and we continue to get better.

Our third quarter gross margins declined slightly by 66 basis points. Reflecting the impact of the lower margin business of our rapidly growing For Sure dot-com business. Some softer furniture sales and somewhat lower percentage supplier volume rebates and some overall mix changes primarily at Viking. Our third quarter selling operating expenses were down 136 basis points year-over-year, reflecting the continued improvement in warehouses and call centers around North America. Looking ahead, we do expect some pressure on fourth quarter operating margins in this segment, as we further increase the mix of technology sales at For Sure dot-com.

We activate additional sales force hiring which we deferred until late in the third quarter. And began to put more emphasize on large accounts and we have managed the ongoing pressure on sales and margins in our Viking domestic mail order business. We did in the quarter defer the hiring of some sale reps in this business segment, in essence, making this quarter's 10.4% operating income a little high on an ongoing basis. We have hired those reps and will continue to invest as we intend to grow this business.

Our DSO in this business improved to 46 days from 51 last year, reflecting tie-in sales compensation to the behavior we want from our sales reps. It affects order size and helps it. It affects account profitability and it drives receivable collections. And that's an indication as you can see by the strong cash flows in our businesses.

Turning to the international front, our third quarter internation sales in U.S. dollars grew 17%, up 8% in local currencies, year to date, 9%. Foreign currency translations as I said earlier did benefit the quarter by $32.7 million. Our European contracts sales in five new countries continue to grow and meet our expectations. We launched Italy in September, we are on track to launch Germany in January. We're very encouraged by our contract start-ups in Europe. This represents an investment in growth for the future. That we know how to manage and grow a contract business based on our experience in the U.S., and we're delighted with our European results in these segments.

Our sales results reflect Viking's two newest countries, Spain and Switzerland, both which are accelerating. We're pleased to date with the performance of the two new Viking countries and that serves as a foundation to later on launch Office Depot sales reps from the existing infrastructure we built in Spain and Switzerland. Retail comps in France in the quarter softened and were 5% in local currency. 15% in U.S. dollars. We had 32 stores at the end of the third quarter, one opened and one closed. We intend to continue to add to our retail presence in France. France Office Depot, which includes retail catalog and BSD, that's our contract business, actually grew 18% in local currencies in the quarter,r 29% in U.S. dollars. Reflecting where we're putting our emphasis in France, growing the business other than the direct mail business, which we think reaches at some stage in maturity so we have invest in other ways to grow our business. Retail comps in Japan were minus 11% of local currency and 9% negative in U.S. dollars. No new stores were opened. We finished the quarter with 12 stores open in Japan.

On the operating profit basis, third quarter operating profit declined 9% for the quarter but excluding the gain in our London warehouse, which we had last year, operating profit was actually up 10%. It was down as a percentage of sales, reflecting our planned investments in new countries and new channels, and exchange rates did positively affect operating results this quarter by $4.2 million. On a year to date basis for 4. So, you can see the exchange rate helped both revenue and operating income in this segment for the quarter. Gross margins decreased 71 basis points in the third quarter, primarily the result of higher prospecting from the new countries of Spain and Switzerland and a little higher mix of BSD, which has slightly lower margins and retailed lower margins. So, it's really a mix issue, not a price issue.

Our sales and warehouse operating costs increased 18% or 9 basis points. This was driven by the start-up costs in Spain and Switzerland and the heavy payroll costs by adding contract sales reps now in five countries. We opened the U.K. about 18 months ago. We now have 175 sales reps in the U.K., Office Depot sales reps. We are not making money in this business segment yet, but we're on track with our plan, and this business will be profitable and forms the foundation for our continued growth in Europe. In spite of the negative comps in Japan, operating losses in Japan were less than last year. And as I said, our operating margins have been and will continue to be impacted by the country's start-up costs in Spain and Switzerland, our new contract sales channel, as we continue to invest in this high Rona business, this positive cash flow business and high return on sales business, we continue investor growth for the future.

So, in summary, as I said in the release, looking forward, we remain comfortable at this time with the fourth quarter consensus earnings expectations. We do see operating strength across all of our businesses in virtually every one of our key operating quality, customer service and employee retention metrics. Changing our culture to a compelling place to work, shop and invest is paying huge dividends as our people continue to find ways to improve processes that take costs out of our business without cutting payroll and people. And improving quality. Our supply chain remains the best in class with industry-leading inventory turns and high customer service levels.

