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ODP.OQ - Q2 2004 Office Depot Inc. Earnings Conference Call

EVENT DATE/TIME: JULY 22, 2004 / 12:00PM GMT

OVERVIEW:

ODP met the qtr. consensus estimates of $0.23 per share and increased its comparable 2Q earnings by 44%. Co. recorded its second consecutive qtr. of positive North American retail comps, up 3%. ODP reported 2Q04 GAAP EPS of $0.25, up 32% YoverY and 2Q04 worldwide sales were $3.2b, up 12% YoverY. In late June, ODP launched its Millennium2 or M2 format with the opening of Venice, Florida store. Q&A Focus: Guilbert, GM, Expenses, Catalog business, Remodels, and Reorganization.

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PRESENTATION

Operator

Good morning. We'd like to welcome you to the Office Depot second quarter 2004 earnings conference call. All lines will be on the listen-only mode for today's presensation. After which instruction 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. Sean McHugh, Director of Investor Relations, who will make a few opening comments. Mr. McHugh, you may now begin.

Sean McHugh - *Office Depot Inc. - IR*

Thank you, good morning. 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 of 1995. Except for historical finance and business performance information, comments made on this call should be considered forward-looking. Actual future results may differ materially from those discussed on the call due to risks and uncertainties both foreseen and unforeseen. Certain risks and uncertainties are described in detail in our report on form 10-K filed with the SEC on February 26, 2004 and in Form 10-Q filed with the SEC this morning. During portions of this call our chairman and CEO, Bruce Nelson, and other executives will refer to numbers of our second quarter 2004 which are not GAAP numbers. A 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, Bruce Nelson.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

Thanks, Sean, and good morning everyone. Thanks again for taking the time to listen to our call this morning. Joining me today from Delray Beach are Charlie Brown, our CFO; Rick Lepley, our EVP of North American retail stores; and Chuck Rubin, EVP and Chief Merchandising and Marketing Officer. Before I turn the call over to Charlie, I would like to quickly comment on our many second quarter achievements. Worldwide second quarter sales were 3.2 billion, up 12% year-over-year. Second quarter GAAP earnings per share was 25 cents, up 32% year-over-year. In the quarter we did record a 2 cent per share gain resulting from the settlement of certain commercial legal claims. Also in the second quarter of last year, we recorded a 3 cent gain from a foreign exchange benefit related to the Guilbert acquisition. That being said, we met the quarter's consensus estimates of 23 cents per share and increased our comparable second quarter earnings by 44%. Consolidated operating profit increased by 47% for the quarter to 120 million. For the first six months of 2004 operating profits were up 22% to $295 million. We recorded our second consecutive quarter of positive North American retail comps, up 3%, additional proof that we're moving in the right direction after 15 consecutive quarters of comp declines.

We increased our second quarter North America retail segment operating profit by 54% to $71 million. I'm extremely proud of the cooperative efforts of our store operations, merchandising and marketing organizations, as well as those of our 24,000 retail employees who had a good quarter. By addressing both costs --both growth and costs they were able to deliver very strong results. As of mid-July we have virtually completed our technology remerchandising initiative in our North American retail stores. This is a continued effort to improve our sales and profitability in this category, as well as to further differentiate ourselves in the eyes of our customers. Chuck Rubin will give you more incite into this later in the call.

In late June we launched our millenium 2, or M2 format with the opening of our Venice, Florida store. The improved format is intuitive, logical and designed specifically for the way that people make purchase decisions. In addition to the merchandising innovations we believe that this format will be less expensive to open and more efficient to operate. M2, both as a new and remodeled store format, represents a key element of our primary strategy of repositioning our North American real estate portfolio. Rick Lepley will discuss M2 in further detail later in the call. Local E-commerce sales grew by 22% to 742 million for the quarter. Domestic sales grew 12%. We are continuing our leadership position in this space and we remain on track to deliver 3 billion in online sales in 2004. In our North American business services group, the strategic realignment of our contract sales force is taking hold. Early results are encouraging and we expect the initiative to continue delivering growth to our delivery businesses.

North America catalog sales accelerated during the second quarter compared to prior periods. Our international groups segment operating profit margin increased by approximately 60 basis points for the quarter, despite the addition of our lower gross margin Guilbert business. This performance is a tribute to the integration efforts of our European team and our outstanding European leadership position. We are focusing our efforts on restoring top line growth to our European contract business. Finally, we acquired the Hungarian business from one of our licensees and this acquisition now sets the stage for additional growth in eastern Europe. Those are the highlights of the second quarter performance. I'd now turn the call over to Charlie Brown, our CFO, who'll give you more incite both to the results for the company as well as comments within each business segment. Charlie.

Charlie Brown - *Office Depot Inc. - CFO*

Thanks Bruce, and good morning everyone. I would now like to share more incite into our second quarter performance. Total company sales for the first quarter grew by 12% to 3.2 billion compared to the second quarter of 2003. For the first six months of 2004, sales grew 15%. Worldwide comparable sales in our 925 stores and 80 delivery centers increased by 2%, both for the second quarter and first half of 2004. Local E-commerce sales increased 22% to 742 million in the quarter compared to the same period last year, further expanding our industry-leading position. Operating profit for the second quarter increased by 47% to 120 million, and by 22% to 298 million for the first half compared to the same period of 2003. Our profit increase primarily reflects improved North American retail comparable sales, the addition of Guilbert to our international group, lower BSG operating costs, and positive foreign currency impacts.

General & administrative costs increased compared to the second quarter of last year, primarily as a result of consolidating Guilbert into our international group, the negative impact of translating international expenses from higher foreign currency rates and increased professional fees largely related to our efforts to comply with Sarbanes-Oxley. We currently anticipate spending fewer dollars in G&A during the second half 2004 than we spent last year. Second quarter GAAP earnings were 25 cents per diluted share compared with 19 cents for the same period last year. Included in the second quarter 2004 results was a 2 cent per share gain related to the settlement of certain claims associated with our European distribution system. Last year miscellaneous income included a 3 cent per share foreign exchange benefit related to the Guilbert acquisition. For the first half of 2004, GAAP net earnings per diluted share were 62 cents compared to 45 cents for the same period in 2003. Our 2003 results reflect the adoption of EITF-0216, which reduced diluted earnings per share by 8 cents for the first quarter. Our first quarter 2004 results included a 1cent per share cost related to settlement and outstanding legal claim.

