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ODP.OQ - Q2 2006 Office Depot Inc. Earnings Conference Call

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OVERVIEW:

The Co. reported sales of $3.5b, net earnings on a GAAP basis of $118m and GAAP EPS on a diluted basis of $0.41 for 2Q06.

CORPORATE PARTICIPANTS

Ray Tharpe *Office Depot - Director, IR*

Steve Odland *Office Depot - Chairman & CEO*

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

Pat McKay *Office Depot - EVP & CFO*

CONFERENCE CALL PARTICIPANTS

Colin McGranahan *Sanford Bernstein - Analyst*

Bill Sims *Citigroup - Analyst*

Matthew Fassler *Goldman Sachs - Analyst*

Dan Binder *Buckingham - Analyst*

Gary Balter *Credit Suisse - Analyst*

Jack Murphy *William Blair - Analyst*

Brad Thomas *Lehman Brothers - Analyst*

Chris Horvers *Bear Stearns - Analyst*

Danielle Fox *Merrill Lynch - Analyst*

PRESENTATION

Operator

Good morning and welcome to the second quarter 2006 conference call. (OPERATOR INSTRUCTIONS). At the request of Office Depot, today's conference is being recorded. I would like to introduce Mr. Ray Tharpe, Director of Investor Relations, who will make a few opening comments. Mr. Tharpe, you may now begin.

Ray Tharpe - *Office Depot - Director, IR*

Thank you and good morning, everyone. Before beginning today's conference call, I would remind you that certain statements made during this call are forward-looking statements under the Private Securities Litigation Reform Act of 1995. Except for historical, financial and business performance information, comments made during this call should be considered forward-looking. Actual results may differ materially from those discussed on this call due to risks and uncertainties both foreseen and unforeseen. Certain risks and uncertainties are described in detail in our report on Form 10-K filed with the SEC on February 15, 2006 and in our recently filed Form 10-Q.

During portions of this call, we may refer to results which are not GAAP numbers. A reconciliation of non-GAAP numbers to GAAP results is available on the Investor Relations area of our website at www.OfficeDepot.com.

Now I would like to introduce Office Depot's Chairman and CEO Steve Odland.

Steve Odland - *Office Depot - Chairman & CEO*

Thank you and thank you for joining us today for Office Depot's fiscal 2006 second-quarter conference call. With me today are Pat McKay, Executive Vice President and Chief Financial Officer; Chuck Rubin, President North American Retail, and Ray Tharpe from Investor Relations. I hope you have had an opportunity to read our press release and learn about the second-quarter results. If not, the release along with the accompanying webcast slides are available on our website at www.OfficeDepot.com. Just click on Company Information and then Investor Relations and you can follow along.

Our second-quarter sales grew 4% to $3.5 billion when compared to the second quarter of 2005. Sales in North America were up 5%, while international sales increased 1% in U.S. dollars and 2% in local currencies. North American Retail comparable store sales were up 1% for the quarter, but a shift in the timing of the holidays negatively impacted sales beginning of the second quarter, and after adjusting for that effect, we estimate that comp sales may have been 2% to 3% for the quarter. Comp store sales after the holidays were consistent with those experienced in our first quarter of this year.

Net earnings for the quarter on a GAAP basis were $118 million compared to earnings of $100 million in the same period of 2005. GAAP earnings per share on a diluted basis were $0.41 for the quarter, up from $0.31 in the second quarter of 2005. We recognized $8 million of charges during the second quarter of 2006 associated with the implementation of plans announced last year and disclosed in our previous SEC filings. Those charges had a $0.02 per diluted share negative impact on the results for the quarter. Without those charges, our second-quarter 2006 net earnings were $125 million or $0.43 per share, which were up 39% from the strong earnings per share results of the second quarter last year.

During the quarter we completed the previously announced acquisitions of businesses in North America and South Korea, and we acquired an incremental interest leading to a majority stake in Office Depot Israel. These acquisitions were those of small private companies, and their inclusion in our results for the quarter were not significant. Therefore, we have not disclosed the specific number regarding their performance. But each of these businesses does provide profitable growth opportunities for the future.

Our overall performance benefited from continuing our strategy of tailored marketing efforts and from expense leverage on increased sales. We are also seeing the benefits of operational efficiency take hold. Total operating expenses as a percentage of sales were 25.9%, an improvement of 70 basis points compared to prior year. EBIT adjusted for the second quarter charges was $186 million in 2006 or 5.3% as a percentage of sales. That is compared to $150 million or 4.5% in the prior year period. Our effective tax rate declined for the quarter, and the year-to-date tax rate reflects that which we now expect to realize for the full year, which is in the range of 30 to 31%.

Sales on a trailing four quarter basis were up 5% compared to the year ago number. Pro forma EBIT increased 23% from the prior year, and pro forma EBIT margins expanded by 80 basis points to 5.1%. Our efforts to streamline our business have resulted in reduced cost structure and leveraged further with the higher sales. Our overall share count declined in the trailing fourth quarter based on -- compared to prior year due to the impact of our share repurchase program.

Lastly, pro forma earnings per share for the trailing four quarters have improved to $1.64, which is a 30% increase. We are also pleased with the significant expansion in ROIC of 250 basis points to 13.9%, as well as the increase in our ROE of 500 basis points to 17.6%.

As part of our previously announced charges to consolidate and streamline functions, we recorded an additional $8 million in the second quarter of 2006 as the plans were implemented. We anticipate an additional $34 million of related charges being recognized over the remainder of the year, bringing the full-year amount to approximately 61 million. However, future charges may change as the plans are implemented. We have provided a reconciliation of GAAP to non-GAAP results that you can access on our website, www.OfficeDepot.com, under Company Information and then Investor Relations.

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

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

Thanks, Steve. Good morning, everybody. Second-quarter sales in the North American Retail division were $1.5 billion, a 4% increase compared to same period last year. Comparable store sales in the 986 stores in the U.S. and Canada that have been open for more than one year increased 1% for the second quarter. This represents our 10th consecutive quarter of positive comparable sales led by strength in the technology product category.

