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ODP.OQ - Q1 2004 Office Depot Inc. Earnings Conference Call

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OVERVIEW:

ODP announced 1Q04 sales of $3.6b, up 18% from 1Q03, with EPS of $0.37. FY04 EPS guidance of $1.20-1.25 was reiterated. Q&A Focus: New store openings, advertising, GM comparisons.

CORPORATE PARTICIPANTS

Charlie Brown *Office Depot - CFO*

Chuck Rubin *Office Depot - EVP Merchandising and Marketing*

Eileen Dunn *Office Depot - Director IR*

Bruce Nelson *Office Depot - Chairman & CEO*

CONFERENCE CALL PARTICIPANTS

Dan Binder *Buckingham Research - Analyst*

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PRESENTATION

Operator

We would like to welcome you to the Office Depot first-quarter earnings conference call. All lines will be on a listen-only mode for today's presentation, after which instructions will be given in order to ask a question. At the request of Office Depot, today's conference is being recorded. I would like to introduce Ms. Eileen Dunn, Vice President of Investor Relations and Public Relations, who will make a few opening comments.

Eileen Dunn - *Office Depot - Director IR*

Good morning, everyone. Before beginning today's conference call I'd like to remind you that certain of the 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 of those risks and uncertainties are described in detail in our report on Form 10-K filed with the SEC on February 26, 2004 and in our 10-Q filed this morning with the SEC which provides detailed segment information for your review.

During portions of this call our Chairman and CEO Bruce Nelson will refer to results of our first-quarter 2004 quarter which are not GAAP numbers. A reconciliation of non-GAAP numbers to GAAP results as well as detailed segment information is available on our Website at www.OfficeDepot.com. Now I'd like to introduce Office Depot's Chairman and CEO, Bruce Nelson.

Bruce Nelson - *Office Depot - Chairman & CEO*

Thanks to all of you for joining us this morning. First an overall summary, sales were up, North American comps were positive and earnings were up. In 11 of the last 12 quarters, including this one, earnings have met or exceeded expectations. Our seven key strategic initiatives we outlined last year are delivering promised results and are positioning us for accelerating growth rates in both sales and earnings for the remainder of 2004 and beyond. As a reminder, those seven strategies are -- number one, reposition our North American real estate portfolio; two, control costs while enhancing quality; three, create a customer centric experience; four, develop differentiated product assortments; five, excel in Europe; six, grow our people, talent and leadership; and seven, builder acquired to generate breakthrough growth.

Before I turn the call over to Charlie Brown, our CFO, who will discuss our financial performance, and Chuck Rubin, our new EVP of Merchandising and Marketing who will share with you some additional insight into our North American business, I would like to provide you some brief headlines on each of the initiatives and how our actions are translating into results full in the first-quarter as is well into the future.

First, strategy number one, reposition our North American real estate portfolio. Our purchase of the Kids 'R' portfolio will give us the opportunity to convert 50 to 60 of the 124 sites we acquired to Office Depot stores and 25 to 30 of those sites will become the foundation for our entry into new northeastern markets. Including the KRU sites, we now plan to open 80 to 100 new stores in the second half of this year and remodel another 50 or 60 older Office Depot stores as well. Virtually all of these new stores and remodels will be designed around our Millennium 2 format, or M2, which reflects all of the customer and operational earnings of our original Millennium format that's designed around a lower overall operating cost.

Strategy number two, control cost while enhancing quality. 12 consecutive quarters of reducing North American warehouse operating cost as a percentage of sales have resulted in more than $150 million in savings in the past three years at the same time increasing virtually every important customer quality measure metric. This quarter was no exception. Our numerous global purchasing initiatives are beginning to be reflected in overall lower purchasing costs, higher gross margin dollars and percentages, and increasing our worldwide assortment of private-label offerings.

Strategy number three, create a customer centric experience. The launch of our new North American Office Depot Advantage program, which rewards customers for purchases and loyalty and provides us the ability to recognize our customers across all channels. Office Depot Advantage customers tend to buy more frequently, give us a higher share of wallet, purchase from more than one channel, have an average ticket higher than our non-Advantage customers.

Strategy number four, develop a differentiated product assortment. Our unique and proprietary Christopher Lowell line of office and home furniture and accessories offer customers design, functionality and value that no other office supply superstore retailer offers; as a result continue to exceed our expectations. Our significant technology assortment changes and results in our North American retail speak for themselves; 11 percent positive comp growth in technology in quarter one 2004 versus -20 percent comp declines in the first-quarter of 2003. During the second-quarter we will expand our notebook assortments, the fastest-growing hardware category, and at the same time significantly remerchandise plan-o-grams and signing more than two-thirds of our North American stores by the end of this quarter.

Strategy number five, excel in Europe. The Guilbert acquisition remains on track to deliver planned results. International revenues in the quarter were 27 percent of the Company's total and the operating profits from our international businesses were almost 40 percent of our consolidated company results in this quarter. Our French retail comps grew almost 18 percent during the quarter and early in the second-quarter we acquired our Hungarian franchiee business giving us a solid management team and a strategic gateway for future growth in Eastern Europe as 10 new countries will soon enter the European Union.

Strategy number six, grow our people, talent and leadership. We strengthened our executive leadership with the employment of three new executives to head North American retail stores, North American merchandising, marketing and global human resources. We continue to make large investments in the training and development of our people on a worldwide basis.

Strategy number seven, build or acquire to generate breakthrough growth. We will keep you informed, updated as appropriate. I'd now like to turn the call over to Charlie Brown, our CFO, who will discuss our financial performance, and then Chuck Rubin who will share with you additional information insights into our North American business and merchandising marketing issues.