Now let's turn to the individual segment results. International group sales now represent 26% of our consolidated sales, grew 38% in local currencies, and 45% in U.S. dollars during the quarter. Second quarter revenues in U.S. dollars increased in all countries. Germany, the Netherlands, and Japan experienced local currency declines. European catalog sales declined slightly, as continued improvement in the United Kingdom was offset by softness in our major European countries. Catalog sales in recently opened markets continued to show strong percentage growth and European comp sales were positive for the second consecutive quarter. Guilbert, while contributing strongly to our European earnings, experienced negative comparable sales in the quarter and year-to-date. In April we announced the acquisition of our licensed business in Hungary. This represents our first wholly-owned expansion into eastern Europe. The acquisition added 4 retail stores, a distribution center serving delivery customers, and additional Internet sales capabilities in our international group.

International sales, when reported in U.S. dollars, benefited from stronger foreign exchange rates by $42 million in the second quarter and 123 million in the first half of 2004. Gross profit from the international group, as a percentage of sales, decreased by about 120 basis points in the second quarter of 2004; reflecting a higher mix of lower margin contract sales partially offset by better buying and increased purchasing discounts associated with our Guilbert acquisition. The increase in total store and warehouse operating and selling expenses reflect the addition of Guilbert, however, second quarter selling and warehouse expenses as a percentage of sales, excluding the gain I mentioned earlier, declined about 70 basis points compared to the prior year because of planned cost reductions and increased leverage from higher sales. International segment operating profit also benefited from the foreign exchange rates by $7 million during the quarter and by $20 million during the first six months compared to last year. This was another strong operating quarter for our international group, bolstered by our acquisition of Guilbert.

Segment operating profit improved by about 60 basis points compared to last year, despite the increased mix of the lower gross margin contract business. Our integration efforts to capture cost synergies remain on play. We are now increasing our focus on driving top line growth from the transaction.

For our North American business services group, total sales increased by 3% in the quarter. Contract sales also increased by 3%. Catalog sales remain soft but the trends are improving. Comp sales in our combined catalog businesses improved over 300 basis points compared to the second quarter of last year. We expect to see increasing benefits from the strategic realignment of our sales force and we expect our growth initiatives in the small and medium-size customer segments to take hold in the second half. Domestic E-commerce sales grew 12% during the quarter. We expect our worldwide E-commerce sales this year to exceed $3 billion. BSG's gross margins declined about 130 basis points in the second quarter, primarily because of the increased mix of large contract accounts and promotional activity in our catalog business. Our North American warehouses had another strong quarter with operating costs, as a percentage of sales, declining about 150 basis points compared to the same period last year. Payroll leverage contributed over two-thirds of that improvement.

On an absolute basis, operating cost declined by $8 million quarter-over-quarter. Warehouse operating costs have declined in each of the past 13 quarters. These combined results generated a 5% increase in segment operating profit for the quarter or roughly a $4 million improvement over last year. BSG operating profits were up 2% for the first half of the year as well.

And finally, our North America retail business. Total sales increased 5% to 1.5 billion in the quarter. Comparable sales increased 3%, our second conservative quarter of positive comps. The increase in comparable sales was primarily attributable to improved sales of technology products which was a direct result of several technology initiatives launched during the second half of 2003. Comparable technology sales increased 18% for the quarter and 15% year-to-date. Comp sales in our furniture group increased 4% for the quarter and 6% year-to-date, in part a reflection of the success of our Christopher Lowell line of products. Our aggregate furniture and other category recorded a comp sales decline of 2% for the quarter and year-to-date. Core office supplies year-to-date largely because of the strong comparison to sales from the 2003 launch of Inc. Depot, which drove positive comparable retail sales last June. Average transaction size increased for the second quarter and first half, while comparable transactions declined in both periods.

During the quarter the company opened 1 retail store. At the end of the second quarter we operated a total of 901 office product superstores throughout North America. Rick Lepley, our EVP of North American retail, will provide additional color related to our 2004 retail outlook later in the call. Increases in sales of technology products, which generally have lower margins, adversely affected gross profit as a percentage of sales during the quarter. This decline was offset by reduced strength and occupancy costs compared to the second quarter of last year. Gross margin percentages in core office supplies and furniture categories increased in the quarter on a year-over-year basis. Second quarter store and warehouse expenses declined by 100 basis points compared to last year, primarily because of continued payroll leverage and lapping higher operating costs associated with the 2003 launch of Inc. Depot. Our retail payroll was almost 60 basis lower in the quarter than last year. This is after absorbing almost a penny a share for the initial merchandising of our technology category. Segment operating increased 54% in the second quarter representing a 25 million, and 170 basis points, improvement over last year.

I would now like to briefly share some of our balance sheet and cash flow metrics for the total company. Our cash and short-term investments exceeded $1 billion at the end of second quarter, down just slightly from the first quarter. Inventory levels declined by 90 million from last year to $1.17 billion, reflecting continuing improvements by our supply chain. North American contract DSO was flat with second quarter last year, however at 42 days, it declined sequentially from 46 days in the first quarter. Year-to-date, capital expenditures sit at $168 million. Year-to-date free cash flow was $140 million. We recorded a 30% effective tax rate and we expect that rate to remain relatively stable for the balance of the year. Based on improved visibility into the impact of the Kids 'R' Us transaction, we have updated several financial metrics for the balance of 2004. These include free cash flow of 300 to 350 after considering the impact of KRU. And capital expenditures in the 400 to $450 million range. And inventory levels flat -- virtually flat after opening 80 new retail stores.