As Steve mentioned, the later holiday season negatively impacted the comp sales early in the quarter, but comp sales for the balance of the quarter were in line with Q1. Excluding the effect of the later holiday, we estimate that our comp store sales for Q2 may have been 2 to 3% for the quarter.

Comparable average ticket size continued to increase, and average sales per square foot were $229. During the second quarter, North American Retail had division operating profit of $96 million, a 26% increase over the same period last year. As a percentage of sales, operating profit for the quarter was 6.4%, up 110 basis points from Q2 of 2005. Second-quarter charges negatively impacted operating results by $1 million.

Division operating profit margins expanded due to both a continuation of gross margin expansion and reduction in the division's cost structure. Gross margins improved over last year, in part reflecting an expansion in product margins driven by category management and an increase in private brand sales from both growth in existing SKUs and the introduction of new SKUs across many product categories.

Our cost management initiatives have resulted in reduced operating costs. These improvements in gross margin and savings from cost management initiatives continue to more than offset incremental expense associated with new store openings, new store remodel activities now underway.

During the second quarter, the Company opened 22 stores and relocated two. At the end of the second quarter, Office Depot operated a total of 1071 office product stores throughout the U.S. and Canada. Our plan remains to open about 100 stores this year.

Previously we announced that we may accelerate our plans to remodel our stores to our M2 format in 2006. In the second quarter, we remodeled 49 stores, and our plan remains to complete approximately 150 store remodels this year with a goal of remodeling almost all stores in the next three to five years. These remodeling activities affect the performance of the North American Retail division as we accelerate depreciation on existing store assets, as well as incur costs associated with the specific remodel efforts, some of which are not capitalizable. But overall we anticipate that these remodels will positively impact the P&L.

We're steadily introducing new products in each of our private brands with approximately 350 introduced in the second quarter. Some examples include Office Depot "No Tools" furniture, Ativa Flash drives, Ativa LCD digital picture frames, Christopher Lowell desk accessories and Break Escapes breakroom snacks. Our private brands offer our customers great choices, not only in terms of price but also in terms of unique functionality. Our easier to shop M2 store format combined with our ever increasing selection of private brand products offers customers a marketably improved and distinct shopping experience.

We continue to be consistent in the strategy deployed on our promotional and other marketing activities during the quarter with both product promotions and other programs providing an integrated framework to stimulate customer response.

For example, during the quarter, we announced a new loyalty program called Worklife Rewards. All of our customers who are members of the Advantage Loyalty Program were automatically enrolled in Worklife Rewards. With this program we're the only company to offer customers unlimited rewards, which we believe provide the best incentive for our most loyal and higher spending office supply customers. Our loyalty program provides an excellent means for us to expand our relationships with our small-business customers and also offers us valuable insight into their product and service needs.

We continue to leverage our relationship with NASCAR. The winner of our small-business of NASCAR contest had their company name displayed on the Office Depot 99 car for a recent race. Small-business customer participation in this contest exceeded our expectations and helped us to further build our relationship with these core customers.

And finally, just in time for the back to school season, we have launched a new promotion called Great Tools for Your Schools Sweeps. One school will be randomly chosen to win over $65,000 in new school supplies and technology products to be delivered in person by NASCAR star, Carl Edwards, driver of the Office Depot 99 car.

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

Now in keeping with our practice established over the last several quarters we have provided three additional examples of our cost management initiatives. These include one, reducing our distribution costs by improving our truckloading and routing techniques. Two, reducing the number of weekly inserts sent to stores for use in store. And three, implementing a [coraget] recycling program, which has led to a reduction in waste disposal costs, as well as created a revenue stream from the sale of the [coraget]. The average for each of these operational cost savings initiatives shown in this slide is over seven figures. As a matter practice, we will continue to focus on identifying and executing on opportunities like these, which will enable us to achieve our cost management goals and position us for profitable growth.

We're pleased with the trend in our North American Retail results the quarter. We continue to make good progress, and we're optimistic about our opportunities for future growth in this division.

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

Pat McKay - *Office Depot - EVP & CFO*

Thanks, Chuck, and good morning, everyone. North American Business Solutions division sales increased by 6% to 1.1 billion in the second quarter compared to the same period last year. Our Business Solutions division experienced growth in key product categories, and division average order values and transactions increased when compared to the second quarter of 2005. We're pleased with our recent contract stationer acquisition Allied Office Products, and its results have been consolidated into our performance for part of the second quarter. The addition of Allied lends strength in key markets in the Northeast and in California. Our integration efforts are proceeding as planned and are on schedule for completion this year.

Division operating profit increased 16% to 101 million for the quarter as compared to the prior year and as a percentage of sales was 8.9% during the second quarter, up 80 basis points from the same period last year. Second-quarter charges in 2006 negatively impacted operating profit by $4 million. Division operating profit margins expanded due to lower costs, which were partially offset by a slight decline in gross margin. Gross margin was negatively impacted by cost pressures in certain product categories and a shift in the mix of sales.

Expense leverage was achieved from call center optimization efforts initiated in past quarters and front current period advertising efficiencies. We did invest in the expansion of our sales force in the quarter, and we estimate that the expansion pays out within a year. Our supply chain continued its history of improvements in operating expense ratio improvement.

The North American Business Solutions team remains focused on profitably growing its business. The direct segment of the office products industry is still very highly fragmented, and we're pursuing new profitable customers via this channel. The Business Solutions division continues to expand its use of telephone account managers as an efficient and an effective way to enhance our relationships and expand our business volume with existing customers. We are targeting strategic customer market segments by educating our sales force on the specific products and services that customers in these markets need to successfully run their business. Specific capabilities gained through our Allied acquisition in the customer market segments of health care and legal have formed the basis of additional offerings.

