THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

ODP.OQ - Q2 2005 Office Depot Inc. Earnings Conference Call

EVENT DATE/TIME: JULY 21, 2005 / 1:00PM GMT

OVERVIEW:

ODP reported sales of $3.4b for 2Q05, a 6% increase over 2Q04. Net earnings per diluted share increased 24% to $0.31. No EPS guidance was given. Q&A Focus: Pricing, stores, and operations.

CORPORATE PARTICIPANTS

Ray Tharp *Office Depot Inc. - Director of IR*

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

Charlie Brown *Office Depot Inc. - President, Office Depot International, and CFO*

Chuck Rubin *Office Depot Inc. - EVP and Chief Merchandising and Marketing Officer*

CONFERENCE CALL PARTICIPANTS

Gary Balter *Credit Suisse First Boston - Analyst*

Matthew Fassler *Goldman Sachs - Analyst*

Daniel Binder *Buckingham Research Group - Analyst*

Colin McGranahan *Sanford Bernstein - Analyst*

Scott Nesson *Lehman Brothers - Analyst*

Mark Rowen *Prudential Equity Group - Analyst*

Michael Baker *Deutsche Bank - Analyst*

Michael Cox *Piper Jaffray & Co. - Analyst*

Dana Telsey *Bear, Sterns & Co. - Analyst*

PRESENTATION

Operator

Good morning. We would now like to welcome you to Office Depot's second-quarter 2005 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 Mr. Ray Tharp, Director of Investor Relations, who will make a few opening comments. Mr. Tharp, you may now begin.

Ray Tharp - *Office Depot Inc. - Director of IR*

Before beginning today's conference call, I would remind you that certain statements made on this call are forward-looking statements under the Private Securities Litigation Reform Act. Except for historical, financial and business performance information, comments made on this call should be considered forward-looking. Actual future results may differ materially from those discussed on this call due to risks and uncertainties both foreseen and unforeseen. Certain risks and uncertainties are described in detail in our Report on Form 10-K filed with the SEC on March 10, 2005, and in our 10-Q filed with the SEC this morning.

During portions of this call, Office Depot executives may refer to results of our second-quarter 2005 which are not GAAP numbers. The reconciliation of non-GAAP numbers to GAAP results is available on our website at www.OfficeDepot.com.

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

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

Thank you for joining us today for Office Depot's fiscal 2005 second-quarter conference call. With me today are Charles Brown, our President of Office Depot International and our acting Chief Financial Officer; Chuck Rubin, our Executive Vice President and Chief Merchandising and Marketing Officer; and Sean McHugh and Ray Tharp from Investor Relations.

I hope you've had an opportunity to read our press release today and learn about this quarter's results. If not, the press release, along with the accompanying web-cast slides, are available on our website at www.OfficeDepot.com and just click on the Investor Relations tab.

For the second quarter, we reported sales of $3.4 billion, a 6% increase over fiscal second-quarter 2004. All of our divisions contributed to the sales growth in U.S. dollars with North American retail and North American business services accounting for most of the increase. Only in our international business, where we saw in -- sales decline in local currencies did we have a disappointment for the quarter.

Company gross margins remained flat for the quarter. The benefits from higher North American retail sales volume and margin rate were offset by margin rate decreases in our international division. Total operating expenses as a percentage of sales declined 47 basis points for the quarter. We recorded rate reductions in both general and administrative expenses and store and warehouse operating and selling expenses, primarily driven by sales leverage and expense control.

As a result, consolidated operating profit increased 20% versus the second quarter of last year.

Taking into account our net miscellaneous income, EBIT for the quarter was $150 million, up 22% from the same period in 2004. EBIT margin improved to 4.5% for the quarter compared to 3.9% last year.

Net earnings increased 26% compared to the prior year because of reduced interest expense following the repayment of high interest rate debt last December and because of a lower effective tax rate. Net earnings per share -- per diluted share increased 24% to $0.31.

Return on net assets for the trailing four quarters was 9.8%, up from 9.4% in the same period in the prior year and above our cost of capital. We need to demonstrate even greater capital discipline in the future as we seek to widen the spread between our returns and our cost of capital. Office Depot is committed to improving this metric going forward as we take actions to increase shareholder value.

Now, let's discuss our division results. We'll begin with North American retail. Second-quarter sales in North American retail were $1.5 billion, an 8% increase compared to the same period last year. Comparable store sales in the 890 stores in the U.S. and Canada that had been open for more than one year increased 3% for the second quarter. This represents our sixth consecutive quarter of positive comparable sales.

We recorded comparable sales increases in all major merchandising divisions, with strong technology sales leading the improvement. Comparable average ticket size increased and comparable transaction counts increased slightly for the quarter. A significant portion of that transaction comp decline, however, is attributable to low-ticket purchases, which we believe are from nonbusiness customers.