Now, as many of you know, we recently opened our first M2 store in Venice, Florida. This new store format will be used for all new and remodeled stores from this point forward. I'd like to turn the call over to Rick Lepley who will provide some insights into this and other important initiatives in our retail division.

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

Thanks Charlie. Good morning everyone. Let me start by highlighting some of our retail achievements for the first half of the year. First, our retail segment operating profits were up 54% for the second quarter and 12% for the first half of the year. Our positive comp sales, expense control, and lower strength all contributed to this improvement. And as Charlie indicated, we reduced comparable payroll by continuing to manage our full-time, part-time employee mix and by controlling our hourly wage rate increases. We reduced our comparable shrink rate over last year through the use of electronic product tagging and improved employee training. Our shrink rates remain well below industry averages. Profits earned by our underperforming stores, in other words the bottom 20% of the stores in our portfolio, improved by over 50% compared to last year. As you may or may not know we reorganized North American retail and this improvement can be attributed to that reorganization and to the application of dedicated management resources to this opportunity. And finally, we have measurably improved the profitability of our Canadian stores. This was also part of the reorganization of North American retail in that we have now dedicated operational and merchandising management in that region.

Talk a little bit about M2. Our first M2 format store opened in Venice on June 30th. And that was the same day that we hosted a launch event from our prototype store near our headquarters here in Delray Beach. Members of the media and the financial community, in fact many of you on this call, were able to come to visit with us that day and to learn more about our new format. Overall reaction from our visitors was very, very positive and quite encouraging. As we outlined the design of M2 and it's intended economic and customer-oriented benefits, people showed genuine excitement about this differentiated store format. In terms of the early results we're happy to share with you that the Venice M2 is exceeding our expectations on every level and every metric. In fact, it's so far over our expectations, that we're anxious to get some more and I would caution you that obviously this is just one store, and as we are able to open more of these or get through our remodels, we'll have data points in our composite to better evaluate the project's overall performance.

For those of you that have not seen the M2 format, let me describe some of the key attributes. From a merchandising and operation perspective, a great many elements are different from our standard store profile. As you enter you'll notice groupings of products in horseshoe pods around the perimeter of the store. These pods are visible from almost any vantage point and allow customers to quickly orient themselves and find the products that they need. The pods also facilitate viewing of entire categories simply by standing in front of the pod, a huge win that allows us to gain visibility for entire categories in a more prominent way. In the middle of the store is our technology section displayed on 60 inch gondola. This provides the customer with a very clear view of the entire store, our products, our signs and our employees. It also allows our employees to see our customers, enabling prompt customer service and a more efficient labor model.

We've increased other holding power at the point of sale by using high steel on the outer walls with increased shelf depth. This improved holding power on the floor reduces customer perceives out of stock as well as a number of employee product touches. We've also increased our use of bulk stacks for high velocity items. This reinforces our brand value statement and also reduces labor. And we've also cut the number of peg hooks in the the store by 50%, further reducing our labor allocation away from the products and toward the customer. From a packaging perspective, we have moved in the direction of display ready trays. This minimizes stocking and zone recovery labor. When possible, we have also implemented gravity fed and string loaded bins to keep products organized and out in front of the customer. And finally, our graphics package uses more prominent photos of products highlighted on a warm, differentiated color pallette. This allows our customers to more easily find our products using visual cues from all over the store and the color creates a warm and inviting environment that clearly differentiates us from our competitors.

On the financial side, we expect the M2 remodel costs to be lower than those experienced in our original millenium format. I think they'll come in about 250 to $300,000, versus 350 to $400,000 in the M1. Now this creates a much lower sales hurdle to achieve our cost to capital and allows us to remodel a greater percentage of our chain. And we also expect that the new store buildouts will be much lower utilizing this format. In terms of store labor we expect to use the operational labor savings to either reallocate labor hours to more customer-centric activities or to eliminate the hours, as appropriate.

I'll take a minute now to give you a quick recap of where we are in the KRU transaction. Back in March we announced our agreement to acquire 124 sites for $197 million. In the same month we agreed to sell 20 of these sites to Petco for $45 million. We began the closing process on retail sites in early May. At the end of the second quarter we had closed on only 25 locations, behind where we had initially planned. However in the past several weeks we have seen acceleration in site closings, even though we are still behind our original plan. To date, an additional 15 stores have been removed from the transaction by mutual agreement. Given where we are today the comparable transaction value has now been reduced from 197 million to a forecasted value of about $120 million. While we plan on closing the remaining properties over the second half of 2004, these delays have caused us to adjust our new store count for the second half. We now expect to open an additional 80 new M2 format stores during the remainder of 2004. Approximately 40 of which are the KRU sites acquired in the Toys R Us deal.

The majority of these 40 locations will be in the northeast. This number may fluctuate slightly depending on the timing of the closings from the KRU deal as each site is closing on an individual basis. In terms of how we are scheduling the opening of the 80 stores, we're looking at opening approximately 30 stores in the third quarter with the balance falling in the fourth quarter. Finally, our M2 remodel program will now consist of approximately 40 stores in the second half of the years. We plan on remodeling several more during the third quarter but we've put it on hold at the request of our store managers during the back to school season. So we're going to take a pause of about four weeks an then resume the remodel program. Because of this you should expect most of the M2 remodels to occur in the fourth quarter this year. Another point regarding our remodels. By utilizing new partnerships and new processes, we've reduced our expected average remodel time by 50%. This will minimize customer disruption and reduce any potential negative sales impacts that can sometimes occur in a remodel.

To conclude I would say that we are encouraged by what our focus groups, market research and live customers are now telling us about the M2 format. We encourage each analyst, investor, and anyone listening on this call to come to visit one of our new stores as soon as they become visible in your individual market. Now I would like to turn the call over to Chuck Rubin.