We have also expanded our strategic partnership with Scholastic Corporation in further support of our customers' needs in the education vertical. We believe we are one of the world's largest Internet retailers. During the quarter we initiated several changes in our website's both expanding content and functionality of the site. One example of content expansion is around design, print, ship capabilities. Customers are now able to initiate a print on-demand request from their desktop and store content and digital file cabinets. Customers may also order promotional products and obtain graphic design services from our site.

We have also introduced more rich media to our site. We intend to continue to enhance this important tool to enhance our customer's experience with us.

Shifting to international, the International Division second-quarter sales increased 1% in U.S. dollars to $859 million and grew by 2% in local currencies compared to the same period last year. The change in exchange rates from corresponding prior year period decreased sales reported in U.S. dollars by approximately 8 million for the quarter. This quarter we completed the previously announced acquisition of Best Office, an office supply company located in South Korea and increased our ownership interest to a majority stake in Office Depot Israel. Both of their results have been consolidated into our results for part of the second quarter. Division operating profit decreased 11% or approximately 6 million to $46 million for the quarter as compared to the prior year and as a percentage of sales was 5.3% during the quarter compared to 6% in the same period last year.

Our second-quarter charges in 2006 negatively impacted operating profit margins by $3 million or 30 basis points as a percentage of sales. The comparison for the second quarter is impacted by allocation of certain onetime credits realized in 2005 that increased the prior year operating margin by as much as 70 basis points. The operating profit margin for 2006 was impacted by a slight decline in gross margin, which was due to the effect of a mix of sales and continued pricing and cost pressures in key product categories. This decline was offset by broad-based expense savings resulting from consolidation and cost management efforts.

Our new managing director of Europe is now in place, and along with his management team is beginning to establish a selling culture in Europe. As part of our international growth initiative to globally expand our business, we have previously announced our intention to establish regional management organizations. Earlier this way we announced that Teddy Chung will be joining Office Depot as the Managing Director of our developing Asian Operations and Direct Sourcing efforts. Mr. Chung is a veteran of the office supply industry and the Asian region. We expect to continue to grow this region of the world from both a market and a sourcing perspective.

In our delivery business, we have achieved incremental sales through expanded customer communications that include limited time and event-related product offerings. These communications have created interest and stimulated purchasing behavior with our customers.

We have three strong private brands in international -- Office Depot, NiceDay and Viking. Our private brands are helping us to distinguish ourselves versus other office suppliers in this highly competitive market. We plan to drive additional sales of our private brand products by an expansion of the assortment and an increased emphasis in marketing of those products. Additionally, we intend to expand our direct sourcing efforts.

We are also encouraged that our cost management initiatives in the International Division are taking hold. We have continued the consolidation of our supply chain operations in Europe with the recent closures of four locations -- three in the UK and one in France. We have also integrated our supply chain operations in France establishing -- enabling next day delivery throughout the country.

Lastly, we have established a satellite distribution location in Paris that is helping us to decrease our distribution costs in that significant market. As a result of these and other initiatives designed to improve our operating efficiency, operating costs in the quarter have declined significantly compared to the prior year.

The macroenvironment in Europe remains somewhat challenging, but we are beginning to gain traction in our own efforts to optimize our cost structure, as well as grow our topline sales. We are also making progress in the integration of our newly acquired businesses in Israel and South Korea. We remain optimistic on the long-term potential of our international business.

For the year-to-date, second-quarter 2006 cash flow before share repurchases was $362 million versus a use of cash of 69 million for the same period in the prior year. The year-over-year increase is attributable to a reduction in inventory levels, improvements in vendor terms and improved collection efforts. Cash provided by operating activities was $484 million. Depreciation and amortization totaled 137 million for the first half of 2006, relatively consistent with the same period last year. EBITDA was 515 million for the year to date. However, adjusted for charges EBITDA was 542 million, an increase of 19% when compared to adjusted EBITDA in the same period of 2005.

Capital expenditures year-to-date have been $121 million. We continue to identify and execute on investment opportunities to drive returns above our cost of capital. We currently are estimating capital expenditures for the year of between 350 and $400 million.

During the quarter we repurchased 7 million shares of our common stock at an average price of 38 million -- $38 rather for $272 million. Year-to-date we repurchased approximately 19 million shares of our common stock for $670 million at an average price of 36 under the reproduce programs previously approved by the Board of Directors.

Turning to the balance sheet, we ended the first quarter with $341 million in cash and short-term investments. Our investment in inventory totaled 1.5 billion globally. Our second-quarter inventory balance includes improving in-stock positions across all channels and the seasonal wrap-up for the upcoming back to school season, as well as the inventory from recent acquisitions. Despite that, we ended the second quarter with average inventory for a North American store of 995,000, a 6% reduction from the same period last year. Working capital decreased by 43% as compared to the second quarter of the prior year. This was driven by an increase in Accounts Payable to inventory ratio of 102%, an improvement on the prior year's level of 89%. We continue to work on initiatives to improve the payables to inventory relationship and driving improvement in overall working capital levels.

Our long-term debt at the end of the second quarter was $582 million, and our debt to total cap ratio was 18.6%. Our outstanding 2013 senior notes are rated investment-grade by both Moody's and Standard & Poor's, and our balance sheet remains very strong. Our return on equity adjusted for charges for the trailing four quarters improved by 500 basis points to 17.6% as compared to 12.6 for the comparative period of fiscal 2005. Return on invested capital adjusted for charges increased to 13.9% from 11.4% in the prior year.

That concludes my remarks. Now I would like to turn the call back over to Steve.

Steve Odland - *Office Depot - Chairman & CEO*

Thanks, Pat. First, as a reminder, we have three strategic growth priorities. Number one is North American Retail. We want to continue to improve store productivity and implement our store expansion and remodel plans. We have accelerated our remodeling efforts and plan to completely refresh our chain over the next three to five years. We also opened 22 stores during the quarter and are tracking towards approximately 100 for the year.