Division operating profit as a percentage of sales increased during the quarter to 6.9% compared to 5.3% in the same period last year. Gross margin improvement drove the increased profitability. Broad-based product category margin percentage improvement and increased vendor program support were the main contributors. Back of store and warehouse expense controls delivered benefits again this quarter, as incremental costs associated with adding stores during the period were absorbed by higher sales volume.

Payroll and related costs decreased as a percentage of sales. Division operating profit increased 41% in the second quarter compared to the same period in 2004.

I would like to highlight a few of our ongoing initiatives to drive profitable growth in North American retail. In the second quarter, we continued our Taking Care of Business strategic marketing campaign, which was launched during the first quarter. This reintroduction of our brand to the marketplace under our most successful business theme in the history of our Company reflects our unwavering commitment to the business customer -- the customer segment that is the most critical to our success.

This strategy returns Office Depot to the customer commitment made during our period of greatest growth and strength, and we are confident that it will serve us well in the next growth period. The campaign continues to be well-received by our customers.

In July, we announced the expansion of our partnership with NASCAR and the Roush Racing team. Beginning in 2006, Office Depot will become the primary sponsor of Carl Edwards and the Roush 99 Ford Taurus and will continue our exclusive Office Products-NASCAR sponsorship. As many of you know, NASCAR fans rate among the best in the world in terms of brand loyalty, and we will continue to leverage our association at both the local and the national levels with this premier, high-growth sport and top-tier racing team.

Marketing effectiveness remains a priority for Office Depot. We will continue to review the return on investment of all of our advertising vehicles to ensure that we concentrate on the highest-yielding vehicles. The Advantage Card loyalty program, now in its second year, contained 2.5 million active members at the end of the second quarter. Our Advantage members demonstrate a higher purchase frequency compared to non-Advantage members. And we continue to observe strong double-digit sales lift among measurable customers.

In merchandising, our ongoing initiatives continued to deliver the results as well. Private brand sales increased to 19% of sales, up from 16% in the second quarter of last year. Private brand IMU rate also improved significantly over the same period. We expect to continue to expand our private brand SKU count in all channels.

Global bids were conducted in several product categories during the second quarter, resulting in lower cost of goods for the selected items. Additional product categories are scheduled for bid every quarter for the balance of 2005.

Our category management initiatives from 2004 also delivered results in the second quarter, as we continued to refine our product and pricing strategy to meet the needs of our customers while delivering returns for our shareholders.

Also, the Magellan system capabilities continue to support our more analytical and disciplined merchandising processes. During the second quarter, we completed the integration of our space productivity applications. These applications will provide us with a detailed view of our store space productivity that will further support an analytical approach to assortment, development and inventory management.

The North American retail team has done a great job in delivering operational cost savings over the past year. Last quarter, we mentioned three examples of cost-saving programs. If you remember, those were, first, retrofitting the energy-efficient light fixtures in our high-energy-cost stores; second, upgrading energy monitoring systems that allow us to adjust store electricity usage in real time; and third, executing more favorable lease agreements for store technology hardware -- things like cash registers and copy center equipment.

But here are some additional examples of cost-saving programs that are currently underway. First, we are shifting store broadband communications from frame relay to less expensive DSL. Second, we're reviewing and adjusting shopping bags specifications -- saved over $0.5 million annually by these adjustments. Third, we're shortening the customer register receipt text printout, resulting in register tape savings across the chain.

So you can see that the savings from any individual program isn't a home run, but as these programs are executed, many more of them become -- they represent the singles and the doubles that will add up to substantial cost savings over time.

During the second quarter, the Company opened 17 stores, closed one and relocated four office supply stores. At the end of the second quarter, Office Depot operated a total of 1011 office product superstores throughout the U.S. and Canada. Our second-quarter store count grew 1.6% over the end of the second quarter. Gross square footage increased 1%, reflecting the opening of smaller-than-average footprint stores during the quarter.

We're pleased with the North American retail results this quarter. We continue to benefit from our new store openings and existing in new markets, along with improved performance from our existing stores. For example, in the Chicago market, we recorded double-digit sales growth over the second quarter of last year. We will continue to execute against our strategic priorities in an effort to drive future profitable growth.

Now, turning to North American Business Services -- Business Services group sales increased by 7% in the quarter to $1.1 billion compared to the same period last year. Increased sales in the contract channel, particularly in large customer and national accounts segments, contributed to the overall revenue growth.

We are also seeing benefit from our recent investment in our sales force. Division customer transaction counts and average order values both increased during the quarter compared to the second quarter of last year. Division operating profit as a percentage of sales increased during the second quarter to 10.9% compared to 9.7% in the same period last year.

Gross margin rate improvements were offset by higher sales contribution from lower-margin contract channel sales. Significant store and warehouse expense leverage drove the overall operating margin improvement.

In dollar terms, higher payroll and cost -- call (ph) center optimization expenses were offset by reduced warehouse and delivery expenses. The division operating profit increased 20% in the second quarter compared to the same period of 2004. The North American Business Services team remains focused on several key initiatives to drive profitable growth in our efforts to increase our market share.