Charlie Brown - *Office Depot - CFO*

Thanks, Bruce. Good morning, everyone. Total company sales for the first-quarter grew by 18 percent to $3.6 billion compared to the first-quarter of 2003. Worldwide comparable sales in our 909 stores and 37 delivery centers increased 2 percent during the period. Global e-commerce sales increased 27 percent to 762 million compared to the same period last year, further expanding our industry leadership position. Operating profit for the first-quarter increased by 9 percent to $176 million. Our profit performance reflects strong European results bolstered with the addition of Guilbert operations and favorable currency rates, continued growth in our large customer segment in North America, and improvement in our North American retail sales.

General and administrative costs as a percent of sales were down sequentially by almost 100 basis points in the first-quarter, but up over last year primarily as a result of consolidating Guilbert into our international segment and stronger European currencies. In February of this year we announced our efforts to more fully allocate our general and administrative expenses to our business units. While this process has no impact on our reported net income, we believe it will provide better insight into business unit profitability. We have not completed this analysis. While some allocations are relatively easy, our support functions are highly integrated and support all business units therefore developing a meaningful allocation methodology is a complicated process. We will continue to develop our allocation methodology while also evaluating the cost and the benefits of this effort.

Net earnings per diluted share were 37 cents compared with 25 cents for the first pay period last year. Included in first-quarter of 2004 was a $4 million charge, or a penny a share, (inaudible) certain outstanding litigation. Included in 2003 results was the adoption of EITF 02-16 which reduced diluted earnings per share by 8 cents for the first-quarter. Now let's turn to the individual segment results.

International sales, which now represent 27 percent of our consolidated sales, grew 78 percent in local currencies and 94 percent in U.S. dollars during the quarter. These results reflect the addition of our Guilbert acquisition as well as solid sales gains in all countries except Germany, the Netherlands and Japan. International sales reported in U.S. dollars benefited from stronger foreign currency rates in the first-quarter of 2004 by $81 million, a significant portion of which was anticipated in our 2004 plan. European sales continue to be the main growth vehicle for Office Depot International. Overall European Viking catalog sales were solid and (indiscernible) retail comps reached almost 18 percent in the quarter.

International gross profit as a percentage of sales decreased by about 300 basis points in the first-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 reflects the addition of Guilbert. However, selling and warehouse expenses as a percent of sales declined almost 300 basis points compared to the prior year because of the planned cost reductions and increased leverage from higher sales volume. International segment operating profit also benefited from foreign exchange rates by 12.8 million during the quarter when translated into U.S. dollars.

This was another strong quarter for our international segment bolstered by the acquisition of Guilbert. Our integration remains on track, our (indiscernible) is in place in all countries and doing well. At this point we're capturing the purchasing synergies we modeled and are making good progress in rationalizing the combined infrastructures.

For North American business services group total sales were flat in the quarter. Contract sales increased 3 percent with higher growth rates among our large customer segments offset by continued softness in our catalog businesses. While our domestic catalog business remained soft during the quarter, the Office Depot brand catalog did achieve planned sales and is on track to reach positive sales growth in the second half of this year.

Domestic e-commerce sales grew 11 percent during the quarter. We now expect our worldwide e-commerce sales this year to exceed $3 billion continuing Office Depot's industry leadership position in this channel. Both gross profit and total (inaudible) warehouse operating and selling expenses in this segment were relatively unchanged in the first-quarter of 2004 compared to the same period of last year.

We are continuing to benefit from our focused growth initiatives in the large customer segment. During the quarter we completed the strategic realignment of our sales force which we expect to accelerate growth rates in our small and medium customer segments for the remainder of this year. Our North American warehouses had another strong quarter with operating costs as a percentage of sales continuing to decline. Warehouse operating costs have now declined in each of the past 12 quarters resulting in more than $150 million of cost reductions over the past three years.

And finally, our North American retail business. Total sales increased 5 percent to 1.6 billion in the quarter and our comparable sales increased 3 percent. That's a 10 percent improvement over first-quarter of last year. The increase in comparable sales was primarily attributable to increased sales of technology which are a direct result of several technology merchandising initiatives launched in the fourth-quarter of 2003. During the quarter the Company opened three new retail stores, relocated three stores and closed three stores. At the end of the first-quarter we operated a total of 900 office product superstores throughout North America.

Office Depot has the oldest store base among our direct competitors at just over eight years and, as you know, older stores comp at lower rates. As our total comparable sales have improved we are very encouraged that the 75 stores opened in the last three years that are now in our comp base are growing at 15 to 20 percent per year. This year we expect to open 80 to 100 new stores and remodel more than 50 to 60 stores in our M2 format which we expect will further strengthen our comp store trends. Increased sales of technology products, which generally have lower margins, adversely affect the gross profit as a percentage of sales during the quarter.

Occupancy costs also increased as planned reflecting more new stores in our base. Gross profit percentages in our core office supply categories increased on a year-over-year basis. Store payroll experienced significant leverage from increased sales. However, these savings were more than offset by planned higher advertising expenses compared to the same period in the prior year and the costs associated with closing -- with the planned closure of three stores.

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 the first-quarter. Inventory levels were up slightly from last year to 1.2 billion because of the addition of Guilbert. Without Guilbert inventories were actually down about $40 million compared to last year. Free cash flow was $185 million in the first-quarter and capital expenditures totaled 70 million for the period. We remain on track for CAPEX in the $300 to $350 million range, flat inventory levels and free cash flow generation of $400 to $450 million for the year. These numbers exclude the impacts of the previously announced Kids 'R' Us transaction.