Number two is North American Business Solutions. We plan on profitably growing our market share through new customer acquisition and new products and service offerings. We have not only grown our sales force, but we've also devoted more of our existing sales resources to acquire new customers, supplementing the growth with the targeted acquisition of Allied office products in the Northeast. We are making strides to enhance our e-commerce site from a content as well as a functionality perspective.

And third is international. We need to reignite the profitable market share growth in Europe and over time increase our geographic reach. Our new management team in Europe is already making great progress in creating a sales culture there and improving profitability. We have completed acquisitions in the quarter, reflecting our confidence in opportunities to expand our reach in emerging markets around the globe.

And finally, as we mentioned, we have a managing director in Asia and are beginning to strengthen our sales and sourcing capabilities in that region. We don't issue earnings guidance quarterly, and I believe we remain committed to making decisions and taking actions consistent with the long-term interest of our shareholders.

We have a business that generates substantial cash flow year in and year out, and we can use our cash flow to profitably grow our business by opening new stores in new geographic markets, by making necessary investments in the core business like we're doing with the store remodels, by acquiring assets or businesses in our key priority areas as we have this quarter, and finally by repurchasing stock as long as we believe it is accretive. All of this has been done in this quarter.

Our Company continues to make a lot of progress. We achieved profitable sales growth, as well as continued expansion of our operating margins. Our EBIT margins expanded and ROIC increased 250 basis points to 13.9%. We are particularly pleased with these results when you consider that we measured our performance against the prior year quarter that had 24% earnings per share growth and 3% North American retail comps. On a trailing 12-month basis, our earnings per share now stand at 30%. So going forward, our growth strategy combined with our continuing focus on cost management should enable us to drive profitable growth and create shareholder value.

Now I would like to open up the call for questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS). Colin McGranahan, Sanford Bernstein.

Colin McGranahan - *Sanford Bernstein - Analyst*

The first question is on the BSD division. I know you're not going to break out Allied, but can you just tell us what the organic growth rate of BSD was?

And then also, you talked about the increase in sales force. Can you give us any sense of what the percentage increase or the number of sales people that you have added in the current quarter and maybe over the last year or so?

Steve Odland - *Office Depot - Chairman & CEO*

Yes, we're not breaking out these private company acquisitions. I can say that we had solid growth in BSD this quarter without Allied. Allied contributed some during the quarter. It wasn't the full quarter as you know, so it contributed some at the top line. It really did not have a material impact on the bottom line.

As we look at our salespeople, we are finding very good results from our salespeople. I think that goes to the quality of the people that have joined us, as well as our training program. We're seeing them more productive than we have historically. So we have not shared a specific number for that competitive data, but we have added dozens of salespeople in the quarter. We find that they pay out within about a year, a little less than a year. So it is a great return, and we don't have a lot of turnover there. So it's a really good investment in our business.

Colin McGranahan - *Sanford Bernstein - Analyst*

Steve, can you also just comment on the remodels, what you have learned so far and any results you are seeing out of the 49 you did in this quarter?

Steve Odland - *Office Depot - Chairman & CEO*

Well, I think that the results of the early ones that we have done in this quarter are very consistent with all of our test results. Remember we spent about nine months going through various tests and control before we decided to roll this thing. So we have a really good idea what would happen to the stores. In fact, the results bear that out, which is why we have accelerated the program, and we now say that we will open -- we will remodel about 150 this year, give or take if we get the schedule to work right, could be a little more or a little less. But this gives us great confidence to go through the entire chain. Having top-line impact, it's also having a bottom-line impact.

Most importantly, though, I think it's beginning to differentiate our chain versus the other kinds of places people can shop for similar products.

Colin McGranahan - *Sanford Bernstein - Analyst*

Okay. The final question is for Chuck. I have just been amazed at the progress in private-label year-to-date. Can you talk a little bit of the strategy there, what categories you are going after next? Your pricing strategy with Ativa versus Office Depot and any additional color you can just give us on the program. I'm hoping you will give us penetration, although I'm not too optimistic that you will.

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

No, I'm not going to give you the penetration, so I'm sorry to disappoint you with that. The strategy around private brand has really been consistent for a period of time. There is virtually no category of product that won't be touched by private brand, and we are approaching it in a prototypical category management approach, meaning that they will be good, better, best across private brand product. There will be multiple brands within our assortment as there are today, and we will continue to add them as we go forward. And Break Escapes is a new private brand that we just introduced. Ativa has expanded. We've actually seen expansion in every one of our labels. So it will be a broad-based continuation, and we are seeing the benefits of some of the work that we have laid the groundwork on over the past year, year and a half.

Operator

Bill Sims, Citigroup.

Bill Sims - *Citigroup - Analyst*

I have two questions. First, it appears that the back to school season has gotten an even earlier start than last year. Can you comment on your outlook for back to school, the competitive landscape? The impact on gross margins as the season starts earlier and earlier and your view on the promotional environment?

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

Back to school has started earlier. It is a competitive season. It is too soon to tell how it will turn out. It is a long season because it kind of rolls through the country as different parts of the country go back to school at different stages. So we're really in the midst of it, and we're very optimistic about how it will turn out we will see in the next six weeks or so.

Bill Sims - *Citigroup - Analyst*

From a gross margin pressure perspective, you pointed some higher cost of goods in certain categories that impacted your international delivery business. Presumably that was paper pricing. Can you give us an idea of what impact -- what percentage of the drag you are seeing on the gross margins came from paper pricing and what your outlook is for the remainder of the year from a price inflation perspective?

Steve Odland - *Office Depot - Chairman & CEO*

We have talked about paper in the last few calls, and we're seeing paper pricing continue to affect all of our business segments globally. I think this is due to the rationalization that is going on throughout that industry and the closure of paper mills and so forth. So this is clearly a phenomenon going on, but it is happening globally. We have not said what specific impact it has had, but we're doing our best through various supplies around the globe to make sure that we take care of our customers.