First is private brand. We continue to emphasize private brands to deliver value and to provide differentiation in the eyes of our customers. In fact, private brand was a key topic of discussion in our recent Customer Advisory Council meeting.

Second, sales force effectiveness and automation. By providing our selling team with updated tools and improved processes, we hope to increase their effectiveness and support their account growth goals. The primary project planning was completed in the second quarter.

Third is customer-centric delivery. We have established cross-functional teams to identify operational improvement opportunities to ensure that we are delivering the highest-quality delivery service to our customers.

And fourth is telephone account management, which continues to be an effective program to drive efficient demand creation and to properly manage existing accounts.

Now, turning to the International business. Our International division's first-quarter sales increased 3% in U.S. dollars to $848 million, but it declined 1% in local currencies compared to the same period in 2004. The favorable change in exchange rates from the corresponding prior year increased sales reported in U.S. dollars by 32 million in the quarter.

Our International division continues to operate in a very challenging economic and business environment. Sales as measured in local currencies declined in most major markets and across most sales channels. Division operating profit as a percentage of sales declined during the second quarter to 10% compared to 12.9% in the same period last year. Reduced gross margin was primarily responsible for that decline. The growth declined because of continue pricing pressure in key product categories and increased competitive activity.

Second-quarter selling and warehouse expenses as a percentage of sales increased primarily because of deleveraging associated with the lower local currency sales volumes and the prior-year benefit related to settlement of certain commercial claims.

Division operating profit declined 20% -- actually, it declined 23% in local currencies in the second quarter compared to last year. International division operating profit, when translated into U.S. dollars, benefited from foreign exchange rates by $3 million during the quarter.

These operating results are not up to our expectations, but we remain optimistic on the long-term potential of our International business. Second-quarter sales trends, while below our plans, did improve over the first quarter. So, excluding currency impact and the unfavorable comparison resulting from the commercial settlement in the second quarter of last year, our store and warehouse operating expenses were relatively flat in local currencies.

We see great potential outside of North America and we believe that we can grow this business at a more rapid rate and deliver higher profitability in the future. In the meantime, we're taking action to improve the performance of our International business. First, we're continuing to roll out our telephone account management program to deliver more cost-effective customer relationship management and demand generation.

Second, we need to accelerate our efforts to rationalize our supply chain and other assets as part of the Guilbert post-merger integration process.

And third, we need to accelerate the streamlining of our overall processes and cost structure to ensure that we remain competitive in the marketplace.

Now, I will turn it over to Charlie Brown to take us through cash flow and the balance sheet. Charlie?

Charlie Brown - *Office Depot Inc. - President, Office Depot International, and CFO*

Thanks, Steve. Let me start with cash flow. During the first half of 2005, cash provided by operating activities was $86 million, down from $309 million in the same period last year. This year-over-year change primarily reflects the timing of trade and other accounts payable settlements during the first half of 2005 compared to the same period last year.

Merchandise inventories declined from year-end, but remained at higher levels compared to the same period last year. Cash provided by operating activities was positive in the second quarter. Depreciation and amortization totaled $135 million for the first half of 2005, up over last year primarily because of increased store openings in North America.

First-half EBITDA was 286 million, up 13% over the same period in 2004. Capital expenditures amounted to 155 million for the first half of 2005.

North American retail new store openings represented the biggest capital investment area. For the full year of 2005, we anticipate CapEx in the 275 to $325 million range. We will continue to identify and execute in investment opportunities that drive returns above our cost of capital.

We used $69 million of free cash flow in the first half. The year-over-year change is primarily attributable to the reduction in cash flow provided from operating activities. Note that we were free cash flow positive in the second quarter.

Last fall, we announced a $500 million share repurchase authorization to be conducted over a two-year period. We commenced purchasing under this authorization in November of 2004. During the second quarter, we repurchased $62 million worth of stock. From a cumulative program basis, our shares repurchased totaled $106 million. We remained committed to our buyback plan over the long term and we intend to continue to seek disciplined buying opportunities to over time.

Now, moving onto the balance sheet. We ended the second quarter with 845 million in cash and short-term investments. Our investments in merchandise inventories totaled $1.4 billion. Inventory per store was $101,006,000 (ph), slightly lower than our ending first-quarter average.

Our second-quarter inventory balance included the year-over-year impact of opening 110 net new stores in the past year, spending, assortment key categories in North American retail and earlier setting of store merchandise for our back-to-school program.

Working capital increased year over year, generally as a result of lower accounts payable levels relative to inventory and increased accounts receivable. We're focused on improving the inventory to payables relationship over the balance of this year.

Our long-term debt declined substantially compared to last year as we redeemed $215 million in senior subordinated notes this past December. This action reduced our interest expense and eliminated restrictive covenants associated with those instruments.

At the end of the second quarter, our long-term debt to shareholder equity ratio was 17%. Our outstanding 2013 senior notes are rated investment grade by both Moody's and Standard & Poor's.