And finally, we continue to expect 2004 EPS growth in the range of 15 to 20 percent compared to non-GAAP EPS in 2003 of $1.04 or about $1.20 to $1.25 for this year. For the second-quarter we expect 15 to 20 percent growth in EPS compared to the 19 cents reported last year. As previously noted, we launched a number of focused merchandising and marketing initiatives during 2003 which are driving growth in our North American retail business. I would now like to turn the call over to Chuck Rubin who will provide more insight into our plans and initiatives.

Chuck Rubin - *Office Depot - EVP Merchandising and Marketing*

Good morning, everybody. I'm very pleased to speak to you about our positive Q1 results. The focus of my comments today concerning performance will be primarily our North American retail. My comments concerning our initiatives and go forward strategies will generally apply to retail as well as our other direct channels. Overall our Q1 performance was achieved through disciplined execution of our merchandising strategies. It included a more analytical fact based assortment management and promotional planning process along with tighter integration of merchandising, marketing, inventory management and store operations. We manage our product assortments in four distinct groupings -- technology, furniture, supplies, and copy and print.

During this quarter tech, furniture and supplies, the majority of our business, comped positive and the core foundation of businesses that make up each also comped positive. In terms of gross margin we achieved higher rates in most of the core product categories; this was partially offset, as you heard, by the impact of a higher penetration of technology sales on the overall sales mix. Nonetheless our total gross margin dollars improved over the year earlier quarter.

To provide some additional context around our performance let me speak for a moment about each of our major product groupings. In technology desktops and laptops contributed greatly to our improved results. The performance of laptops was especially noteworthy as the trend towards mobility becomes more prevalent. Our core customers are increasingly seeking products that help them capitalize on this mobility movement and we intend to capitalize on this trend. We also realized our 'take-with' assortment to reflect the brands, prices and promotions that customers desired. We accomplished this while still improving our inventory turnover. Strong inventory management and our best in class supply chain capabilities enabled this.

Additionally we enhanced our configurative (ph) order or CTO platform. Previously our CTO customer experience was inconsistent. To successfully execute our strategies we made appropriate investments to deliver a customer friendly front end. Additionally we leveraged the assets of our 4Sure division along with our close vendor relations. This effort delivered strong comps and wide praise from both our customers and our vendors. HP, our largest vendor, credited Office Depot as being best in class in this type of offering. This CTO capability is significant because it allows Office Depot another means to deliver an outstanding customer service. Financially it is attractive because it delivers incremental sales with no inventory investment. This CTO offering will be a key component of our go forward strategy to help profitably manage the lifecycle demands of our TC business.

Rounding out technology sales were strong sales improvements in higher margin businesses like software and services, for example warranties. This also is critical to our strategy of developing broadbase solutions for our customers that have provided improved sales and margin basket for Office Depot.

Turning to furniture, our comps there were positive as well. Driving this performance was desking which is our foundation department in furniture; computer furniture, which benefited from our stronger technology sales; and as Bruce mentioned, our exclusive Christopher Lowell collections of furniture and accessories. This last point is particularly important. Not only does Christopher Lowell product deliver strong sales and margins, it represents the successful implementation of our strategy to deliver great looking high-quality and high-value product. We believe this will serve to extend our market leadership position within furniture.

Our largest product division, supplies, achieved positive comp sales as well, specifically we exceeded last year's performance in our core departments of paper, ink and toner, dated goods and school supplies. The performance of this last category, school supplies, was driven by our commitment to maintain a 365 day presence in this product.

Our final product division, copy, print and ship, experienced slightly negative comps. This was due to softness in our black and white copy business, which is a diminishing component of our offering, and our shipping business. The latter we believe is a result of the increased UPS retail presence. As we look forward we plan on improving this part of our business by offering a broader range of shipping choices to our customers. On the positive side, a number of critical milestones were achieved during Q1 in our copy and print business. Specifically we successfully implemented the organizational and technical infrastructure necessary to allow us to capitalize on this business segment.

Let me turn for a moment to the results of a few of our key merchandising initiatives. Each of these has been critical in our Q1 performance and are building blocks of our go forward strategies. I'll start with our Magellan project managed by Mark Holifield which is the largest single business project in Office Depot history is both on time and on budget. We are in month 13 of a 33 month rollout. During this first-quarter the successful implementation of a number of modules allowed us to achieve the following -- improved planning and forecasting capabilities; improved replenish with greater service levels and less inventory; and significantly improved store planning capabilities which will become critical as we accelerate our store opening schedule for the balance of this year.

Other key merchandising initiatives included a comprehensive review of product pricing which delivered incremental margin in the first-quarter; increased private brand penetration which has added to our margins and supported our product differentiation strategy; continued focus on inventory management which resulted in improved inventory productivity for Q1; and global purchasing which accelerated our ability to leverage the buying power of our worldwide company.

Turning to advertising, our spend in Q1 achieved our plan which, in fact, higher than last year. The incremental dollars were primarily in inserts in local retail marketing. As we look at Q2 our plan calls for a moderation of this trend and we are, in fact, on plan for the second-quarter. During Q1 we conducted a performance analysis of our various retail media vehicles and have begun to implement changes based on that analysis. We also improved in store sales and margin productivity by applying a more rigorous structured earned space approach to select product, offers and layout.

As was mentioned, we launched our loyalty program, Office Depot Advantage. Initial membership and sales results have exceeded expectations with over 1 million members enrolled in the first month. And finally, our strategy targeting our core customers through our event marketing continued. The Office Depot fourth annual Success Strategies Convention for Businesswomen was a highly visible and highly attended event.