You see the impact largely in contract where the prices are guaranteed to customers in advance. We want to honor what we have said to our customers. In retail we have a little bit more flexibility.

The important thing to point out, though, is that there is no supply shortage here, so it is a rational pricing environment. It just is not an inflating environment.

Bill Sims - *Citigroup - Analyst*

Is there any other category that is having a material drag on your gross margins, or is it paper makes up the majority of that drag?

Steve Odland - *Office Depot - Chairman & CEO*

It is really paper at this time. There is some inflation happening in other areas driven by commodities of metals and plastics that's built on effect from oil. But that is relatively modest, and we control that through our buying. As we get bigger, our buying is more effective. We're doing more global sourcing, too. I think Chuck mentioned that, sourcing from Asia in our private brand. So as we begin to put these needs together from all divisions globally, we're able to affect some lower prices. So we don't worry about this over the long run. I think you're just seeing a short-term impact on paper.

Operator

Matthew Fassler, Goldman Sachs.

Matthew Fassler - *Goldman Sachs - Analyst*

I guess the first question I would like to ask similar to Colin's question about the contribution of Allied. I know that you only owned Israel and Korea for part of the quarter. Any sense as to the magnitude of their contribution to international sales?

Steve Odland - *Office Depot - Chairman & CEO*

Well, again in Israel we had a 22% take in Office Depot Israel. We raised that to a majority stake, and that only impacted a part of the quarter. Best Office in Korea is again we took a majority stake in it. It is relatively small, so they did contribute a positively to the bottom-line, and the effects were relatively neutral at the bottom-line. But the base business without them would have grown as well. So forgive us for not disclosing specific numbers on these small private transactions, but I think suffice it to say that if -- you would feel the same about the business if it did not include these acquisitions for the quarter.

Matthew Fassler - *Goldman Sachs - Analyst*

Understood. A second quick question. You are now a couple of quarters out from transitioning your Viking customers into the core BSG business. I am wondering if that is having any impact on revenue at all, or if you can update us on sort of the customer retention? And also given the gross margins that you generated in that Viking business, which were on the higher side I would imagine, is that part of the mix shift that you are seeing in BSG?

Steve Odland - *Office Depot - Chairman & CEO*

Really good questions. As everybody knows, we had the Viking catalog and the Office Depot catalog, so we had duplicated expenses on those two businesses as we ran them separately. We've had a multiyear effort now to bring the businesses together. We started with all the backoffice activities and the supply chain activities. That all was finished over a year ago and then finally the customer facing portion. So that portion has changed in the last six months, and we're very pleased with the transition. We were able to keep the Viking customers that accounted for the profitability, and yes, we did give up some unprofitable business. People who were shopping Viking simply to take advantage of the high low deals and we were not making any money on that.

Now we're focusing all of our prospecting and marketing efforts on the Office Depot business. That has a material impact as we build this business over time because, remember, as you know, we have the Office Depot name on retail. We have it on contract, and we have it in direct. We have it in e-commerce, and so we begin to get the synergies from the cross-channel marketing by simplifying that go-to-market strategy. So the sales in that business, the Viking sales, of course, as measured purely have gone away, and the Office Depot catalog is up substantially as a result of moving those people over. So we're pleased with the transition and now forward to continued growth on that business under one brand name.

Matthew Fassler - *Goldman Sachs - Analyst*

Great. Just one more quick one. You mentioned in the release that technology was a pretty big driver of your retail sales this quarter. If you could sort of differentiate between hardware and then some of the technology consumables and also talk about its impact on grosses?

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

It is Chuck. I missed the last part of the question, but on the technology we had pretty good success across all the technology categories. So our notebook computer business continues to be exceptionally strong. We continue to see a shift from desktops to notebooks, which higher ASP is involved with them. But all the attachments that go with technology and is really how you make money in the technology business we also good strength with. So networking gear, all the wireless accoutrements that go with technology purchases. So we saw broad-based success there.

Matthew Fassler - *Goldman Sachs - Analyst*

Thank you very much.

Steve Odland - *Office Depot - Chairman & CEO*

Part of the question was hardware versus software.

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

Hardware versus software. Our software business had some challenges. I think everybody has followed some of the changes in tax software, but otherwise it was really a pretty stable environment. But overall the balance of our technology business was quite good.

Operator

Dan Binder, Buckingham.

Dan Binder - *Buckingham - Analyst*

Just a couple of questions for you. First, I was wondering what you estimate the comp benefit may have been at the holiday shift in Q1?

And then with regard to Q2, what you estimate the comp benefit may have been from paper price inflation and the OfficeMax store closings?

Steve Odland - *Office Depot - Chairman & CEO*

Well, starting with the shift of the holiday, our quarters are January, February, March and then April, May, June. Others in the sector have different timings, so they were not impacted by the quarter to quarter shift. But because the holiday shifted from the middle of March to the middle of April, we actually saw the timing shift between the quarters. If you believe that there was a day or day and a half worth of volume that shifted between the quarters because on Easter we closed the stores as an example and then there is vacations with that, then that would have impacted the comp,

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the North American Retail by 2 to 3 percentage points. Frankly, the period of time -- I'm sorry, 1 to 2 incremental, so it would have been a 2 to 3 comp. But if you look at the comp strength, it was after the holidays were concluded, business came right back, and we had a terrific quarter consistent with the first quarter.

As it relates to paper, again we have not said the specific impact. It did hurt the North American BSD business more than the other divisions because of the structure of some of those contract relationships. But it did not materially impact the retail business, and international was less impacted by this. So I think as we go forward the paper prices, depending on what happens here, it could continue to affect us in the same way over the coming couple of quarters. But over time I think things ought to stabilize.

The OfficeMax store closings were relatively minor because there were a few stores, and they were the absolute worst stores presumably. So the closings did not really have a material benefit on our business anyway.