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

Thanks Rick. Good morning everybody. Let me begin by highlighting two key points about North American retail. First, the continued execution of our key merchandising strategies resulted in a second consecutive quarter of positive comp sales. Technology and furniture were the biggest contributors to the growth, with 18 % and 4% comps respectively. Second, we increased our retail gross margin dollars over the prior year for the second consecutive quarter. Our gross margin rate improved quarter-over-quarter in most non-technology product categories. However, the higher growth rate of technology products created a mix shift that caused the overall margin rate to decline. Now for some specific category information, beginning with technology. Computer sales drove our comp performance. Desktops and our best-in-class, build-to-order both performed well. Notebooks, which deliver higher margin, also saw significant increases and contributed a higher percentage of our total computer business. This is in line with our strategic focus on mobility products.

Software and technology services, both higher margin businesses, also experienced solid increases. We continued to implement initiatives intended to boost the sales of higher margin technology items as well as to improve attachment rates of supply items. Our technology remerchandising initiative, which you've heard about, is nearing completion in all planned stores. This reset involves improvement product adjacencies of add-on, higher margin items, intended to increase the size of our market basket. Also, a redesigned sign package provides an improved directory of product information to help better inform our customers. We believe this will help drive trade up sales of better spec high margin items. To complete the rollout we anticipate a 1 to 2 cent impact of additional costs in Q3. We have also instituted sales incentive programs to reward our associates for better attachment selling. Early test results from each of these programs are encouraging.

Turning to our other product categories, furniture sales, as you heard, improved year-over-year led by a strong performance from our exclusive Christopher Lowell furniture collections. Overall gross margins benefited from both the higher sales volume and improved gross margin rates. Supplies experienced flat gross margin dollars as significantly higher gross margin rates were offset by a decline in overall category sales. As you've heard, I'd remind you again that our performance was up against a very strong initial launch of Inc. Depot and other supply initiatives that occurred in second quarter of 2003.

Now let's review BSG. BSG merchanidising sales improved all across all major product divisions. Furniture and technology turned in the best relative performances, but increased sales of supplies contributed the most to the overall dollar improvement. Supplies did well across categories in BSG. They performed exceptionally well in contract with comp sales up across almost every supply category. BSG gross margin dollars declined slightly in the second quarter compared to last year due to a higher mix of large contract customers and increased promotional activity in our catalog and Office Depot E-commerce channels. Now I'd like to give you some insight into our current merchandising initiatives. Private brand penetration as a percentage of our sales increased in the second quarter to 13%. During the quarter we improved the design, quality and packaging of our Office Depot paper products. We also expanded our successful Christopher Lowell brand with new accessories. Finally which expanded our private brand efforts with a new label introduction into the writing instruments category.

On the global purchasing front we worked more closely than ever with our international counterparts to further combine our worldwide purchasing efforts. We successfully achieved lower costs on all product categories addressed, during both this quarter and the year-to-date. In the area of pricing, we continued our North American retail category pricing review. This review was and is intended to ensure that we are remaining competitive in the marketplace while optimizing our margin expansion opportunities. This effort positively contributed to our Q2 financial performance.

Moving onto our Magellan project. A reminder that we are now just past the halfway point of the 31 month implementation. Our team's hard work has ensured that the program remains on time and on budget. Modules now in place across the chain have given us improved planning and forecasting capabilities. To be more specific, these new capabilities allowed us to complete the M2 layout and planogram in less time than previously needed and in a much more analytical manner that leveraged performance data. Magellan has provided us the capability to better manage our inventory. Our Q2 turnover improved compared to last year and, furthermore, we anticipate opening our 80 new stores this fall with no significant incremental inventory to our last year levels. As we look to Q3 and Q4, Magellan will go live with additional functionally in the areas of assortment, pricing and merchandising.

Let me quickly recap some of our advertising initiatives. As we said on our last earnings call we continue to focus on rationalizing our overall marketing spend. Second quarter spending levels were lower than those in the first quarter, furthermore we expect overall 2004 ad spend to be lower than 2003 levels on a comp store basis. This pull back is consistent with our plan to improve our overall marketing effectiveness by spending only on those vehicles that drive sales returns. An example of our progress in this area is the higher in store productivity that we achieved this quarter. By taking a more analytical approach to space allocation, we are ensuring that product categories earn their way into the Sunday circular.

Finally, an update on the Advantage loyalty program. Our membership numbers over 1.5 million customers a figure above our initial plan for this time frame. Member spending patterns continue to be attractive and, furthermore, we have achieved a critical mass of members to support the development of targeted marketing campaigns which we expect to launch in the near future.

I told you where we've been now let me give our view of what's ahead of us. We will continue to expand our penetration of private brand across all channels. With our organizational structure now in place, we plan on increasing our volumes significantly over the next few years. We will continue to seek margin improvement opportunities through both increased global purchasing programs and other targeting initiatives including our retail pricing efforts. We will continue to offer a product and service assortment that is both differentiated from our competition and squarely focused on customers needs. The introduction of product from both Apple and IBM over the past few weeks is a prime example. Additionally, our recently launched technology recycling program, which we are offering in conjunction with HP, is the first nationwide free recycling program. This effort is being greeted with huge enthusiasm from our customers and reinforces our corporate values.

We will continue our efforts to optimize our marketing spend. The analytical processes will be refined and applied to additional areas to ensure that we are earning a return on our investment. And we look forward to our sponsorship efforts for next month's summer Olympic in Athens. We are extremely proud to be affiliated with such a high profile and global event. And critical to all of the above, we will continue the focus established last quarter on the improved execution of our merchandising and marketing initiatives. Finally, while we have seen a slight softening in our recent sales, we remain confident in our strategies and our ability to carry them out. With that I'd like to turn the call back over to Bruce.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

Thanks, Chuck, Rick and Charlie. I'll quickly summarize and turn the call over to all of you for questions. We continue to execute against our seven key strategic initiatives and our efforts are delivering tangible and measurable results. Let me quickly remind all of you of those seven key strategic points. Grow our people, talent and leadership. Reposition our North American real estate portfolio. Control costs while enhancing quality. Create a customer-centric experience. Develop differentiated product assortments. Excel in Europe. And build or acquire to generate break-through growth. On each of those initiatives, we made significant strides in the second quarter. I am confident that our leadership team and our nearly 50,000 global employees will continue and are continuing to press forward to deliver value for our shareholders and our customers. Now I would like to turn the call over to you for questions you might have and further insight you'd like on our second quarter performance and our outlook for the remainder of 2004.