With our positive net cash position, our balance sheet remains very strong. Our return on equity for the trailing four quarters was 11.4%, down from 12.2% for the comparable period ended in fiscal 2004.

I have one final comment regarding the presentation of our financial statements. As we announced last year, we have been reviewing the composition of our general and administrative expenses and assessing the appropriateness of additional allocations to the operating units. The Company plans to allocate all G&A and other operating expenses to the operating segments and redistribute certain other amounts based on refined allocation methodologies.

We believe this change will result in a more meaningful presentation of our segment results. This methodology is being refined for internal reporting and is likely to be used for both internal and external reporting by the end of the year. Prior periods will be reclassified for useful comparison once we begin to report in this manner.

That concludes the cash flow and balance sheet discussions. I would like to turn the call back to Steve for some final remarks before we open it up for questions.

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

Thank you, Charlie. Before we conclude our remarks today, I just want to remind everyone of our three strategic growth priorities. First is North American retail, where we intend to improve our store productivity while continuing our store buildout program. Second is North American Business Services, where we plan on profitably growing our market share through new customer acquisition and new product and service offerings. And third is International, where first we need to improve profitability, but then we need to grow our European contract business and over time increase our geographic reach.

As far as our outlook goes, I want to remind everyone that we do not issue formal business performance and earnings guidance. We remain committed to making decisions and taking actions consistent with the long-term interests of our shareholders. I think it's appropriate to remark, however, that it may be a mistake to assume that the extent of our favorable results in the second quarter is totally incremental to the overall anticipated results for 2005. We've had a good quarter, but in some cases, the timing of various items has had a favorable impact on quarter two, and it may not be appropriate to assume that all of our results in this quarter establish a new based on which to project future results.

As we have previously disclosed, we have launched a review of strategic alternatives with the intent of improving our long-term performance. All of our business units, including corporate staff groups, are reviewing existing assets, commitments and programs to assess their appropriateness and usefulness as we move to improve our competitive position. This is a wide-ranging review and will include assessment of the effectiveness of both recent as well as long-standing investments, as well as the ability of existing assets to generate their desired returns.

In addition to this asset review, business units are focused on ways to improve efficiency and streamline operations over a multiyear horizon. Management's recommendations will be subject, of course, to approval by the Board of Directors. The outcome of this process cannot be predicted at this time, but may result in a material charge being recorded during the third quarter of this year, 2005, and additional impacts in future periods.

We have a business that generate substantial cash flow year in and year out. We can use our cash flow to profitably grow our business by first opening new stores and new geographic markets; second, making necessary investments in our core business; third, acquiring assets or businesses in our key priority areas; and finally, repurchasing stock as long as we believe it's accretive.

The Company is clearly headed in the right strategic direction. I believe our clear direction, along with improved execution and a sharp focus on costs, are the keys to achieving our industry leadership goal. In closing, I see enormous long-term potential for our Company and I look forward to periodically updating you on our progress.

Now, we would like to open up the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Gary Balter, Credit Suisse First Boston.

Gary Balter - *Credit Suisse First Boston - Analyst*

(technical difficulty) for your today is really regarding pricing in the contract segment. What are you seeing in terms of the pricing environment there?

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

I'm sorry. We didn't catch all the question. Could you just give it to us one more time?

Gary Balter - *Credit Suisse First Boston - Analyst*

Pricing environment in the contract segment.

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

Right. Well, you know, the contract segment of course is our segment of Business Services that services the larger corporations. And those kind of companies tend to get out their business and hence pricing is a key component of it. We continue to see contract pricing be pressured, of course. All businesses are under pressure to cut costs, and this is one consistent area. But we believe we've done a great job of adding private brands and also service levels to enhance our value offering so that we're not judged purely on price alone. Remember, private brands are higher-margin for us than our average brands and we're able to offer a better value in total, so lower prices and better products.

So, overall -- also, we've done a great job of lowering our warehouse expenses in that segment. So, while the prices will continue to be pressured in the future, we're reacting in the way that we're strategically offering our products and services.

Gary Balter - *Credit Suisse First Boston - Analyst*

Great, thank you. And related to that, in terms of retail pricing, where are you in rolling out zone pricing?

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

Where are we in terms of rolling out zone pricing? Chuck, why don't you address that?

Chuck Rubin - *Office Depot Inc. - EVP and Chief Merchandising and Marketing Officer*

Good morning, Gary. We started our pricing strategy implementation last year in 2004. We continue with that. Zone pricing is a component of that strategy. We're well into that program.

Gary Balter - *Credit Suisse First Boston - Analyst*

Okay. Thank you.

Operator

Matthew Fassler, Goldman Sachs.

Matthew Fassler - *Goldman Sachs - Analyst*

I would like to ask two questions. The first is to dig a little deeper into the working capital discussion, Charlie, that you had. Can you give us a little bit of insight as to where the receivables increase is coming from by region, if you could? I think International was the source of a lot of it last quarter.