Dan Binder - *Buckingham - Analyst*

Just two follow-ups. I was wondering if you can give us a sense even if you don't want to put exact numbers to it, just sort of an idea of how category comps looked, supplies, furniture, and then we know technology was good. (multiple speakers)

Steve Odland - *Office Depot - Chairman & CEO*

Overall you see the strongest growth not surprisingly in technology, and this picture has not changed over time. Supplies were solid. They were growing. Essentially the issues that the whole industry has struggled with has been furniture. We have actually done I think a better job than a lot of people in furniture because of our private brand development there with the Christopher Lowell collection. We have private branded designs in that business that are unique, and we introduced some new categories and some new lines in that business in the past quarter which were very well-received. So, therefore, the margins have been proved, impacting the profitability as well. So overall a pretty good picture and a pretty balanced picture.

Dan Binder - *Buckingham - Analyst*

And then just last item, I don't remember what the -- I don't remember reading what the 70 basis point credit on international, the onetime credit you mentioned today, what was that related to a year ago?

Pat McKay - *Office Depot - EVP & CFO*

Actually last year given if you remember, we did not allocate G&A out amongst the various divisions, so that is new to this year. Pluses and minuses when you looked at our overall G&A as a total company is that (indiscernible) didn't ultimately cause us to think about disclosing it separately, but we allocated that out to the individual divisions than it popped out in terms of just some of the discussions and making sure there was clarity around the performance in international. So there were onetime credits from sales and resolution in certain matters last year that were favorable to the overall Company. But again, there were some offsetting items in total for the Company as it again just did not -- we ultimately concluded we needed to discuss it globally.

Dan Binder - *Buckingham - Analyst*

I think in the past you have given us, if I recall, a local currency organic growth number, even in quarters were you did not have acquisitions. Do you have a rough idea of what that might look like?

Steve Odland - *Office Depot - Chairman & CEO*

That is what we said. It is 1 to 2% in local currencies again, which is consistent with last quarter. So we have had two consecutive quarters of positive local currency growth, and that contrasted to the last couple of years where we have struggled there.

Dan Binder - *Buckingham - Analyst*

That is in organic?

Steve Odland - *Office Depot - Chairman & CEO*

We still have a lot of progress to go in international, but we are making progress. So we are pleased with the direction of that business.

Dan Binder - *Buckingham - Analyst*

Is that 1 to 2 an organic number, though?

Steve Odland - *Office Depot - Chairman & CEO*

Yes.

Dan Binder - *Buckingham - Analyst*

Okay. Great. Thanks.

Operator

Gary Balter, Credit Suisse.

Gary Balter - *Credit Suisse - Analyst*

First of all, Steve, I saw you on CNBC. You looked good.

Steve Odland - *Office Depot - Chairman & CEO*

Thank you, Gary.

Gary Balter - *Credit Suisse - Analyst*

Two questions, one is on the expense line. You put up a few new initiatives on the slide today, and those keep on going forward. How do we think about as you anniversary the first impact of that and how do we -- when do you stop seeing the benefits that we are seeing right now to the degree that we are seeing it? How should we be thinking about that?

Steve Odland - *Office Depot - Chairman & CEO*

That is a good question. As everybody knows, we're working on hundreds of initiatives, and any one of these things seem small, but they are not in aggregate. I think some people think it is magic.

I have been asked the question, what is the magic secret here and it is really not magic. That is why we give the expression of these programs, and we try to share a few more with you each time, which you know on the average, each one of these has $1 million or more. If you look through and characterize these initiatives, they are and should be material "permanent" impact to the cost structure. So as the costs come down, those costs ought to form a new level from which we can take it in future years. Our challenge will be to continue that improvement on top of those improved cost numbers in future years, while dealing with the natural kinds of inflationary items.

Gary Balter - *Credit Suisse - Analyst*

And how do we do that? Can you do that?

Steve Odland - *Office Depot - Chairman & CEO*

Well, that is the challenge. I think successful businesses deal with the natural inflation by having an ongoing cost focus and culture of thrift. That whole culture of thrift is something we talk about here. It is not a slogan; it really is the way we're trying to operate the business. So while we don't give specific commitments for the future, it is a focus going forward.

Gary Balter - *Credit Suisse - Analyst*

Second, at your previous company, you levered up a lot more and bought back stock, and here you have been very aggressive at buying back stock, but you still have a very strong balance sheet. What is your thinking on the balance sheet?

Steve Odland - *Office Depot - Chairman & CEO*

Well, just to be clear the actions in my prior company were taken before I got there. So what you saw during my tenure was a fairly consistent use of the free cash flow. That is pretty consistent with how we're approaching things here.

We have had an excess cash position on the balance sheet. We have utilized that excess cash position in a period of time where we thought that our stock was significantly undervalued, and we believe that we have created shareholder value by deploying that cash in share repurchases.

Going forward, we're happy with our current debt rating. We think that investment-grade offers us a good balance of cost to debt and balances out our cost to equity and drives an efficient cost of capital. We could use the balance sheet. We have strong -- we can use it for material kinds of things in the future whether it is an acquisition or a big share buyback, if that was something that we wanted to do. But, on a normal course going forward, I think you should expect to see us use our excess cash flow after capital needs in the business to reproduce that stock as long as it is in a period of time where we believe it is accretive. We do buy opportunistically with our share buybacks, and therefore, we have been able to affect an average purchase price over the past six months to about $36 a share.

Pat McKay - *Office Depot - EVP & CFO*

Gary, if I could, one more thing is actually you saw us execute in a very disciplined way in Q2 because we had as we have talked about what our disciplines are in terms of the choices of where we want to spend our cash flow and we did that through CapEx, we did acquisitions and then when we had excess cash, we spent it on share repurchases. But we still have a pretty significant amount of the prior authorization that the board provided to us is available to us on a go forward basis, but executed in a very disciplined way in Q2.