We are on track to significantly improve our Rona in 2002 to low double digits. Our fourth quarter assumptions look for a gradual revenue acceleration in our North America delivery businesses. A little softer growth rate in our international business in the third quarter, but not a lot softer. And flat to slightly positive comps in our North American retail business. While we expect strong growth in operating income in the third quarter, we do expect some pressure on fourth quarter operating margins, particularly in BSD, as we increase the mix of technology, sales and retail in For Sure, activate additional sales force hiring that we have deferred and manage the ongoing pressure on sales and margins in our Viking domestic mail order operations.

Our balance sheet has never been stronger and we remain poised to accelerate our sales and earnings growth when the economy regains momentum and it eventually will. We have made significant strides in making Office Depot one of the most compelling places to work, shop and invest, as evidenced by our ability to continue to generate strong operating results in very difficult economic environment. I continue to say and I say again, I just wouldn't bet against Office Depot in the long-term. On that basis, we'd like now to turn the call over to you and we will answer what questions you have about the quarter, the outlook for the remainder of the year and the business as we see it. So, we'll turn the call now over to the operator for questions.

QUESTIONS AND ANSWERS

Operator

Thank you very much. [INDISCERNIBLE] The first question is from Matt Kassler of Goldman Sachs.

Matt Kassler - *Goldman Sachs*

Thanks a lot and good morning. Can you hear me?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

We can, good morning, Matt.

Matt Kassler - *Goldman Sachs*

Great. Good morning. Two questions if I may. First of all, what is it that you see in the business that gives you a sense that retail comps are likely to show better in the fourth quarter than they did in the third quarter?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

In the kind of economic environment, it is difficult to predict, but we saw sequential improvement during the third quarter based -- with our best month in September. Now that, comes against anniversarying the year ago the events in New York of September 11th. And the early part of October, we've seen some signs that lead us to believe that at this point that we can comp either neutral or slightly positive on our North American retail stores. That's looking at the product mix, it's traffic counts, it is transactions. It's the activities as we see it. We do all have a holiday season we have to look at and I don't know that any one of us has a handle on that. Holiday gift-giving is not a really significant part of Office Depot, however, the business part of holiday gift-giving is. So, based on what we saw in the third quarter, some trends we see to date, we believe that retail will comp either slightly flattish or slightly positive.

Matt Kassler - *Goldman Sachs*

Gotcha. My second question I put under the broad topic of international asset management. You've got a tremendous amount of cash, you're net inventory negative, so you're working capital management has given you a lot of liquidity. You've talked about selling Japan and can you've also talked about doing some things in the contract business overseas and we've seen some precedent for that in the past quarter. Can you give us a sense of the timing with which you'd look to do something in Japan to the extent that business doesn't get better? And the timing with which you'd look to get more agressive in Europe?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Well, I think several things. What I have talked about Japan is it is a critical part of our future. We have continued to improve our operating losses, albeit it's still significant. We have no current plans to exit Japan. We continue to evaluate it. We do see some signs in some aspect of our business model that are encouraging. It's too soon for us to exit. We believe we've taken a lot of actions, particularly in the last six months and while it is not a great economic environment, I think for the foreseeable future we plan to stay in Japan. I think if we can't see some light by mid next year that's more -- better than what we've seen on the sales side, I think it -- we may have to take a look at it. But we've invested a lot of time there, a fair amount of money, and believe that from a competitive standpoint, if we can make this succeed, it will be an enormous success. But I think this is a -- this needs a little more time to cook, if you will.

Matt Kassler - *Goldman Sachs*

Sure.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

We are selling Australia. We've announced that sale and we're in the process of doing that and we just couldn't get scale and it's an indication for us that if we can't get scale and have a significant presence, then the business doesn't have a lot of interest to us. As it relates to Europe, we are getting very aggressive on investing in organic growth. That organic growth will have our sixth country open, be it Germany, in January. That's a significant P&L investment in growing. But, you know, investment as sales rep sales managers, some incremental inventory and incremental advertising costs. The question I suppose you really have is are we going to use our balance sheet to grow our contract position outside the United States? And I've said and will continue to say and I can't and won't comment on any particular transaction, but clearly contract represents an important part of our strategy in Europe.