Let me turn to Q2 for a moment and touch on just a few points where we will conduct to focus our attention. First and foremost disciplined execution of our merchandising and marketing efforts. This is absolutely critical to our strategy and the entire management team is aligned on this topic. As an example, Rick Lepley, who heads our stores, and I will be providing standardized presentation guidelines for all of our stores to ensure a consistent customer shopping experience. Layered on top of this centralized merchandising direction will be a decentralized customer service program that will continue to provide our stores great latitude in providing fanatical customer service.

Second, as Bruce mentioned, in two-thirds of our stores we will introduce a new technology layout which will drive sales and margin by supporting our expanded assortments and drive higher attachment rates. We have tested this concept during the first-quarter and it's produced very strong results. Third, we will continue to apply a more disciplined assortment rationalization process to improve our productivity. Fourth, we will realign our marketing spend to reflect a more rigorous fact-based allocation approach. We expect this to improve both the efficiency and effectiveness of our spend. And fifth, we will continue to scale our private brand business.

In summary, before I turn the call back to Bruce, let me just add an overarching comment. During my first four months with Office Depot we have made much progress enhancing the disciplines to create and successfully execute our strategies. This along with the collaboration, enthusiasm and efforts displayed by our team has led to our improved Q1 performance. I think importantly it is also evidence of the significant opportunities that lie ahead. Again, thank you very much and now I'll turn the call back to Bruce.

Bruce Nelson - *Office Depot - Chairman & CEO*

Before I turn the call over for questions I'd like just to briefly summarize. First, our strategic initiatives and actions are producing tangible results. From repositioning our North American real estate portfolio to delighting customers with outstanding service and rewarding them for loyalty, to giving customers a broader and more unique range of product assortments, through expanding our leadership position in Europe and worldwide e-commerce, and by building our organization, leadership and capabilities we are fundamentally changing the way we do business. We are investing in enterprise systems to drive revenues and lower costs.

Systems like Magellan, which Chuck spoke about, are delivering results. Systems like PeopleSoft, which turns data into information on a more timely basis, helps us lead, manage and understand our business on a more timely insightful basis. Investments in warehouse technology that have driven productivity and enhanced quality, our M2 format will be a highly differentiated office supply superstore format. We're using the Intranet to drive efficiency in internal processes and we are changing significantly the way we look at advertising and marketing spend to make them more effective and efficient than ever.

We have a maniacal focus on execution from our seven strategic initiatives to our North American sales force realignment to excelling in Europe. Much has changed at Office Depot but, in the four years I've been the CEO, our core values of respect for the individual, fanatical customer service and excellent execution have not changed. Our goal to be the most compelling place to work, shop and invest has not changed. Our focus, our methodology, our leadership, our tools, our systems have changed and we believe the first-quarter is indicative of the kind of results we expect to generate for the rest of 2004 and beyond. What I'd like to do now is turn the call over to you for your questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS) Dan Binder.

Dan Binder - *Buckingham Research - Analyst*

It's Dan Binder of Buckingham. A couple questions for you. First, can give us a little bit more color on the Advantage program in terms of the average spend and frequency that you referred to as being greater than I guess the average customer? And then if you could address what the currency benefit to EPS was. And perhaps what other technology changes you're making this quarter beyond the laptop assortments.

Bruce Nelson - *Office Depot - Chairman & CEO*

Well the first question, Dan, is in the first month we had more than a million of our customers sign up for our advantage program on average. Averages sometimes get you in trouble. They spend 2.5 times greater. Their average ticket is also higher. But more importantly, these are our most loyal, frequent, core customers who we've now given more reasons to buy from Office Depot; and second, by understanding more of who they are, and they're willing to give us information about them, we can more precisely pinpoint our advertising and marketing spend to provide them value and reasons to buy and stay with Office Depot.

On the currency impact, on the operating side in the international is 12.8 million -- that is offset by the G&A costs which go negative (indiscernible). And remember, a significant part of that was already in our plan when we outlined 2004's results.

And finally, as it relates to merchandise, I don't think it serves us well to go into the specificity of all of the initiatives we plan to put in place in the second-quarter in merchandising. But for (indiscernible) to say of the two-thirds of a chain that we're going to touch there is some additional assortment, as Chuck pointed out, mostly in notebook. More importantly adjacencies are better. We believe attachment rates will be better. we believe accessory sales will be better. And that's not just a belief, it's based on some tests we've run in the first-quarter. That's as much depth as I'd like to talk about the assortment in the second-quarter. Certainly when the second-quarter ends, and we believe it will end better than the first in every category, we'll give you some more insight as to what drove that. But we remain confident about the fact that each quarter this year and retail in particular will comp better than the previous quarter.

Dan Binder - *Buckingham Research - Analyst*

And just one final question. You've been slowly relocating stores and remodeling. Do you have any results that you can share with us at this point on some of that activity?

Bruce Nelson - *Office Depot - Chairman & CEO*

I think the most insightful result was what Charlie pointed out that if you look at the 70 some new stores we've opened in the last three years, which, by the way, in our base isn't very many, those stores today are growing 15 to 20 percent in comps. So I think relocation, frankly, looked an awful lot like a new store in metrics, even if you just move it down the street a mile or two, it has all the metrics of a new store. So we continue to put disciplined approach to sight selection. We've talked about some tools in the past that we've used that we believe are more sophisticated.