And then secondly, as you think about the inventory levels that you are carrying today, broadly speaking, is it your expectation that those increases will come in more in line with sales over the second half of the year, or are you comfortable carrying these levels of inventory through the year?

Charlie Brown - *Office Depot Inc. - President, Office Depot International, and CFO*

In terms of receivables, our North American DSG was actually up about 8% in the quarter. So, those receivables are obviously growing in line with those sales. International -- I don't think there was much change. So, I think it's just really the growth of the business that's driving the receivables, primarily in North America this quarter.

On inventory, we're continuing to open -- we opened 110 stores, I believe, year-over-year, and most of the inventory increase is coming from that. What we're really focused on is increasing our leverage with our vendors -- more vendor financing as a way to improve that ratio.

Matthew Fassler - *Goldman Sachs - Analyst*

Got you. And that's something that you think you can continue to do as the year progresses?

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

Yes, Matt, I think the right way to look at it is inventory per store, and I think what we saw in the second quarter is a slight decline versus our inventory per store level in the first quarter. So, that's a metric that I would encourage people to watch. We're pleased with that because at the same time, we believe we've actually enhanced our in-stock positions and the visibility of products around the store. So, it's a double positive.

Charlie Brown - *Office Depot Inc. - President, Office Depot International, and CFO*

We actually -- the inventories also reflect sitting our back-to-school earlier this year than last year. So that also contributes for the inventory build.

Matthew Fassler - *Goldman Sachs - Analyst*

Got you. And just a second question on the sources of the retail sales acceleration. It sounds, by the way, like you are increasingly focused on business customers in that segment. Has that impacted the mix at all, and can you give us any kind of color on where the better results are coming from in that segment?

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

Our efforts have been across the store, Matt, and we've been fortunate in the quarter that our categories are all improving. As you know, we recorded a 3% comp. But we have to just remind people that our retail business is a little different than a lot of retail business in that the majority of our sales is to the small-business customer. So, we have to think of these customers as customers that get delivered sometimes, that order over the Internet sometimes, that come into our store sometimes. So it's just a little bit different kind of a business.

But, across the categories, we saw pretty good performance, with technology leading the way. And so therefore, you saw the grosses blend out over time. We're going to continue our category management activities, and that will include everything from the mix of items that we carry and selection to pricing and how we stock them in the stores and some prices will go up over time, some prices will go down as we continue to optimize our mix.

Operator

Daniel Binder, Buckingham Research.

Daniel Binder - *Buckingham Research Group - Analyst*

Just a couple of topics maybe you could touch on. First, what did you see on the traffic side of the comp? Two, what are you doing different with back-to-school this year other than maybe setting it earlier? Is there anything that you're doing differently on the promotional side? And then three, in terms of the inventory opportunity, you do a lot of your -- as I understand it, you do a lot of your distribution through cross stocks. Is there an opportunity to further streamline and take inventory out through changes in distribution?

Chuck Rubin - *Office Depot Inc. - EVP and Chief Merchandising and Marketing Officer*

I'll take the first couple of parts of that. On the traffic side, as Steve mentioned in his comments, we saw a slight reduction in transactions during the quarter. We believe that the vast majority of those were consumer-oriented purchases. They were low ticket value. So when you extract that, we think our traffic -- our transactions are pretty stable and we've done a good job of increasing the value of that transaction through a number of programs that were put in place in terms of merchandise content and the selling environment in the store.

As to your second part of the question around back-to-school, we've done a number of things differently. If you walk into our stores today, we are ready to go with our presentation and our product. In terms of the mix of the product, in terms of the pricing, in terms of the advertising and the presentation of that product, it really falls under the category of management principles that Steve mentioned before and that we've talked about on previous calls. We're looking at that market as a place for us to perform well during the third quarter. And when you walk into our stores today, you will see us prepared for that.

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

Your third question related to our distribution system and the inventory and so forth. And as part of this effort that we have going to do a complete asset review, we're looking at our entire supply chain and our cross stocks and what we call our customer service centers, which are the warehouses from which we deliver our business customers. We will look hard at that to make sure that we've got the most effective configuration for that network going forward.

But, again, as I mentioned earlier, from an inventory standpoint, we will continue to focus on the inventory per store metric. And I think we've got to be careful in that metric. We're going to make sure that it's at the right level because we don't want to have service problems. But, it is one which we think is relatively stable and we're pleased at where we are at right now.

Operator

Colin McGranahan, Sanford Bernstein.

Colin McGranahan - *Sanford Bernstein - Analyst*

A couple questions. First, if you can talk about CapEx a little bit. I believe that the new outlook is moderately below what we had been expecting before. Can you talk about what has fallen out of CapEx this year? Is that a permanent reduction or is that just a shifting between periods, and how you're thinking about CapEx now that you've been on the ground for about 100 days?