QUESTIONS AND ANSWERS

Operator

Thank you. We are now ready to begin the question and answer session. [Caller Instructions] One moment for the first question. Matthew Fassler, your line is open. Please state your company name.

Matthew Fassler - *Goldman Sachs - Analyst*

Thanks so much and thanks for your comments this morning. A couple of questions. First of all, on the expense line, you took your expense dollars down in both of your domestic businesses as you discussed. Can you tell us whether they are cost pressures abating or was all of this internally driven and how sustainable do you think dollar cost declines are as you look forward into the second half?

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

Thanks, Matt, for the question. The answer is these are internally driven. These are our metrics, our focuses. Cost came out of our BSG business, I think now, for 13 or 14 consecutive quarters. We've said we'll continue to improve with that and we are and we will. Cost came out of our retail business because of a tight focus on payroll, some leverage on our sales volume; and we anticipate continued ability to manage our costs effectively in both those key business segments. We also had cost improvement in Europe too, x out the impact of the addition of Guilbert. It fits one of our core strategies which is to control cost while enhancing quality. And with just a fanatical focus on making sure we do that and we believe they are sustainable.

Matthew Fassler - *Goldman Sachs - Analyst*

Gotcha. Second question if I could. Could you talk through the math of getting from the original 197 million cost of the Kids deal down to 120, just in terms of-- you don't have to get that specific, but what are the basic items in terms of stores and any other costs that reduced that purchase price.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

Matt, I'm going to ask Charlie to answer that question for you.

Charlie Brown - *Office Depot Inc. - CFO*

Okay, Matt. I don't have the numbers in front of me specifically, but I'll give you, kind of, the broad outline. The 197 million was the announced value of the transaction. We sold to Petco, I think it was around 45 million. So you have to X that off. We've had about 12 to $14 million of units that have been pulled out of the deal that was by mutual agreement. And then we have about probably about 30 --no probably $20 million of stores that we're holding we're actually actively marketing that we're holding for resale. Then you've got to add to that some small amounts for broker fees, et cetera, and that's kind of the broad strokes on the math.

Matthew Fassler - *Goldman Sachs - Analyst*

So, it's just your divesture of some of the stores that you're not going to hold on to that takes that down.

Charlie Brown - *Office Depot Inc. - CFO*

That was always the case, Matt. We always -- even when we were first looking through transactions said between 50 and 60 out of the 124 sites. So we've always had plans--

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Matthew Fassler - *Goldman Sachs - Analyst*

Sure. Understood. My final question. You spoke to some softness at Guilbert in the second quarter and the first half overall. You've given some guidance to higher sales overseas in the second half. Can you talk about whether, in local currency terms, Guilbert got better or worse Q2 over Q1 one and just what's in your second half assumption overseas.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

Guilbert quarter-over-quarter got a little better. Wasn't quite as negative as the first quarter comparably. Two things going on there. One is we exited some Guilbert businesses we acquired by intent. Business in Italy, some retail businesses in Germany, furniture business in the Netherlands. So have to like for like that. On a like for like basis, the second quarter was a slight improvement in rate, albeit below last year, than the first. We anticipate some improvement in those rates in the second half. Still think now that the Guilbert business is likely to trend negative through most of the year. We are focusing on growth initiatives there. That's predominantly been a cultural issue.

The Guilbert sales force has really been focused on account profitability, short-term take advantage of account profitability and not focus the resources and the sales rep in growth. We're adding to the sales rep count in Europe as we speak and we believe we can get the Guilbert business to grow positively. We're up against a couple tough economies in Europe. By anything you read you would argue that France and Germany, in particular, are two tough economic environments and we're heavily positioned in France and in have a significant position in Germany. But, got a little better, to answer your question, and we think it will get better throughout the year. Although, it's still likely to trend negative on a like for like basis through most of the second half.

Matthew Fassler - *Goldman Sachs - Analyst*

Thanks so much.

Operator

Danielle Fox your line is open please state your company name.

Danielle Fox - *Merrill Lynch - Analyst*

Merrill Lynch, thank you. Two questions. First, you mentioned that June and July were a bit softer than you'd hoped--North American retail. I'm wondering if that was across the board from a product perspective? And so what are some of the key things that you're doing differently this year heading into back to school.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

Two answers to that question. One -- and the softness occurred predominantly in Inc. as we compared against a very aggressive Inc. Depot rollout a year ago. And, on a purely dollar basis, softness in paper. Units were stronger than the dollars in retail, but some softness in paper. As it relates to back to school we basically launch the key initiatives this Sunday and I would just summarize by saying without the specificity that we're confident this will be our best back to school product assortment, our advertising and marketing spend, and coordination with all channels of our business. So we really launch it in a significant way this coming Sunday.

Danielle Fox - *Merrill Lynch - Analyst*

Okay. And thank you. The second question is just how your filling the real estate pipeline for more aggressive northeast expansion outside of the Kids 'R' Us stores that you've already acquired.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

Well, as Rick talked about earlier, we're on track to open 80 new stores in the next 5 months. We anticipate next year that we could be in the 100 to 120 range. Our plan all along was to open 100 this year. It's the delays of the Toys stores that have caused us, probably, to be in the 80 range. We'll add that to the opening store count--new stores in 2005. And the answer is we are continuing to fill in in those important markets to Office Depot. We've talked a lot about adding density here in south Florida and we continue to do that.

Without being specific in other markets our expansion goes beyond the northeast. Obviously, as we go forward in the next couple of years, a large percentage of the new store openings will occur in that region. But we will continue to open stores in the geographies where we have a strong density where we can fill in and keep the kind of market share and presence we want to have in our retail business. So, we're pretty optimistic about our ability to open that number of stores. We've got an awful lot of sites already either signed or committed to for 2005, so I don't think that number is much as risk. And we're now looking at 2006 and beyond at where we put stores.