We believe we have the base of operations, the knowledge, the technology, the platform, the skills, the language and the culture to be successful in this business combined with our experience in North America. We will use our balance sheet if there are opportunities that make sense for us. And they've got to make sense. They've got to make sense in all the aspects. They've got to make sense first of all from what you pay, if you buy it. They've got to make sense from a cultural perspective. They've got to fit. They've got to make sense from the standpoint do you face issues of integration? People in this business have failed, a lot, by trying to integrate things that don't fit.

So, I'm open-minded and have said all along we'd be open-minded about using our balance sheet to grow, both in Europe and frankly selectively grow in North America and that remains our position and that's why we have cash and what I said about the cash, it's a nice problem to have. It is less than a year old as a problem. And what we've said at Office Depot is we're going to drive Rona. We have good evidence of that this year and intend to do that in the future. And cash sitting on your balance sheet and lots of it over a long period of time does not drive Rona. So, what you've got to find ways to invest that cash to grow your business and I'm open-minded about doing that, but I'm also, and I say I, I've got a board that's very much with me, I'm pretty focused on making sure we get value and if we buy we don't overpay.

Matt Kassler - *Goldman Sachs*

Just one final follow-up, can you tell us what it is costing you now on an annual basis to open these new European contract operations?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

I think if you add -- I think last quarter we broke the number out. But if you, I won't do the contract alone, but if you look at what we're investing in the opening of Switzerland and Spain, plus our contract businesses, you can assume we have 25 to $35 million of operating losses invested in this business in Europe. And I will be directionally accurate.

Matt Kassler - *Goldman Sachs*

Gotcha. Thank you very much.

Operator

The next question is from Danielle Fox of JP Morgan.

Danielle Fox - *JP Morgan*

Thanks, good morning. I have two questions. First, could you just talk a little bit about how the competitive landscape is evolving? In particular, what impact has a seemingly resurgent Office Max had on your business? And what are your initial thoughts on how Sam's Club intensified focus on the small business customer might affect Office Depot?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Thanks, Danielle. First question about the competitive landscape. I think I'd first describe pricing because that's always everyone's concern, is relatively benign. We're all priced competitively on items across our board and the customer makes us do that and that's been that way for a while and I don't see any change in that. I think Max's performance of supply chain is causing them to get a higher share of wallet of the customer that went to Max in the first place. I mean -- this is my perspective and I don't know if my good colleague and friend Mike Foray would share it, but I think a year ago they had some service level issues in their stores. I think they've improved those pretty significantly, and I think they're getting a higher share of the customer who first chooses Max either because of the convenience and/or loyalty. And we've all got customers that are enormously loyal.

I think Max, my perspective, probably had the best back-to-school season. I think it was better than ours. I don't know about Staples, but my guess is it was. And I think that's the case because our research shows, and this may not be what Max research shows because you never quite know, but our research says that Office Max has always had a bigger share of the consumer wallet than the small to medium-sized business wallet. And I think they perform better at back-to-school than we did. I can speak to that. And that performance was an in-stock position and I think a customer mix that leans more toward consumers. Our customer mix in retail has always been predominantly small and medium-sized businesses. Our weekend business is somewhat consumer-oriented and back-to-school consumer oriented. So a resurgence, Max, I was never of the side that said they were going away. And I know lots of analysts predicted the demise of Max. And I've always said internally I plain didn't believe that and I don't. Where they compete with us and Staples on the same corner or across the street. You're convenience.

When you can't find ways to differentiate yourselves, in which we all three struggle with that at the moment, then you get convenience. So resurgent means a higher share of the wallet. I don't think they're taking share from us. I think they're getting a larger share of the wallet of the customer that was loyal. That's my view.

Relative to Sam's, you know, I read the same things you all have and they've got a new leader at Sam's that wants to make a resurgence in the small business. They do have a different model and we will have to see how it works. The average packet side is a lot larger than most small businesses want to buy. The SKU selection is a lot less than most small businesses want to buy and I think their impact could be as much or more on Costco small business customers as Office Depot. I think there are certain SKUs that are attractive to clubs. They've always been attractive to clubs. They always will be attracted to clubs and we price our sales and always had to try to mitigate that price difference between a couple hundred SKUs. So, I don't see today a big issue relative to Sam's getting more aggressive in the back -- in the small to medium-sized business. But we will watch them closely.