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

Well, you know, we're looking at CapEx very, very carefully. We're trying to make sure that we've got our CapEx at levels that by project exceed our hurdle rates and in total achieve our strategic goals. I mentioned that we're going through our business review and during the third quarter, we will have the results of that and the potential impact of that. But we did take our range down a little bit here from last quarter as we have really tightened up what we think that we're going to achieve. We're still targeting the opening of about, round numbers, 100 stores plus or minus a couple for this fiscal year, and we're still targeting that for next fiscal year as well.

Colin McGranahan - *Sanford Bernstein - Analyst*

Okay. Second question on the M2 stores and the northeast expansion, can you talk at all about productivity of those stores, the expense structure and what kind of early return on capital you're seeing?

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

The M2 prototype is one that, as you know, Colin, was developed and tested and we're continuing to modify that design, and frankly I think that's going to be a lifetime project where we are always tweaking it. But we're very pleased with the results of the M2 design and we're very close now to being able to make a decision to take that more broadly. Right now, all of our new stores are being built in the M2 format and all of our remodels are in the form as well. So, everywhere we put that seems to have strong results.

Colin McGranahan - *Sanford Bernstein - Analyst*

Okay. And am I correct in some of the new stores will begin to enter the comp store calculation in the third quarter? And can you comment at all about what cannibalization you've seen so far from the store openings?

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

You're going to see those enter the comp from the third and the fourth -- in the third and the fourth quarters. I think there's a large number in the fourth quarter as well. And naturally, as the stores that are more fill-in stores that are closer to our existing stores come in, you're going to have an impact on our comp base.

Colin McGranahan - *Sanford Bernstein - Analyst*

Just final question on DSG. The 7% growth was certainly an acceleration. Can you talk about how much of that was in -- I know you said contract in the comments was strong -- how much of that was new customers and what the 140 or so new reps, how they are performing in contract, what happened with sales to existing customers in contract and what you've been doing from a prospecting perspective in the catalog business?

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

Well, we did see good results across virtually every channel in our Business Services group. I will remind people that we are the world's third-largest Internet retailer and a lot of our business is moving in that direction. So, we're pleased with that contract did lead the way through -- you've got a combination, as you know, Colin, of new customers that come on stream and so forth. But listen, we're pleased with the lift from new customers. We're pleased with the increased buying from our existing customers and the relative performance across groups.

Operator

Scott Nesson, Lehman Brothers.

Scott Nesson - *Lehman Brothers - Analyst*

My question is for Steve. I'm wondering if you could talk a little bit more about your focus on improving profitability in the International segment as it relates to the comprehensive business review, and any comments there as far as how the Guilbert business is performing relative to your cost of capital?

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

Well, I will let Charlie pitch in here as well, since Charlie is not only the acting CFO, he's also the President now of International. But I think that we have really not affected the Guilbert integration at a high speed, and so right now, we're moving rapidly to do that. We need to improve our profitability and I think the way that we're thinking about it is by our pan-European structure. Primarily, as you know, our biggest international segment is in Europe and we've really grown up as a country-by-country business structure.

We have an opportunity to think about that business across country and take a pan-European approach, and as we do that, we think that we will get more -- be more -- first of all, more effective, which is the most important thing, but also more efficient in how we do that business. Charlie, do you want to add--?

Charlie Brown - *Office Depot Inc. - President, Office Depot International, and CFO*

I think the only thing I would add to what Steve has said, and he is absolutely on point in terms of finding ways to create a more pan-European structure, and we're very much focused on that. But the other issue -- I think we were probably overoptimistic in our assessment of the amount of time it took to integrate a business where we essentially doubled our size overnight, and that has put a strain on our (technical difficulty) in Europe. So we're focused on now getting that back on track. We're getting the right kind of leaders in place and we expect improving results.

Scott Nesson - *Lehman Brothers - Analyst*

Okay. Thanks. Last question is just on the contract business. You mentioned the large accounts being a primary driver there. And I was wondering if you could comment on what you're seeing in the middle market, given some of your competitors' emphasis on building that out?

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

Well, we're seeing good results there as well. I think as I mentioned, we're pleased with the balance of our sales growth. It was just that contract was slightly higher percent than some of the others. But the balance has been good. As you may know, our business correlates highly with the strength of the economy and the level of business formation. And you see that most prominently in the formation of small businesses. And so, that -- the small and medium business really is the heartbeat of our business. Even though the contract and the large business is -- clearly are big wins and a focus for us, day to day, it's the small-business customer that's at the heart of our business and we're seeing good relative performance there.

The technology segment is one to across business segments that -- so from a category standpoint, across business segments is one that continues to grow. I'm sure you've read all the press on that from the various technology companies as people upgrade those products, and we've been recipients of that recent strength in that business.

Scott Nesson - *Lehman Brothers - Analyst*

Okay, thank you. Congrats on the quarter.

Operator

Mark Rowen, Prudential.