Our investment in systems helps us do that. We believe today our analytics to choose sights is better than it's ever been before. And we continue to look at every store as it ages and comes up for renewal as to whether or not we want to make an investment in it, whether we want to keep it or whether we want to remodel it. That's part of our key strategy about repositioning our North American real estate. That is a little longer-term issue because it's going to take us a couple of years. But with the foundation of the KRU stores, our M2 format, which is differentiated, and, by the way, we believe will be lower operating cost model, will allow us to continue to invest in real estate and earn our cost of capital.

Dan Binder - *Buckingham Research - Analyst*

Great, thanks. Nice quarter.

Operator

Aram Rubinson.

Aram Rubinson - *Banc of America - Analyst*

Banc of America. A couple things. I see the 10-K is just starting to -- or 10-Q is just starting to come out and (indiscernible) just yet. Can you just help us understand two things? One, the retail gross margin, if you can give us kind of where this all washes out because just in terms of how that compared to LY? And then secondarily, on the paper business, can you give us a sense as to what the rising commodity costs there have done to either the sales or the margins in that business? And then the final thing, sorry, is when you roll out the technology assortment in Q2 how many variations of that will there be once you're fully national? Thanks.

Charlie Brown - *Office Depot - CFO*

Our gross profit in retail first-quarter was down about 50 basis points. Again, that was mainly mix driven.

Bruce Nelson - *Office Depot - Chairman & CEO*

As Chuck pointed out, margins in core office supplies were actually up, and so the 50 basis points in total is predominantly a merchandise mix issue. If the gross margin dollars were up, which is more important, comp margin dollars were up -- it's margin dollars you run the business by. I'll let Chuck respond to both the technology question and the paper question.

Chuck Rubin - *Office Depot - EVP Merchandising and Marketing*

On the technology side, firstly, the assortment, all of our full-service stores will, in terms of a core, that is and in the adjacent attachments (technical difficulty) other peripherals, the main driving desktops and laptops. As the store volume increases as we go into larger volume stores that assortment will expand as well, but our investment is across the Company in technology. As far as the paper issue is concerned, certainly there are issues out there. But those are issues we continue to work through. From a cost standpoint we obviously are a big paper user; from an advertising perspective we have long-term contracts that we feel comfortable with in terms of paper that we sell. There is some price implication, some margin implication for us. We continue to manage through that and we'll see how that shakes out over the next couple of quarters.

Bruce Nelson - *Office Depot - Chairman & CEO*

The most challenging time we have in rising paper cost is an our contract business where we have commitments to customers that we honor for periods of time. It's less easy to pass all of those cost increases through. On the retail side you can price more quickly, but the market for paper stays incredibly competitive. This will just have to unfold throughout the year. There is a little margin pressure in paper, but I think the take away, Aram, is that the core business margins were up in retail across the product categories, across most categories basis point improvement in margins quarter-over-quarter.

Aram Rubinson - *Banc of America - Analyst*

Thanks, nice to see the positive comp. Good luck.

Operator

Colin McGranahan.

Colin McGranahan - *Sanford Bernstein - Analyst*

Stanford Bernstein. Two questions. First, could you talk a little bit about -- it sounds like in BSG that the Viking catalog business was the weakest aspect of that. Can you talk a little bit about what's going on there and maybe talk about your reorganization of the sales force, how that's going to change the outlook? And then just housekeeping, maybe if you could give us a sense of what those three store closures, how that affected operating costs in the first quarter? Thanks.

Bruce Nelson - *Office Depot - Chairman & CEO*

Let me try to answer your questions. On the catalog business, actually we had softness in both the Depot brand and the Viking brand. We had some encouragement on the Depot brand because for the first time in some time it hit its plan. So we planned the Depot to have a more difficult first half versus the second. We've said all along we thought we would turn positive in the second. And it appears on the Depot brand we're on track. On the Viking side it has to do with prospecting response rates and some margin pressure in prospecting and the cost to acquire. And so Viking's a cost -- a prospecting model that acquires new customers by significant mailings and some of the prospecting is not responding in rate as it once did. So we're refining lists, mailings, frequency, size of book, type of book to try and generate Viking revenue growth.

I'll remind you that even thought this struggles a bit with growth, this is an enormously profitable business, generates and throws off significant cash. And we'll get it to grow but this is not a bad business, this is still a very good solid business.

In terms of the reorganization of the sales force, I think it's suffice to say that we have basically taken a look at where we have salespeople, how we've deployed them, what kinds of behavior we expect from them and we've focused then predominantly on bifurcating, if you will, some of our sales force focused on acquiring and obtaining new business and a good portion of our sales force growing share of wallet and expanding the wallet of existing business.

We like what we see in early results. Whenever you do that it's somewhat disruptive to your sales force and it certainly has been planned in the sense that planned we understood it. Our encouraging signs in BSG is the large customer segment and the national account segments are growing at very healthy rates and we believe that as the quarter goes on, this quarter and into next half of the year we'll see some accelerating growth rates in our small and medium-sized businesses.

As it relates to the closing of three stores, we don't break out the cost. This is a normal process of refining your portfolio. This is three stores out of 900. There are some costs in there, they are all the costs of (inaudible) but we don't, for a variety of reasons, Colin, break out the specificity of those.

Colin McGranahan - *Sanford Bernstein - Analyst*

Just a quick follow-up on the contract then. Can you briefly comment on the pricing as it looks like demand is improving? And I think you had originally looked for high single digit growth in BSG given first-quarter was flat. Are you still comfortable with that?