Danielle Fox - *JP Morgan*

Just one quick follow-up. Has your experience this back-to-school season at all changed your view on sort of how aggressively Office Depot will pursue that business in the future?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Well, by view means that it will be a key part of our future. First of all, we did it differently this year. The large percentage of the SKUs in back-to-school are SKUs that we have year-round. We do have some one-type purchases, frankly, our supply chain performed extraordinarily well and our shrink and markdown of those was less than its ever been. It brings traffic to its stores and to try to turn away that traffic is just plain not smart. We do spend a little more in media advertising in the forms of television at that time of year, but frankly that's a great time of year to media televised advertising any place.

We just happen to focus on back-to-school. So, it is an important part on what we see as our business that seasonality. I might add, by the way, on our delivery side and our contract side, school business is an important vertical to us, and one we have grown our position in, and one we think we can continue to grow our position in, again, because the vast majority of the SKUs are the same. So, back-to-school is an important part of our future. We've -- we've kind of done a -- let's take a look at what we did good and what we didn't do so good. I've got a new merchant that joined us, I think our back-to-school next year will be better.

Danielle Fox - *JP Morgan*

Great. Thank you.

Operator

The next question is from Aram Rubinson of Bank of America.

Aram Rubinson - *Bank of America*

Thanks, hi, guys. A couple of questions, one is the inventory turns seemed to show a bit of an accelerated improvement versus last year. I'm curious whether you are certain that you have enough inventory and that sometimes the inventory returns can go too far in one direction. That's the first, then I have a follow-up.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

The first question, Aram, I'm absolutely confident we have enough inventory because what you won't see and what I won't break out are the in-stock service levels of all of our businesses. That's stores where we measure in-stock on the entire SKU mix in the store. That ads, in which we advertise in retail stores we measure our in-stock position. That's a critical measurement of our customer in the delivery businesses and I can tell you unequivocally that those measurements are up not down. And that indicates to me that we've got enough inventory.

Second of all, one of the reasons why our inventory is sequentially down is that we performed a lot better in back-to-school in spite of a softer season relative to getting in and getting it out. Our supply chain continues to improve. You -- you probably know, I'll just remind you, that we go at store supply chain different than our two competitors. Our two competitors come at it from large warehouses, we come at it from [INAUDIBLE], we basically clear those docks every night, and we've got lots of other people who want to look at our docks and retailers and find out how we do it for the cost we do it at. It is just a good supply chain, and frankly, I think we can take more inventory out of our stores, and more inventory out of our supply chain because I know the metrics of that inventory, again, we don't break out in terms of its age, and there are still opportunities left to do that, Aram.

Aram Rubinson - *Bank of America*

And the other question relates to merchandising. Do you believe that in order to drive sales that your merchandising will head in a different direction and kind of along the same lines, although not really. Are you leaving money on the table in margin because of the amount of accounts payable that you're squeezing out, is there an opportunity to trade at a 2% interest rate environment? Swap the cash for margin.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Two questions first, one is the merchandise. I think there's not going to be any substantial change in the direction of merchandise at Office Depot. I think we're going to get better at vertical merchandising. Both in retail and our contract and delivery businesses. I think we're going get and are getting a lot better at discreet assortments that differ by store, by region, by part of the country. Which means you may not go into a store and see the exact same SKU in every single store in North America because we think there are differences by region.

I think direction-wise we're going to focus on the core office supply items, the things our customers want to buy. We're going to use technology to help deliver information. We have interesting things going on in our stores. As it relates to our accounts payable and using accounts payable, the answer is if you're asking can we get a bigger discount from vendors by paying quicker, I think -- I don't know the answer to that question. I think that we have to focus on -- on a manufactured time. Be more clear with the question for me, would you?