Mark Rowen - *Prudential Equity Group - Analyst*

A couple of questions. The first one for Steve is kind of a broad one. Now that you've been there at Office Depot for awhile, could you just comment on what you see as the organization's strength and what you see as the biggest challenges over the next 12 to 24 months for the organization more from sort of a human capital perspective?

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

Well, I tell you, I'm very pleased with the group here at Office Depot. I think we have very, very good people, very high-quality team, and we have worked very closely at the officer level, the top 100 people in the Company, to build a team. I think before, we were operating in a more siloed environment, and our efforts have been to build more teamwork. We've spent a lot of time working as a team, developing our strategic plans, and that has I think shown dividends in our performance, quite frankly.

So, part of what we're seeing this quarter is the soft side, which is our people really have come together nicely. We have a couple of key searches out -- a replacement for Charlie, who has been promoted to a new position, the President of International, and then a recruit for a new position that we've established for President of the North American retail business, and those are both ongoing. But I will tell you that the team is terrific here and is very excited about our prospects for the future. So, I think as we go forward, we're going to continue to evolve our team and I think that will show over time in our business results.

Mark Rowen - *Prudential Equity Group - Analyst*

Okay, and then, could you be a little more specific in your new stores in the Northeast -- give us some performance metrics on how you are doing there, particularly in Boston, New York, Philadelphia -- some of the Kids"R"Us locations that you took over?

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

Well, you know, whenever you go into a new market where you haven't been before, it's more challenging than going into a market where you've been for a long time. That's true across the country, and the Northeast is no exception to that. We've got well-entrenched, tough competition in the Northeast. So, as we've gone in, we modeled our expectations based on the kind of expectations we develop from any market entry. And we've been pleased with the results compared to those models. So, this is the kind of thing where, as we build our stores out across the country, we're building to stay, we're building for the future, and so we're pleased so far with what we've seen in the Northeast.

Mark Rowen - *Prudential Equity Group - Analyst*

So, does the early results in the Northeast give you confidence that you can repeat that in other parts of the country?

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

Well, I think it's the other way around. The other parts of the country have given us confidence that we can go into the Northeast, which gives us confidence that we're going to be viable in every market we go into and we're there for the long-term. I think what we've also seen is pretty rational competition, and that is a good operating environment.

Operator

Michael Baker, Deutsche Bank.

Michael Baker - *Deutsche Bank - Analyst*

Real quick, I just want to follow up on one of the last things you said on the conference call, and that is that you had some timing issues that helped you in the second quarter. I was wondering if you could be more specific about what you are referring to? Thanks.

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

Thanks, Michael. I'm not trying to call out any items. There are things that are timing in every single quarter. The only thing I want to say is we got a little lucky in the quarter. Things fell our way. We were pleased with the comp results and so forth and we were pleased with our cost savings. But it's still very early. And I just want to remind people that it is early, that we're working very hard, but we've got a lot of challenges ahead of us. We're going into the third quarter, we're doing the strategic review, it likely will result in a significant charge, and so I'm just trying to make sure that people really understand this is very early and that these results, they are good. We're very pleased with them. They are results that are from a lot of hard work from our people. But I just want to be cautious about straight-lining these kind of results.

Michael Baker - *Deutsche Bank - Analyst*

Okay, so there's nothing specific in terms of vendor programs helping the margins more than the other lines as well going forward or maybe that the private label seemed like an acceleration. Is that kind of growth likely to continue and anything specific like that, or--?

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

Well, I don't want to call out anyone particular item. All of those areas are areas of focus for us. Just, you know, some quarters, everything falls your way; other quarters, you don't have exactly that kind of luck. But we're pleased with the results across all of our efforts this quarter.

Michael Baker - *Deutsche Bank - Analyst*

Okay fair enough. Great quarter. Thanks.

Operator

Michael Cox, Piper Jaffray.

Michael Cox - *Piper Jaffray & Co. - Analyst*

Congratulations on a great quarter. I was wondering if you could give us an update on the Magellan program -- where you are in terms of nearing completion on that and quantify any of the benefits you're seeing?

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

Yes, we're pretty well -- I'll let Chuck address this as well. We're pretty well finished with the -- almost finished with the implementation. We've reintegrated the team -- most of the team back into their business units, and we're just about there. I think, you know, in the next quarter or so we'll probably stop talking about Magellan per se because it now is baked in and showing benefits in our SKU planning, our assortment planning, our category management efforts and so forth. And I think that we'll see the benefits from Magellan over a multi-year period. But, Chuck, I don't know if you have any additional color you'd like to put on it.

Chuck Rubin - *Office Depot Inc. - EVP and Chief Merchandising and Marketing Officer*

I would just reinforce Steve's point. Across the different modules that we've talked about previously -- space planning, merchandise planning, inventory management -- for all intents and purposes, they are all up and running. They are running well. And to the other point that Steve mentioned, the people who were so critical in integrating that within our environment who have been dedicated to the Magellan project for a period of time have now been brought back into the merchandising group, so the benefits of their talents is being brought to life every day. So we're very pleased with how it's working.