Bruce Nelson - *Office Depot - Chairman & CEO*

For the year we're comfortable with accelerating growth rates in BSG. First of all, we are. Second of all, from the pricing standpoint of BSG I think it's pretty much the same as always. The larger account can sometimes get irrational at the huge national highly visible accounts. But I don't know that that's accelerated any more than it used to. It's a competitive environment. Customers today are smarter than they once were; they have more information how to buy better than they once did. We provide an in-depth analysis how to buy better. Frankly, one of our objectives is to lower the cost of the acquisition of office supplies to more customers. We think that's one of the reasons why they stay with us.

So, there's always margin pressure there but I don't -- it's not any more than it's ever been and I think we manage that business quite well and in spite of not growing a more profitable gross margin from a small and medium-size business, this business segment is still enormously profitable. And that's a good (indiscernible) to do is the fact that we've taken so much cost out of this business and our quality is good. So we're still optimistic about growth in BSG throughout the year. The best evidence we have of it is the growth in the large and the very large customer base. And we've got some very strong growth in some very important regions across the U.S. in this category -- or this segment.

Colin McGranahan - *Sanford Bernstein - Analyst*

Thanks. Good luck with the initiatives.

Operator

Jeff Black.

Jeff Black - *Lehman Brothers - Analyst*

Lehman Brothers. I just had a quick overall question. We've got accelerating comps, we've got accelerating, hopefully, sales in North American delivery. It looks like you beat your own expectations for the first-quarter but we don't have any raised guidance here. What's the disconnect there? What are you seeing out there now in your business that makes you a little more conservative than we thought you'd be?

Bruce Nelson - *Office Depot - Chairman & CEO*

The answer is we are now a grand total of 20 days into April. I'm encouraged by what we see so far. We believe we'll continue to accelerate. Frankly I think at this point -- this answers a good number of questions a number of you had. We've had a great quarter. We believe that we'll deliver another one the second-quarter and our results will speak for themselves as it relates to guidance. We're still going to grow this company in terms of EPS this year over the 104 last year, 15 to 20 percent. There's nothing that we're seeing that takes away from our optimism for the year. There's an awful lot of things going wrong in the economy, you want to make sure you continue to be solid, but we remain very confident about our business.

Jeff Black - *Lehman Brothers - Analyst*

Fair enough. And just a follow-up. Where are you coming in on costs specifically with the Millennium 2 format versus the old format? And the 50 to 60 remodels that you're going to do I guess are all Millennium 2's. Is that an indication that we've got a format here that you can move forward with and refurbish a bigger part of the store base? And if that's the case, how much would you expect to eventually remodel?

Bruce Nelson - *Office Depot - Chairman & CEO*

The answer to the question is we now believe our M2 format will be in the 250 to 300 range, down from the 350 to 400 range of the M1 format, that's first and foremost. To this we're also convinced that some of our smaller older stores may not take a full 250 to do, so 250 is kind of an average. Three, by the fact that we're going to do 50 or 60 remodels in the second half of this year and make sure we execute those flawlessly, that we do this without too much customer disruption and we understand how to do these. Assuming we do that well, and we think we well, then as you look into 2005 we would significantly accelerate our remodel program in 2005 and 2006.

We also think, as I said earlier, without going today into a lot of specificity that the way we've designed into will be a much more efficient labor model than even we have today. Charlie spoke earlier, we had good payroll leverage in North American retail in the first-quarter. We think M2 will give us even more leverage going forward. And our real focus is to lower the breakeven point both of existing stores and new stores. And I talked earlier about our maniacal focus. As we enter the northeast you can rest assured that we're going to that with the best, most efficient, lowest cost highly executed model we know how to do and we've lined up the resources necessary to do that. So give us a couple of quarters of results and we'll give you a lot more insight as to what those stores are doing, how they're performing and our expectations for 2005 and 2006. But at this stage to say we're optimistic would be a good way to characterize what we believe M2 can do.

Jeff Black - *Lehman Brothers - Analyst*

Okay, great. Thank you very much.

Operator

Matthew Fassler.

Matthew Fassler - *Goldman Sachs - Analyst*

Goldman Sachs. I'd like to ask three questions, and the first couple dig into some of the details of the financial outlook in the retail business. It sounds from Chuck's comments like you're sharpening your marketing spend in the first-quarter and that's unlikely to be a drag. That said, you've got some new store expenses and remodeling expenses that are likely to hit the numbers as we move through the year. Do you think that as comps presumably stay at this level or accelerate a bit like you should be able to get expense leverage at retail?

Bruce Nelson - *Office Depot - Chairman & CEO*

I'll let Charlie answer part of this, Matt. Let me speak to the advertising. Chuck pointed out that we did increase advertising spend planned in the first-quarter. I might comment about that -- in the first-quarter of last year we tried to reallocate advertising dollars and spend and it proved out not to work which is why we plan to get back to kind of "normal spend levels" and we believe we've now got the model in terms of ad price spend that works, we're going to continue to refine it.

As to the second question about leverage, yes, I believe that our North American retail business will make more money this year than it did last for the full year, even though that's not true in the first-quarter. So we'll see the flow-through of increasing comps and payroll average. Third, we still -- we have not -- on the toy stores -- the Kid's stores, we plan to close those stores in May. In other words where we physically take the possession of those. We are putting together our specific store opening plan for the second half, and as we get that more synced up -- I mean when we get the site, when we can take it over, when we can get construction -- give all of you some clarity as to what that means to us in terms of store operating costs, opening costs and new store opening costs. But we still in total remain confident about the 15 to 20 percent EPS growth this year.