Aram Rubinson - *Bank of America*

I guess there is an opportunity, you can either take the cash and extend the payment dates, but in a 2% interest rate environment, I didn't know if it made more sense to try to get those discounts rather than hold them out to terms.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

We looked at each supplier. I think -- you know, Dave certainly is going to take a look at that. But -- I don't think there is a huge opportunity there, Aram. I think we're pretty good negotiators today, I think we trade off pretty well, payment terms versus discount terms versus volume rebate terms versus ad money. I think what you look at when you look at a supplier is not just one element of that. You have to look at the whole package and I think we're pretty good at it. Do I think we can we get better at it? Yeah. And I think Dave, our new merchant-help us get even better at that.

Aram Rubinson - *Bank of America*

Good luck, Bruce, thanks.

Operator

The next question is from Colin McClanahan from Sanford Bernstein.

Colin McClanahan - *Sanford Bernstein*

Yes, on the line for Colin McClanahan. Most of our questions have actually been asked and answered, but I just have two quick ones. First, you showed a lot of improvement in the gross margin in the North American retail and there are obviously a number of factors that led to that improvement. Could you also give us some sense of just how much the shift from -- away from furniture and technology and towards core office products helped the improvement year-over-year?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Well, actually the shift away from furniture doesn't improve margins. Furniture is a pretty high-margin item because it has a lot of cost. So actually the shift away from furniture would have the impact of bringing margins down, not up. The technology question is -- I just frame it -- if you go back a year ago, we had roughly about 20% of our North American sales in retail sales in technology. I will define that for a minute, it's hardware, laptops, desk tops, all in one machines, printers, digital cameras, scanners. That was roughly 20% a year ago. Two years it was over 25%. Today it is less than 14%. That business generally has a margin mix in the low teens, some have lower than that, some higher than that. Frankly, I haven't done the math to figure that out.

I think when you get all done, you'd say that what's really driven the margin improvement is that we've got a growing private label, sales and retail in particular, we buy it better, frankly. We've been global sourcing for well over two years. We don't talk a great deal about it. We happen to be unique in the sense that we can both sell it, buy it globally and we can sell it globally. We think that gives us some leverage that others can't do. If you look at our shrink and markdowns over the last two years, it's less and that means our supply chain is better. If you looked at how we've merchandised some stores, we've got related items side by side better, so, today when someone buys a low-margin all in one machine, we have remerchandised that to have a cable next to it in some stores and that drives margin. It is not one thing, it is not raising prices because the environment won't let you do that. It's, Colin, 10s and 20s of little things that add up. I know there's always been a concern that says this thing runs out of gas.

Well, our opinion is certainly we're not going to get the huge increase in margins we've seen over the last year but this model is not out of gas. There is 20, 30, 40 basis points that can just -- we can find ways to do this. And it's a combination of all of those things. So, it is not just one thing. I think if you saw, our shrink is industry-low in fact, sometimes I would argue with our people that shrink is maybe too low from the standpoint sometimes we ought to take a lot more risk. We execute better today. That means plan-a-grams are in and out better. That means discontinued SKUs are out. That means stuff goes back to manufacturers quicker and faster and we get recovery from that. It is just lots and lots of little things. It isn't one big thing and frankly our people, every quarter, every month, every day, find another little idea that adds just a little bit and it is the aggregation of those little bits that add up to be meaningful numbers.

Colin McClanahan - *Sanford Bernstein*

Thanks. And actually, in your response you kind of touched on my last question, which is -- I was hoping you could give us an update on kind of the status and your outlook for private label penetration?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

We've always -- I say always, in the last two years we started private label two years ago. This is an interesting discussion because in some cases you discuss it and it makes your key suppliers really nervous. And suppliers have to be somewhat partnerships with you to make this effectively work. But I think you can say just directionally we'd like to see private label sales in retail exceed 20%. If you go a target and I think it could go north of that. But if you just said 20%, we got lots of room to grow on that. Private label sales in the delivery businesses have always been higher because primarily large customers demand private label frankly from a price perspective, but retail, directionally, I think you're looking at north of 20% as a goal.

Colin McClanahan - *Sanford Bernstein*

Great, best of luck in the current quarter.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Thanks.

Operator

The next question is from Daniel Bender of Buckingham Research Group.