Michael Cox - *Piper Jaffray & Co. - Analyst*

Okay, and then one follow-up question to some comments you made on the International side. Could you be -- could you provide some maybe more specific detail on your plans to improve the profitability in the International segment, given the type of economic backdrop you're facing there? Are there specific areas that you can focus on that will drive that profitability improvement without the recovery in the topline that is closely tied to the economy?

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

Well, the first thing that I want to say is that the economy, the weather and those kind of things are things that affect businesses everywhere every day, and what I don't want is for the economy or the weather or anything like that to become an excuse for our people. And so I know the first thing that Charlie is focusing on with our European team is to remove that as an excuse and just start focusing on -- the economy is there, what are we going to do about it and how are we going to market our product?

The International business is part of our strategic asset review and we will expect to take decisions in the third quarter related to that business. But, Charlie, you may want to just talk about what we're doing to reinvigorate the topline.

Charlie Brown - *Office Depot Inc. - President, Office Depot International, and CFO*

Well, a couple of things. First, on the cost, I think Steve commented earlier that we had grown our European business as far as, you know, on a country-by-country basis. And then as we've added to our pan-European business, we end up with a cost structure that needs to be rationalized. So, we're focused on that. I think the Guilbert acquisition will also have a -- completing the integration will also have a positive impact in terms of taking costs out of our supply chain. So in terms of reinvigorating the topline, I think that probably the single biggest opportunity -- there is two.

One in the contract side is to create a more aggressive selling culture. I think that is something that we can take a few lessons from our U.S. colleagues. And on the catalog side, we want to become much more rational about how we go to market. We have some of our customers, obviously, that account for a huge portion of our sales and profits. We're going to spend a lot more money on those folks as opposed to a more generalized approach to our customers who are not as large or as loyal. But that's really focused on the topline -- how we spend our marketing dollars.

Operator

Dana Telsey, Bear Stearns.

Dana Telsey - *Bear, Sterns & Co. - Analyst*

Can you give a little more color on the asset review? How are you going about prioritizing which division? Is it just a third-quarter event, or do you continue for the balance of the year taking a look at that, and where you see the greatest opportunities with it? And also, any updates on operating margin targets and what you see for each of the divisions? Thank you.

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

Well, let me start with the last part. We actually don't set operating margin targets, mostly because I think that that could actually inhibit performance. What we say is that we want to make sure that we've got the best value proposition and that we're taking decisions throughout our category management processes in order to drive those -- the product assortment and the pricing of those products. So then, you couple that with whatever cost savings we take out and the operating margin is an output of those activities rather than the driver.

As it relates to our asset review, this is something that we're just -- we're doing and it's something that I think we will do periodically over time and have done periodically. But we're looking through our entire asset base, looking at all of our companies from sea to shining sea, essentially. There's no prioritization on what order or what division; we're looking at everything. And we're evaluating recent decisions as well as old decisions, and we're just trying to make sure that first of all, we implement a culture of thrift in our Company.

And so I think regardless of what comes out of this in terms of any kind of a charge in the third quarter, I think one of the biggest outcomes and the most positive outcomes will be a cultural shift that really thinks about the deployment of capital in a more structured and disciplined way, such that there is a higher probability of higher productivity in the future.

But we will look at everything and we will take decisions in the third quarter that may be tough decisions, and there are no sacred cows here. We will not avoid the tough decisions. And I can't predict at this point, Dana, what those decisions will be and where they will be. We will let everybody know as soon as we're complete with that.

But I'm pleased with the progress and I'm pleased with the attitude of our people, and it is a lot of hard work, and I think once we're through it, it will really set us up to focus on -- focusing on the topline and focusing on profitable growth for the future. Charlie, do you want to add anything to that?

Charlie Brown - *Office Depot Inc. - President, Office Depot International, and CFO*

No, I think that that's well said. The only thing that I would add is that some of these decisions, just speaking from an accounting perspective, will be a third-quarter event. Others just because of the way GAAP works will be multi-period. What we will try to do is in our future financial statements, quote that out to you as we go along.

THOMSON REUTERS

Dana Telsey - *Bear, Sterns & Co. - Analyst*

And just lastly, on the gross margin rate improvement, is it coming from lower cost of goods, higher markups, is there something changing within the complexion of gross margin that you are seeing either by category or competitive environment?

Chuck Rubin - *Office Depot Inc. - EVP and Chief Merchandising and Marketing Officer*

Dana, this is Chuck Rubin. It's coming across a range of topics. It is coming through our increased private brand penetration; it's coming through a better mix of product sales that are going out the door, so to speak; it's coming through better costs that have resulted from our global collaboration amongst all of our groups to merge our buying decisions and work with our vendor partners. So, it's no one function only, it's really a compilation of many.

Operator

And this does conclude today's question-and-answer session.

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

Thank you, everybody, for joining us today for our second-quarter conference call and we will look forward catching up with everyone over the coming quarter. Thanks very much.