Operator

Jack Murphy, William Blair.

Jack Murphy - *William Blair - Analyst*

On Business Solutions, cold you talk a little bit about the competitive environment, whether that had any impact at all in terms of any moves by large competitors? Also within that division, could you talk about how you're doing a new accounts versus existing accounts in terms of your source of sales growth?

Steve Odland - *Office Depot - Chairman & CEO*

Sure. The overall BSD is very competitive. We have reasonably low market share we estimate using the SHOPA numbers, the industry numbers that we have a three to four market share, which is relatively small. But the fragmentation is considerable. I think the top three players together have under a 10% market share. So you see competition coming from the big players, you see competition coming from pure contract players, and you see competition coming from hundreds and hundreds of smaller local firms that have great footing in their regional areas.

However, having said all that, it has been a pretty rational environment. We are not interested in unprofitable growth. We only want to acquire customers where we can make money. We don't see any sense in acquiring customers who are bidding on customers where we cannot make money, and I think that you see that rational behavior from most of the marketplace.

We have had some success in the quarter with new customers. We don't disclose those customers due to their privacy needs, but we are pleased with a number of new customers that we have added on the contract side. Some big ones, mostly medium ones and of course, we have the direct business as well to complement the contract business where we focus on the smaller customers. We do lose customers occasionally for a variety of reasons, but this quarter was exceptional in the gains column.

Jack Murphy - *William Blair - Analyst*

Great. On the Worklife Rewards, I'm trying to get a sense of the magnitude of the impact that that could have on sales and gross margin. Do you expect those changes that you have made to be material, or are you already seeing a material benefit in this quarter?

Steve Odland - *Office Depot - Chairman & CEO*

Material benefit from what, say it again?

Jack Murphy - *William Blair - Analyst*

From the changes in the Worklife Rewards program.

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

It is Chuck. We have actually seen a good balance of that where the program previously was a bit upside-down in the sense that it rewarded some of our lower performing, lower value customers, and now we reward our higher value customers. We have been able to absorb that as part of our overall marketing package, and thus far we're very pleased with it. These customers, our Worklife Rewards customers, are our most valuable. They shop more often with us. They spend more money with us.

So we are pleased with how the transition has gone. It has actually been incredibly well received, and we have high hopes that we will be able to balance it as we have as part of our overall package.

Steve Odland - *Office Depot - Chairman & CEO*

You know, I have received questions on this program, and are we concerned about the fact that we have enriched the program? Actually the cost of the program is neutral between the old program and the new program. It is the structure that has changed as Chuck has described. So it is interesting that people think that this is a much richer program, and that underscores what should make it a more effective program and impactful to our customers. But from a cost basis, it is pretty comparable to the old Advantage programs that we had before.

Jack Murphy - *William Blair - Analyst*

Okay. That is helpful.

Operator

Brad Thomas, Lehman Brothers.

Brad Thomas - *Lehman Brothers - Analyst*

First of all, just a little bit of color on Europe. I don't know if you had broken out same-store sales. Are you going to provide that this quarter by any chance?

Steve Odland - *Office Depot - Chairman & CEO*

Well, we have not provided same-store sales by country, but let's just suffice it to say that we are up. We were pleased with all of our country results where we have stores. But in international, retail is a much much smaller portion of our business, and most of our retail business is in North America and in Mexico and Central America through our joint venture there. We only have stores in a couple of countries in Europe. But good progress on the retail side in Europe.

Brad Thomas - *Lehman Brothers - Analyst*

Okay. Then I don't know if you've had a chance to talk about your strategy in terms of the M2 remodel, though. I was wondering if you could share any color in terms of how you plan to pick which stores you are going to convert. Will you be doing it market by market or trying to select the oldest stores first? Any color would be helpful.

Steve Odland - *Office Depot - Chairman & CEO*

Yes, the M2 remodel is something that we need to carry across the entire marketplace. So it is a good question. How do you pick -- where do you go first? Part of that deals with the stores that are in the most need. Part of it is you balance with where we have the people and the work crews and the ability to do it.

So I think you're going to see us do them in a seemingly random fashion. There is logic, internal logic to it depending on the balance of the workloads and the store need. But you're going to see us doing it in every market around the country over the next three to five years.

This is a really important program for us because I think that you see us taking the concept and moving it from where it began, which is a marble warehouse kind of environment with a lot of steel and pallet kind of program to an evolution now to more of a warmer shopping experience with lower gondolas, and you can see across the store. We think it is a more friendly shopping experience.

Part of the deal would the M2s, though, is that we have the oldest store base, and the stores have not been refreshed over a long period of time. So, therefore, you could consider the money that we are putting into the stores as just normal routine maintenance. Because if we did not do this, we would still have to paint the stores and take care of the counters and the floors and that kind of thing. But, in the process of this maintenance, we're able to give it a different look. So I think it is a very financially astute way to go through the chain and get a fresh new look.

Brad Thomas - *Lehman Brothers - Analyst*

Okay. Thank you. Just one more question if I may. Steve, some of the initial expense initiatives that you all launched were very similar to what we saw you do at your prior company. Obviously some of the newer initiatives that we have seen are more unique to Office Depot. Can you just give us a sense for where we are in terms of building this culture of thrift that you like to talk about? For example, are we at a point where a majority of these new ideas are being generated from within, or how should we think about how this is being adopted?

Steve Odland - *Office Depot - Chairman & CEO*

Well, remember, I have been here now about a year and a half. The team is the same team that has been here right along, and the ideas that have come through the marketing and merchandising groups globally are all unique ideas or ideas that are focused on our business. The cost savings have been unique to our business as well, but there is cost to be saved in every business no matter what you are in and they look similar.

So if there are similarities, it is only incidental. But we are uniquely trying to take care of our customers. We are uniquely trying to evolve our business model from a multiple channel approach that is country-centric to an integrated approach. Remember this looks like a retail business, but in fact, 80% of the volume in the stores goes to business customers.