Remember these are smaller stores on average. I mean, on average, we're going to be looking at 17,000 square feet of--17,500 of selling space. So, while we're adding store count, we are not adding proportional square footage growth and we feel confident, based on both the initial returns or the results of this; which Rick said are exceeding our wildest expectations, albeit it's one store. We believe that we can generate the return on capital and establish a significant presence in the geographies we're not in. And we remain highly optimistic about our ability to do that.

Danielle Fox - *Merrill Lynch - Analyst*

Thank you.

Operator

Bill Sims your line is open state your company name.

Bill Sims - *Smith Barney - Analyst*

Morning. Smith Barney. Two quick questions. One, can you give us just some additional color on what's causing the severance cost related to your French warehouse to jump significantly compared to initial expectations?

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

Could you repeat the question, you chopped up a little bit. I think you had a question regarding the severance cost in the French warehouse.

Bill Sims - *Smith Barney - Analyst*

That's correct. It seems like relative to your initial plan severance costs for the warehouse are jumping up fairly materially can you just comment what changed since your initial plan?

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

Certainly I can. First of all, I remind all of you if you don't know the environment in France, any decisions you come to about pulling you facilities require the agreement of explicit agreement of workers councils. With the addition of Guilbert we have many more than one council. Two is, we've always had historically, it goes back to the Viking days a very large warehouse just outside of Paris. Historically, we have had very challenging labor environments in that warehouse. In fact, in the last two or three years, we've had multiple strikes. It's a difficult workforce. It's difficult to find the kind people outside of Paris that want to work in warehouses. It's caused our cost and operating costs to often be higher than we wanted to live with. We plan to move that warehouse and put into our plan what we anticipated the costs might be to come to agreement with the workers councils.

We finally reached agreement in July. That cost us more than we anticipated. But the net result is we plan on opening now-- and will open in the first half of next year, a large warehouse about 60 or 70 miles from France -- Paris excuse me. Lower cost to operate, more efficient with, we think, a much more harmonious workforce. And so, in conjunction with the discussions with the multiple workers councils, we agreed to a severance period of time and the cost associated with the people to make that happen. It was higher than we anticipated but, in our judgement, clearly positions us better to perform better in France and avoid the costly disruptions we've had in the last couple of years as a result of labor issues.

Bill Sims - *Smith Barney - Analyst*

Thank you. And one more quick question. It's a housekeeping question. Do you have the diluted shares outstanding for the end of the second quarter. I didn't see it in the release.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

I am sorry I didn't hear it.

Bill Sims - *Smith Barney - Analyst*

Diluted shares outstanding.

Charlie Brown - *Office Depot Inc. - CFO*

317.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

About 317 million.

Bill Sims - *Smith Barney - Analyst*

Thank you very much.

Operator

Dan Binder your line is open. Please state your company name.

Dan Binder - *Buckingham Research - Analyst*

Hi, it's Dan Binder at Buckingham. Couple questions for you. You mentioned that, I guess, the majority of the retail margin was really driven by the mix. I am curious if paper pricing played into that at all. You mentioned that paper had softened a bit. Is that a function of Office Depot trying to take price up and competitors not. Is that playing into this at all and then my second question was, I guess, given your comparable transactions still being down slightly, what do you think you need to do to really start to drive traffic and is M2 the answer to that or does it go beyond that?

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

Dan, good questions. I am going to have Chuck answer both of those. I may have a comment, a tailing comment on transactions. But, Chuck if you'd take the paper question and the comp transaction one.

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

Yeah. Good morning Dan. The paper question, there have been cost increases as we talked about, I think, in our last call. We have managed those as aggressively as we could. We have been able to pass on many of those increases to our customer. We believe we are still competitively priced. We are in as good a position as we believe we can be in from a competitive standpoint both in the costs that we're paying. We are not on allocation for product and we believe that generally we are retail competitive in our retail pricing. It continues to be a bit of a dicey marketplace as we are looking into the next couple of quarters but, again, I'd reinforce that we feel comfortable, as comfortable as we can be with where we are from a competitive standpoint.

As far as the traffic is concerned and actions that we're taking, I talked before about marketing effectiveness and one of the things that we're measuring is-- from an analytical standpoint is certainly sales and margins but traffic counts. We're trying to build a program of marketing vehicles that drive sales, as well as traffic, into our retail stores. So as we go forward for the back half of this year we've made adjustments in our marketing spend to do just that. We also believe that as M2 rolls out with the additional stores that there's an up swing to that for those stores impacted.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

Just add to that, Dan. Just a reminder all of you, it is about our portfolio and we've talked an awful lot about it. But 75% of our North American stores are more than 5 years old and we've virtually not remodeled those stores in the past few years that does impact comps and transactions. Second of all, by intent over the last three years, the majority of our new stores have gone into the heart of existing Office Depot territory. Building stores out in California, Texas and south Florida where we then take hits on our own transactions. We cannibalize ourselves. We think that all the customer feedback that we've gotten on M2 and the one store would tell us that we can drive comps back with a better differentiated store format, and coupled with what Chuck said about differentiated product and service offerings and better allocation of advertising spend; we're confident we can get transactions to turn positive.

Dan Binder - *Buckingham Research - Analyst*

Just a couple follow-ups to that. On the gross margin at retail, while I guess it was up 70 basis points, it was probably up less than some expected. Can you quantify what the impact for accrual on the Advantage program may have had, if it was material, or was this just strictly a technology mix issue? And then the second question was, do you expect the catalog business as it continues to shift to Internet does it really pay to promote catalog aggressively at the cost of margin or just sort of redirect those promotions towards shifting that business to Internet?

Charlie Brown - *Office Depot Inc. - CFO*

Dan, it is Charlie. I'll take the gross margin. The gross margin was very much a mix issue where as we -- the margins were up in all the categories but obviously mixing much more heavily into technology brought the overall number down. We did have accruals for the Advantage program but those were anticipated opened in our guidance and we're in line with that. So that program is not a runaway train.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

Dan, virtually all of the supply categories had nice margin increases across most categories in retail. We've said that would occur all along and it did. It is a mix issue. Chuck's got a comment he'd like to make as well.