Charlie Brown - *Office Depot - CFO*

Let me also add that last year, as you know, we had a fair amount of clearancing activity -- (indiscernible) activities as we got ready for merchandising issues that we had launched in the third and fourth quarter. We won't have that activity this year and so any new store expenses are pretty much going to be offset. So we're still comfortable with our 15 to 20 percent even with those store openings in.

Matthew Fassler - *Goldman Sachs - Analyst*

You just anticipated my second question which related to the peculiar gross margin compare in the second-quarter. It sounds like you should expect the mix shift to be able to deliver an outsized gross margin increase over that depressed number, is that fair to say?

Eileen Dunn - *Office Depot - Director IR*

Yes, we should. And again we were up in gross margin dollars, down in rate but up in dollars.

Matthew Fassler - *Goldman Sachs - Analyst*

Yes, down in rate year-to-year off last year's number?

Charlie Brown - *Office Depot - CFO*

Yes.

Matthew Fassler - *Goldman Sachs - Analyst*

Okay. My final question relates to international. Can you tell us --just as we try to dig a little deeper into the number with the acquisition and currency it's hard to get a sense of the underlying trend. If you're to look at the legacy businesses that Office Depot owned a year ago, what kind of growth did you see in local currency in those numbers? And then if you could give us some sense as to the contribution of -- I guess that we could calculate the contribution of the acquisition.

Bruce Nelson - *Office Depot - Chairman & CEO*

Two things, Matt. First of all, the Viking catalog businesses in Europe had a good quarter, as did the Office Depot startup contract businesses in most countries had a good quarter and the existing French retail business Office Depot had a good quarter. And the strong growth was -- kept those (technical difficulty) Second, we were way down the path of integration. It is increasingly more difficult for us to operate existing legacy Office Depot/Viking from integrateds that are there. We've integrated sales forces, we've integrated management teams. We haven't integrated many facilities albeit a few small ones. And as time goes on this will be impossible to segment.

Needless to say, we believe we achieved from Guilbert what we planned to achieved. There was some softness in Guilbert's business compared to last year for them in the UK and France. But remember, that was not in our base. It's just more and more difficult for us, Matt, to break out, and you'll see us once we've anniversaried the Guilbert, which comes in the second-quarter, that these are now comingled businesses relative to G&A costs, relative to sales rep/sales force advertising look into the business. It still has a Guilbert brand but it's an integrated way we go to market.

Matthew Fassler - *Goldman Sachs - Analyst*

So Bruce, if I were to summarize what you said it sounds like most of the legacy Office Depot businesses to the extent you can measure those separately are up. It sounds like Guilbert on a comp basis so to speak might have been off a little bit. Is that fair?

Bruce Nelson - *Office Depot - Chairman & CEO*

That's a fair statement. And that two big countries Guilbert had were France and the UK. So if they were off a bit compared to what they did before we owned them a year ago, then they have a pretty big impact on Guilbert in total. But in total the Guilbert -- we remain confident about delivering the plan we said we would and so far Guilbert has been -- met or exceeded virtually almost all of our plans.

Matthew Fassler - *Goldman Sachs - Analyst*

Okay, thank you.

Operator

Mark Rowen.

Mark Rowen - *Prudential - Analyst*

Prudential. Good morning. A couple questions. Number one, on the catalog business you talked about doing some prospecting and things in Viking and some of those things didn't work out. It looks like you've been reducing circulation in the overall catalog business for the last couple of years. Are you continuing to do that or are you now at a level of mailings where you're comfortable and are you going to start to increase that again? That's the first question. Second is on gross margin. You talked about in North American retail a 50 basis point drop year-over-year and you said that a lot of that was due to mix and selling more laptops and desktops. But can you give us a sense for this quarter and also, more importantly going forward, what kind of hit you're going to take from instituting the customer loyalty program because most companies that have instituted one have had, for the four quarters following that, a gross margin hit? Thanks.

Bruce Nelson - *Office Depot - Chairman & CEO*

First of all, Mark, on the circulation plans, we don't break out whether we circulate existing customer books of prospects. We don't break that out separately nor do we plan to. Second, I don't think it's appropriate to talk about our circulation plans other than to say that they're focused, they're databased, they're driven, they're customer specific. We believe that we've got the right plan. When I said prospecting of Viking I want to clarify -- prospecting rates have declined. So it's the prospecting rate itself that's declined not prospecting per se. And I think that's a phenomenon that most cataloguers experience.

As it relates to the 50 basis points mix change, again I want to emphasize that our core categories -- Chuck talked about them -- our core categories of furniture and core office supplies had basis point increases in margins in the first quarter. We anticipate they'll have the same in the second. And third, on the Advantage program, we do not think it's a material hit to margins. For one thing it's offset by some -- how we spend advertising dollars. And so to the extent that there is some margin hit, in our own analysis we'll offset that margin hit by lower advertising costs. So we don't see it a year from now being a hit on our margins. We just don't.

Mark Rowen - *Prudential - Analyst*

Okay. If I could just follow-up on the circulation. I wasn't really trying to get your exact plans, but I'm just trying to get a better sense because it seems like for the last couple of years sales have been down in the catalog business and your circulation has been down as well. Is that something that's continuing? Is that just a mature business that you're in basically every mailbox that you can get dollars out of? Or do you think you can grow that business by increasing circulation or in other ways?

Bruce Nelson - *Office Depot - Chairman & CEO*

I think you can grow the business by selective circulation. The key to circulation, Mark, is cost to acquire. And cost to mail them, you do some analytics. And so the answer is we have not -- we are not focused on driving down catalog circulation as an objective. We're focusing on getting the right number of catalogs to the right customers at the right time and have response rate go up. There is a major element of the Viking businesses. This one of the reasons why Office Depot -- why Viking -- which is the side of the business I was on -- at the time merged with Office Depot. But Viking model matures. There is not as much maturity in the Office Depot model, that tends to be linked to our multibrand multichannel. So in summary we think our catalog businesses can and will grow.