Daniel Bender - *Buckingham Research Group*

Good morning. A couple of questions. You've done a great job on the margin front, you've addressed some of the opportunities you think are out there. I guess specifically focusing on delivery, what do you -- could you quantify for us roughly what you think every percentage point of sales gives you in terms of leverage or operating margin opportunity? That's the first question. The second question, could you give us an update on your buyback program? And third question, if you could provide us with some visibility on what technology and furniture comps look like going forward versus what they have been recently.

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Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

The first question, Dan flow-through. I don't think that's something we ought to try to articulate and quantify because it varies a bit by -- by account and frankly when you get the large contract accounts it flows through less, but it drives volume and you get some benefits in delivery. I think the take-away here without getting specific on it because I don't think that's appropriate, honestly, is to say, look, you can see what happens when we start to get sales increases in our delivery business. We know how to leverage them. And frankly, we're getting better at the flow-through relative to delivery costs and overtime costs and other kinds of costs. We're getting the real benefit of the technology investments we made in our North American warehouses last year in terms of using technology to drive quality and efficiency.

One of the things I'm proud of is we've not had to layoff very many people at Office Depot over the last year and a half in spite of very difficult economic requirements. So as I say, large accounts will mix down this percentage. Large accounts have less gross margin and less net profits but incrementally there is still good return on net assets. So, this business won't stay at 10% because we want a higher mix of larger accounts and you just can't do that. But this business at 7 or 8% is a pretty nice business. That's the first question. Relative to the buyback, our board authorized at the beginning of this year a $50 million buyback. We'll complete that by year-end. We basically said it's basically 80% complete at the moment. And we will complete it during the fourth quarter.

It's on a pragmatic basis so we keep ourselves in compliance with all the laws relative to buybacks. We set a set of instructions and we don't tinker with them. That's been in place since the first of the year. In theory, our board has talked and said we want to take out the effect of stock option dilution going forward and so you can anticipate that we would have an ongoing in the neighborhood of $50 million buyback on an annual basis. We do have some restrictions on buying back more stock than that as a result of some covenants have on bonds. And we'll live within those covenants. One of the things we've tried to do is establish credibility with the financial institutions and the credit rating institutions and we will not violate that. That's the stock buyback issue.

The third question was -- furniture comps. I think that furniture will continue to linger. I would suspect -- I would expect in the fourth quarter it would be negative in retail. I think that's an indication of the confidence small and medium businesses have right now. And when we're talking about furniture and retail, we're talking about a $99 chair, we're not talking about $500 chairs here. You look at that and say that is kind of linked to the economy. We've always had a high furniture position relative to Staples and Max. We long ago emphasized furniture. We think we do it well. We think we will continue to do it well. I will suspect it will be negative comps in the fourth quarter. I think next year is all about the economy and I don't pretend to be an economist, on technology I think that this quarter, with the launch of Hewlett-Packard's broad range of products, of which we're doing relatively well, I would -- I would expect that technology will still be negative but kind of in the same range as today.

We do have some concern about the lingering effects of the dock strike. We've got some goods in the docks. We've fortunately anticipated this and we had about 75% of our holiday season things that we buy overseas on land prior to the stock to the dock -- but we've got manufacturers that -- including some furniture items and technology items that, bring stuff in from overseas, particularly the Far East. And we have to see how this unfolds. Don't know that part yet, Dan. Looking forward to next year, our own outlook of next year is to say from our perspective it will be about the same. We don't see a real change in the economic outlook for next year. We're planning it to be the same as it is this year, hopefully we will get surprised by upside and not downside.

Daniel Bender - *Buckingham Research Group*

Great, thanks.

Operator

The next question is from Jeff Black of Lehman Brothers.

Jeff Black - *Lehman Brothers*

Hey, good morning. Just had one wanted you to answer a brief question on the G&A trends. You mentioned you put off hiring for the direct sales force this quarter. What kind of rate do we expect G&A to continue to increase over the next couple of quarters?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Jeff, I'm going to turn to my colleague on on my right, Charlie Brown and ask him to give you insight on that.

Jeff Black - *Lehman Brothers*

Okay, thanks.