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

Yeah, just to add to that on the supplies. To Bruce's point, supply category margin rates were up. The same is true for furniture as well. That contributed at a higher rate.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

To your second question regarding the allocation--really what you're asking about how is how do you allocate the cost to acquire cost. Do you do it through catalogs, do you do it through online and the different choices you make. And Chuck spoke to, without going into a lot of depth, how we're focused on making our advertising dollars more effective. We call catalogs advertising dollars and we have reallocated how we're spending those catalog dollars to be more effective to lower our cost to acquire and get a better lifetime value as a result of that acquisition and we'll continue to see efforts in that regard. It is one of the reasons why Chuck spoke earlier about our confidence that we can continue to leverage our advertising expense and we'll end up in 2004 with a lower expense percentage than we had in 2003.

Dan Binder - *Buckingham Research - Analyst*

I guess what I am getting at is it just seems like the catalog business as it migrates to the Internet is a business that I guess I would never think could get back to positive. I mean is this a business that we should just kind of -- you know, under invest in and really just focus the efforts on E-commerce rather than --it sounded like earlier you said that you had done some promotions to help drive the catalog business. I'm just trying to understand the logic behind that.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

First, we don't share your view that the businesses can't get back to positive. We're confident that the catalog businesses can. I think the Viking segment of the catalog business may have more challenges to get more positive as it focuses on such a very small specific customer niche. And that's one where we maximize the opportunity to leverage a highly profitable positive cash business. But -- and certainly there's cannibalization to the Internet, but even if you look at our E-commerce sales, a significant portion of our customers are entering sku numbers that they could only get through catalogs. So they go hand in hand. But we believe and we saw Office Depot catalog sales, as we talked early, accelerate during the second quarter. We anticipate that Office Depot catalog sales will be positive in the second half of the year.

Dan Binder - *Buckingham Research - Analyst*

Great. Thanks.

Operator

Colin McGranahan your line is open please state your company name.

Colin McGranahan - *Sanford Bernstein - Analyst*

Sanford Bernstein. First question's just a quick follow up on catalog. Obviously, you've said it's encouraging and some acceleration; can you give us a sense of where those sales are on a same customer basis now? Maybe what you've seen in some of the tests that you've performed and just, you know, what the difference is in trends between the Viking catalog and the Office Depot catalog right now? Just so we can get a better sense of where you are and where you're going.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

Our retention rate on Viking is strong. Our growth in existing customers is good. The Viking challenge has been acquiring new customers. That continues to be a challenge in an acceptable cost to acquire lifetime value formula. That's not new news. I mean, frankly, it goes back to one of the base reasons why Office Depot and Viking decided to get together in 1998; because that model does have some aspects of challenges to it, both domestically and internationally where you see similar characteristics. On the Office Depot catalog side, a little bit of the same, our real challenge has been acquiring new customers. It would appear that we're doing a relatively good job of holding the loyal customers, the ones that buy from us more than once.

One of the many challenges we've all had in Internet marketing is getting a one time customer to become a multiple buy customer. That has been a challenge. That speaks back to the reallocation of effort. So we look at Viking as a little more mature catalog model which will focus on retention and growing share of our existing customer base and a little less aggressive on quoting new customers. And on the Office Depot we'll reallocate resources to get more aggressive on the allocation of new customers using the most effective media to do that with. Some of which might be mailing catalogs and some might be Internet; blending those two things together. And we think we can grow and have got some encouraging signs on the depot side that we're growing new customers.

Colin McGranahan - *Sanford Bernstein - Analyst*

Okay, and then just drilling down into the North American retail gross margin a little bit more. Could you quantify for us what that technology mix impact was and how much shrink improved? Just so we get a sense of how much you're improving and then how much the mix is impacting that. Any kind of quantification of that would be very helpful.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

Well, the answer to your question is that the absolute reported margins is virtually mix related with some improvement in shrink. To get more specific than that, I don't think is meaningful. What you have to take away is that virtually across most major supply categories our margins increased. That's by the way a quarter increase. We had the same impact in the first quarter. Furniture margins increased. So we're getting margin increases and you can say virtually all of the delta between second quarter this year and second quarter last year is mix related with some improvement in shrink. To remind all of you, a year ago in the second quarter we rolled out Inc. Depot.

We had a significant in revenue, but we also talked to you about a significant increase in shrink. In the third quarter last year we said we would address shrink by electronic devices and other kinds of choices. We have begun to do that. We took our inventories in retail in the second quarter this year and trued up our estimate for shrink versus our actual shrink and we brought shrink levels down from historically high levels a year ago to something higher than they were prior to the rollout of Inc. Depot, but still, we believe, industry leading shrink rates. And so it's a mix issue. Our core business is doing well. Well into margins and we anticipated.

Chuck talked about private label. It's a growing aspect of our retail business and we'll grow it further. That means better margins. Chuck talked about pricing initiatives. Some of which was instituted and relatively unsophisticated tools and Magellan gives us many more sophisticated tools to make sure we're competitive and to make sure that we achieve rates. So we're confident about our ability to grow margins.

Colin McGranahan - *Sanford Bernstein - Analyst*

Okay. But they would have been up a lot more, right, without the mix impact? Unless I'm looking at something fundamentally wrong, you gross margin rate was up right in North American retail.

Charlie Brown - *Office Depot Inc. - CFO*

The rates are up.

Colin McGranahan - *Sanford Bernstein - Analyst*

Right, I mean, even including the mix impact; so we're just trying to get a sense of what the rate would have been up without that mix impact.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

The answer is we don't have that calculation at hand. We can try to go offline.

Colin McGranahan - *Sanford Bernstein - Analyst*

Okay, we'll take if offline. I don't want to take more time.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

I would like to answer but we just don't have it at hand.

Operator

Mark Rowen your line is open. Please state your company name.