So I think the way to think about Office Depot is that it is a B2B business where sometimes the businesses pick up in the stores, sometimes they order off the Internet and sometimes they order through our call centers. We are we believe the world's third-largest Internet business. There are external sources that have reported that, but we have nearly $4 billion in business on the Internet side.

So we're changing the business model to have more cross channel shoppers so that we are taking care of small and medium businesses, largely and sometimes they pick up -- you know, whatever their needs are we will market to them in that way. So I'm really proud of our team, and I think we've done some really unique things and some brave things for our industry. We have not just simply done it the old way. We're creating a new business model.

Brad Thomas - *Lehman Brothers - Analyst*

Okay. Well, thank you. That is very helpful to hear.

Operator

Chris Horvers, Bear Stearns.

Chris Horvers - *Bear Stearns - Analyst*

A couple of questions. Recently Dell talked about weakness in the global commercial market. Certainly you're not selling a lot of computers on the commercial side. But I was just curious if that has got you worried about or any signs of end market demand softness?

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

No, our business, as I commented before, continues to be quite strong. We think actually from a retail store perspective it adds an advantage in the sense that customers want to see and feel product. We carry a great assortment of brands, a large assortment of laptops, and the shift from desktop to notebook has been very good for us, and we actually think that that will continue.

Brad Thomas - *Lehman Brothers - Analyst*

Excellent. And then as we think about the category management initiative, the average order basket has been a big driver of the comps. Maybe pricing has changed 2% according to our estimates year-over-year. When do you really start to anniversary the teeth of that when you gained a lot of traction with that initiative?

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

Category management is far more than pricing. We have actually seen our order value going up as we have sold product, and our market basket has gone up. So we're seeing improvement in transaction counts within a market basket. So while pricing has been a factor, it is far more than that which has contributed to our margins. So I think that market basket I'm very pleased with the progress we have made on our attachment rates for instance within the stores. That is what is really driving those numbers up.

Chris Horvers - *Bear Stearns - Analyst*

And really that did not gain -- you gained a lot of traction with that would you say this year, or was that something that started to pick up in the third and fourth quarter last year?

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

On attachment rates?

Chris Horvers - *Bear Stearns - Analyst*

Just on driving the average order basket higher.

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

Well, we have seen that ongoing for a period of time, and we are not where we believe we can be on attachments and selling items. We are here to sell a solution to a customer, and by definition that usually means more than one item. In today's day and age, as products become more complex, they work in an interactive way. Our role is to help the customer buy the solution that they need. That is multiple items, and while we have made very good progress in the past 18, 24 months, we think there's far more progress for us to make.

Chris Horvers - *Bear Stearns - Analyst*

Excellent. And then you talked about adding about 350 SKUs on the private-label initiative. Have you provided what you did in the first quarter or perhaps initiative to date how many SKUs you have added on the private-label side?

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

No, we did not provide that. I think what we have said is that we continue to see very good growth, and believe it will continue to be an increasing portion of our business.

Chris Horvers - *Bear Stearns - Analyst*

One last question. As you think about the comps and if you had a 1 to 2% shift in the second quarter suggesting a 2 to 3 comp, then should we think about the first quarter similarly around the two comp because it shifted into that quarter away from this quarter?

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

That would probably be a fair assessment.

Steve Odland - *Office Depot - Chairman & CEO*

Maybe we can take one more question, and then we will wrap up.

Operator

Danielle Fox, Merrill Lynch.

Danielle Fox - *Merrill Lynch - Analyst*

It looks like you stepped up store openings between first and second quarter, and according to our calculations, it actually looks like new store productivity crept up a little bit but was still down year-over-year. Can you just talk about the trends that you are seeing in new store productivity and maybe comment a little bit on your real estate pipeline?

Steve Odland - *Office Depot - Chairman & CEO*

Yes, we did step up openings sequentially quarter to quarter. That is just how it flowed in the pipeline. Obviously with a target of 100 stores for the year, our stores are going to be focused towards the third and fourth quarter of the year. And that is just the way the pipeline is falling this year.

Our store openings have gone well. We're very pleased with the productivity, and productivity I think is actually a little bit better than prior years given all the initiatives that we have introduced in the private-label expansion and so forth.

So we're pleased with it. We think that we can continue to expand and increase the number of new stores that we opened year-to-year, and it has been a profitable source of growth for us.

Danielle Fox - *Merrill Lynch - Analyst*

Was there anything in terms of the openings within this quarter? Were they grouped towards the end or pretty evenly distributed? Just in thinking about we obviously have less information in thinking about the new store productivity calculation than you did. You mentioned you felt it was up year-over-year.

Steve Odland - *Office Depot - Chairman & CEO*

If you count it in terms of sales per square foot, our productivity has been increasing over time as the category and management initiatives have been rolled out. This is a multiyear process that we have to go in building out our adjacencies dealing with a good, better, best array, the new product pipeline and so forth. All that significantly impacts our new stores because that makes them more profitable and gives us the ability to add and have them to be accretive to our ROIC as we go forward. I think that is a critical measure here. Our ROIC increased on a trailing four quarter basis from 11.4 to 13.9% in this quarter, and it has been a material shift in the past year on our ROIC. So significantly higher earnings over our costs of capital, and I think that is what builds shareholder value. So we're pleased with that creation over time.

Danielle Fox - *Merrill Lynch - Analyst*

Thank you. That is helpful.

Steve Odland - *Office Depot - Chairman & CEO*

Well, I would like to thank everybody for joining us today. Obviously we're very pleased with this quarter, but we have been very pleased with the last five quarters. This quarter sales were up, margins were up, costs were improved, inventory per store were improved, cash flow was up, EPS is up, and what is not to like about the quarter? We still have obviously a lot of progress to make on our business, but we're pleased with the progress so far. Thanks very much for joining us, and we will talk you over the coming quarter.