Charles Brown - *Office Depot, Inc. - Chief Executive Officer*

Well, G&A in the quarter was -- was higher than our normal run rate. Largely because of the investments we're marketing Europe. As you know, Jeff, when we build these business in Europe, we go in first with the Viking, and what we do is build the complete infrastructure and then start our prospecting and our sales efforts. So, international, if you look year-over-year at the increase in international -- in dollars, international is well over 50% of that increase. We're also spending some money here in the U.S., as you know, we're off to a record year from the EPS perspective. That relates to some of the incentive accruals that Bruce talked about earlier. So, our G&A, we watch it very, very closely in dollar terms and we think our G&A under control. It's going to be in about the 4.5% range for the balance of the year.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

We have not -- we have not reduced head count as a way to try and cut costs at Office Depot. That's about our culture. We've been real careful about adding G&A head count, continue to be so. An element of our G&A cost this year that's really unplanned, unforecast and frankly is concerning us is healthcare costs. Which are rising substantially faster than anything we anticipated. And that's a growing problem for corporate America and certainly Office Depot.

Charles Brown - *Office Depot, Inc. - Chief Executive Officer*

And in that regard, we elected not to pass those costs along to our employees this year.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

This past year. But Charlie's right about the range. I think it is driven predominantly by our focus in Europe, if you broke out G&A in North America and took out -- took out the extra incentive pay, you'd say we did a good job in managing our G&A.

Jeff Black - *Lehman Brothers*

And it may be too early to talk about it, but going into next year, you sort of, you know, take us through the first half, same kind of investments in Europe that we've seen over the past couple of quarters, or will that decelerate a little bit?

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

No, I think our -- if you look at -- if I just speak to Europe next year because not the first half because you get the timing of this, we will probably spend a little more CAPEX in Europe next year than this year. As we find ways to use our cash to drive efficiencies in our businesses. Plus, as we grow in Europe, we got some countries that are growing in double-digit rates, we have to invest in facilities. We've got some retail -- we're opening stores in Japan, retail. That takes some CAPEX. We have been careful about CAPEX this year because we want to drive Rona. We're going to end the year probably spending less Cap Ex than we thought and we will carry some of that over into next year. When we talk about next year, you will see a delta in CAPEX next year, but we will end with something less than we thought we would spend. But just directionally a little more investment in Europe next year than this past year as we continue to build and plan for the future in that business. And when I say Europe, I'm predominantly talking about Europe. Like international, I'm predominantly talking about Europe.

Jeff Black - *Lehman Brothers*

Okay, great. Thank you very much.

Operator

Mr. Nelson, there are no further questions, sir. I will turn the call back over to you.

Bruce Nelson - *Office Depot, Inc. - Chairman, Chief Executive Officer*

Well, in summary, thanks very much for your interest and your insightful questions. I've hopefully given you clarity to what brought on our performance. We're proud of what we've accomplished at Office Depot. I know all of you and all of us are concerned about how we grow the top line. I can tell you that we have spent, inordinate amounts of time, effort and energy. We believe we have some ways identified as opposed to speak of those ways in advance, we will let the numbers speak for themselves, but you should know we're focused on continually growing both the top and bottom line. We still see opportunities to get improvements in our operating metrics.

We've now demonstrated well over two years of being able to do that and we think there is more left, albeit it might be a less rate, we're not done with the improvements in Office Depot. We're committed to grow shareholder value. We talk about it a lot at our company. Our board talks about it a lot, how we use our cash to grow the business. And one way or another, we will grow our shareholder value. That will be evidenced this year by a substantially improved Rona. And Rona will go up next year, as well, even in a difficult economic environment. Appreciate your support. If you have any other questions, feel free to give us a call.

I'd like to encourage you and remind those of you that would like to attend our meeting here in Florida in November, we will take the majority of the meeting and talk about the future at Office Depot, won't not a lot about numbers or metrics, we'll talk about some of our growth initiatives and some of our insight about what we learned about our customers and competitors and products and verticals. Hopefully if you come down and hear that, you will leave with the same degree of excitement we all have about our business, not just here in North America, but in Europe, as well. This is a different company than it was a couple of years ago. It is a company that knows how to execute and focus and we can and will deliver extraordinary results when we get a little more benefit in the economy and sooner or later we will. Thank you very much for your time. Have a great day. Bye-bye.

Operator

Thank you for participating in today's conference. You may now disconnect.