Mark Rowen - *Prudential - Analyst*

Thank you Prudential. Couple of questions, sort of follow-up questions. One, on the softness in North American retail, you talked about it softening in the last few weeks. Some other retailers and sectors began to feel that softness in May and June actually improved. It sounds like you started feeling it a little bit later and it is continuing. I wonder if you could just confirm that? And is the softness-- do you get the sense that it's consumers pulling on big ticket purchases like computers and technology or is it just less traffic overall in the stores? My second question is on North American catalog, you talked about promotional activity, I wonder if you could just talk-- or give us a little bit more detail about what that promotional activity is? Are you responding to competitors or is this activity you need to generate new customers or activity you need to keep your current customers buying more? Thanks.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

Sure. Chuck.

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

I'll address the first part of the question talking about the performance of North American retail. Our -- based on other retailers results our sales softened a little bit later than others. On the most recent weeks-- actually to go back to a couple of your comments. We are not seeing any softness in larger ticket purchases. So our technology sales continue to be strong. What we have seen is a softening somewhat due to a marketing shift. We changed our back to school marketing campaign. Bruce alluded to it earlier. For all intents and purposes, that campaign really kicks off this weekend. So that shift in money which ties back to our marketing effectiveness effort has resulted in a slight softening in our retail sales over the past couple of weeks. As many of you know, the back to school season is a rolling schedule depending on what part of the country that you're in. But, we are still feeling comfortable that August, with everything that we have aligned will be a very strong back to school period.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

As it relates to the promotional activity in catalogs a significant portion of that was related to paper and we think that is in response to competitive activity, not being aggressive in the competitive activity. So, the promotional impact was predominantly focused in paper during the second quarter. That always takes place when you get paper price increases from mills, it takes a while for that to roll through the channel. And depending on your inventory position, some are more aggressive, less aggressive. And, frankly, you can't afford to loose share in paper. That's such a core commodity and core item for our customer base. So it was predominantly paper related and it was in response to competitor pressures. We're going to take one more call and then if we haven't answered all your questions feel free to call us after the all and we'll give you further insight. So one more question.

Operator

Michael Baker your line is open. Please state your company name.

Michael Baker - *Deutsche Banc - Analyst*

Thanks. Deutsche Banc. Couple follow-up questions and then one new question. Just wanted to go back on what you spoke about in the catalog where it sounded like if you are not picking up new customers and you said retention is good and the growth in existing customers is good. Well, if the overall business was down, so one of those--unless I'm missing something would have had to have been down. Is it that retention is good but you are losing some customers or the growth isn't as strong or-- I was just a little confused by that.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

Well, let me clarify and try to be more clear with what I said. Was I said--was asked the question response to our catalog business and what the dynamics of it. Our retention has been and always been strong with Viking. The challenge has been for some time, not the last quarter or two, acquiring new customers. We -- in the second quarter, our new customer acquisition rates in the Depot catalog business improved and that led to a better performance in the catalog business and we are optimistic and hopeful that based on how we're allocating spend, cost to acquire and lifetime value, that we will accelerate new customer growth in the catalog business. That's predominantly what we saw in the second quarter on the Depot side of the business.

Michael Baker - *Deutsche Banc - Analyst*

Then spending from existing customers, is that -- where does that relate to a year ago?

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

Generally speaking, it's up.

Michael Baker - *Deutsche Banc - Analyst*

Okay. I'll think about that a little more. Then, last question, can you explain you spoke about reorganization of North American retail and how that helped to improve the bottom 20% of your stores by 50 %. So what are some of the things that you've done in those stores to turn that around? And what's the continuing opportunity there?

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

Well, for example, we had nobody in Canada in charge of Canada and about four months ago we appointed a Canadian as the regional manager up in Canada. Prior to that it had been run by somebody here at corporate who also had other things to do at the same time. We made a number of changes in our regions and we also dedicated resources to working solely on our fast stores and our low 20% performance stores. So, we have a group of people now who were experienced led by a woman who was one of our best district managers and a number of support staff who concentrate solely on that group of stores, for example. There was also an announcement that I think went out last night. Joe Jeffries was named vice president of store operations. I think you'll probably be able to see that on our website today. So we've had a number of ongoing changes here. Some people departed. We've put some new people in new jobs. Certainly, we've tried to refocus in an effort to have dedicated people on stores that were losing money, on Canada, on small stores. There's a group of people dedicated to those and a group of people dedicated to M2 remodels.

Michael Baker - *Deutsche Banc - Analyst*

So are there things that these people that can talk about have done specifically within the stores yet or is it just the change in leadership is, sort of, reinvigorating some of the trends?

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

It's actually about--the change in leadership was important in some of those areas and certainly they've already been doing things that we can see results from.

Michael Baker - *Deutsche Banc - Analyst*

Okay. Thanks a lot.

Bruce Nelson - *Office Depot Inc. - Chairman and CEO*

Thanks for listening. I just summarize I think what the essence of what you're hearing us say is that our efforts to focus on those key drivers of results are producing tangible measurable, specific improvements. From our merchandising efforts in our retail stores, to the remerchandising efforts in technology, to the focus on the right mix of advertising expense and how we do it, to the focus on improving our costs at the same time improving our quality, to our focus of improving our North America real estate portfolio, the rollout of M2, the design of M2, to the improvement in the contract growth rates of our business, to margin improvement across virtually all of our channels; in most key categories, it's about focus on those things that make a difference and drive shareholder value over the long term. Any business has its up and down economic cycles.

We talked in the press release about our cautious optimism. That is cautious optimism. There are lots of things we're continuing to do. And I know a lot of people wonder can we do them all. Reality is we've shown enormous ability to do them and execute them near flawlessly and our confidence in the future of our ability to drive revenue, profitability, growth and RONA remains stronger than ever. Thanks for the opportunity to ask us questions and listen to the call. If we've not been able to answer all of them, please feel free to call investor relations and we'll try to give you the answers you'd like to have. Have a great day and thanks again for listening.