Mark Rowen - *Prudential - Analyst*

One last question if I could to Charlie. When you acquired Guilbert last October I guess, or last year I think in October, you said you expected accretion of 12 to 15 cents and it sounds like that's still on schedule, did I read that right?

Charlie Brown - *Office Depot - CFO*

Yes, actually we acquired Guilbert on June 2nd.

Mark Rowen - *Prudential - Analyst*

But I think in October you talked about accretion of 12 to 15 cents. So is that still the range?

Charlie Brown - *Office Depot - CFO*

For the full year this year and that still holds.

Mark Rowen - *Prudential - Analyst*

Okay, great. Thank you.

Operator

Danielle Fox.

Danielle Fox - *Merrill Lynch - Analyst*

Merrill Lynch. a couple questions. First, just on the 11 percent technology comp, I'm wondering if the strength came from units or average selling prices and if it was both which do you think was the bigger contributor to the reacceleration?

Chuck Rubin - *Office Depot - EVP Merchandising and Marketing*

If I heard correctly the question was units and average selling price?

Bruce Nelson - *Office Depot - Chairman & CEO*

Yes. Which caused the acceleration, units or average selling price?

Chuck Rubin - *Office Depot - EVP Merchandising and Marketing*

We actually had very good results on both fronts. We (technical difficulty) higher unit sales going out the door at higher average order values.

Danielle Fox - *Merrill Lynch - Analyst*

I'm having a little trouble hearing. The other question was just a few items on the outlook. I'm wondering what you're assuming for the tax rate as well as what your underlying assumptions about the impact from the currency will be over the next few quarters?

Charlie Brown - *Office Depot - CFO*

In terms of tax rate, the first-quarter tax rate was 30.5 percent. We think for the balance of the year it's going to be around 30 percent. We don't see any significant movement, maybe down a half a percent. In terms of currency the outlook is for the currency to stay at the Q1 levels which is, as you know, up over last year.

Chuck Rubin - *Office Depot - EVP Merchandising and Marketing*

Assuming that currency stays at the current level. That's our assumption and our go forward plans. If currencies fluctuate up or down from that it may or may not change our outlook, it depends on the materiality of it. But as best as we can understand currency is going to stay at or near these levels for the next nine months.

Danielle Fox - *Merrill Lynch - Analyst*

And just a final question is whether or not you have any updates on the anticipated net purchase price for the Kids 'R' Us stores given the PetCo deal for some of the locations?

Charlie Brown - *Office Depot - CFO*

Danielle, we're still in negotiations on some of these units. Obviously we're on track to get the 50 or 60 as announced to PetCo piece that others that are in the works. So it's moving along nicely. In terms of what it's going to net out at, we haven't completed that yet.

Danielle Fox - *Merrill Lynch - Analyst*

Generally coming down?

Charlie Brown - *Office Depot - CFO*

Absolutely. As you saw in the PetCo, PetCo was about 45 or 46 million off of the 196 that we announced.

Danielle Fox - *Merrill Lynch - Analyst*

Great, thank you.

Operator

Christopher DeBiase.

Christopher DeBiase - *Goldman Sachs - Analyst*

Most of my questions have been answered, but I just want to get one clarification. The 300 to 350 million of CAPEX this year, does that incorporate the necessary expenditures to reopen the 50 to 60 Kids 'R' Us stores that you've acquired?

Charlie Brown - *Office Depot - CFO*

No. The Kids 'R' Us are out of the number. So that's kind of our ongoing CAPEX in terms of the new stores, that does not include the Kids stores.

Chuck Rubin - *Office Depot - EVP Merchandising and Marketing*

It includes the new stores we will open outside of Kids, it includes our remodels, it includes all the other capital we plan to spend across the three business segments. It excludes the capital physically associated with Kids and the purchase price. As I said earlier, as we complete the actual transaction with Kids on these sites and have a more specific store opening plan, then we can be much more clear about the capital and the impact of those as we go forward.

Charlie Brown - *Office Depot - CFO*

And one thing I would add to that, that's our outlook (technical difficulty) the 350. Go back over the past three or four years we have tended to underspend that in the tune of $50 to $75 million -- just as we pushed back on the return rates.

Christopher DeBiase - *Goldman Sachs - Analyst*

Great. Thanks for the clarification.

Operator

Aram Rubinson.

Aram Rubinson - *Banc of America - Analyst*

Actually I must have hit it twice, but since I'm here. I don't know whether this was Freudian slip or not when you said the toy stores that you acquired, if there are other stores out there on the horizon is it safe to say that you might still be interested in additional packages or do you think your plate if full?

Bruce Nelson - *Office Depot - Chairman & CEO*

Well, first of all I meant toys own kids in their kid stores. With a side or two from anybody might be interesting. But a purchase of a block of stores is probably something we would not consider. I suppose there's always a case where a retailer vacates a site or two and you'll look at where it is, does it fit, you might take a set of blocks -- no, that's not in our current thinking today.

Aram Rubinson - *Banc of America - Analyst*

All right, thanks.

Bruce Nelson - *Office Depot - Chairman & CEO*

Thanks for listening. Thanks for your questions. Our 10-Q should be available to you as we speak. We did file it today with our earnings release. It gives you far more insight into our business. Thanks you for your confidence and support. Have a great morning.
