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ODP - Q4 2013 Office Depot Inc. Earnings Conference Call

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OVERVIEW:

Office Depot announced 2013 sales of $11.2b and 4Q13 sales of $3.5b. Adjusted net loss attributable to common shareholders was $0.03 in 4Q13 and $0.11 in 2013.

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PRESENTATION

Operator

Good morning and welcome to the fourth-quarter 2013 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 Vice President of Investor Relations, Michael Steele. Mr. Steele, you may now begin.

Michael Steele - *Office Depot, Inc. - VP of IR*

Good morning, thanks for joining us. Here with me are Roland Smith, our Chairman and Chief Executive Officer, and Steve Hare, our Executive Vice President and Chief Financial Officer.

Please keep in mind that certain statements made on this call, including forward-looking statements, which are subject to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements reflect the Company's current expectations concerning future events and are subject to a number of factors and uncertainties that could cause actual results to differ materially.

A detailed discussion of these factors and uncertainties is contained in the Company's filings with the Securities and Exchange Commission. This call includes non-GAAP financial measures, the SEC filings as well as the earnings press release, presentation slides and reconciliations of the non-GAAP financial measures to the most directly comparable GAAP financial measures are available on our website at investor. OfficeDepot.com.

Today's call will begin with an introduction from Roland, including an update on progress on the merger. He will also outline our key priorities for 2014. Steve will then review the Company's quarterly results, discuss merger integration and review the outlook for 2014. Following Steve's discussion Roland will return with some closing comments and then we'll open up the line for questions. Now I will turn the call over to Roland.

Roland Smith - *Office Depot, Inc. - Chairman & CEO*

Thanks, Mike, and good morning, everyone. Before we discuss Q4 results and our guidance for 2014, I think it's important to address our progress on the merger. On November 5, one week prior to my arrival, Office Depot and OfficeMax successfully closed on a transformational merger.

We are now a Company with $17 billion in annual sales, more than 2,200 stores worldwide, hundreds of thousands of B2B customers, award winning e-commerce sites and a global network of more than 60,000 Associates, franchisees, licensees and partners serving customers in 57 countries.

I'm excited about taking on the leadership role for the new Office Depot due in large part to the opportunity to bring together these two great brands. I believe it's a significant opportunity to integrate, improve and ultimately grow this Company, because we are combining two businesses that offer similar products and services and operate with similar structures. This overlap allows operational and cost synergies to be achieved all the way down the P&L.

I'm also excited about being able to leverage our multiple channels and compete in an industry that can serve customers in a variety of ways that best suits their needs.

Finally, I'm optimistic that we can significantly improve and transform Office Depot's competitive position and build a strong and growing business for many years to come. It's a privilege to have been chosen to lead the combination of two great companies that have the opportunity to transform and grow our business.

I've been leading companies for over 15 years and have had led six significant turnarounds and two mergers. I've learned from experience what works and what doesn't and I'm excited to apply all my experience and energy to this great opportunity.

I arrived on November 13, and in my first two weeks I spent more than 100 hours meeting with all SVPs and EVPs in both Naperville and Boca. I asked them, what was working, what wasn't working, what they hoped I'd do and not do and what they thought were the most important priorities for 2014.

I also reviewed written responses to these questions from over 160 VPs. The benefit of this work was that we were able to quickly develop a focused 100-day plan for our new Company.

Our plan included selecting a headquarters, establishing an executive committee and leadership team, redesigning the organization and selecting the right people at each level, determining the critical priorities for 2014 and confirming the cost synergies that had been identified by the previous management teams.

Last Thursday was my 100th day with the Company, so this is a perfect time to update you on the progress we have made on our 100 day plan.

Before I could choose a leadership team I had to select a headquarters location. While this sounds simple, you can't select a management team without letting them know where they will work. This was a difficult decision, but on December 10, after a very thorough evaluation that took into account a number of important factors including the cost to operate each location, lease and space considerations, tax implications, government incentives and people-related costs, we chose Boca Raton, Florida, as our corporate headquarters.

Our analysis concluded that Boca Raton provides the best platform for us to achieve planned synergies and leverage our assets to drive improved profitability. We expect to transition out of Naperville, Illinois by early 2015.

On December 18, one week after selecting our headquarters, we announced the Company's new organizational structure, which included the appointments of my executive committee and the broader leadership team. The structure of the new team focuses on accountability and streamlined decision-making.

In an effort to build the strongest team I spent significant time meeting one on one with every member of the senior management team from both legacy companies. I wanted the best of the best from each business and having these detailed discussions was the only way to get there. As a result we have a very strong team that consists of talent from both legacy Depot and Max and from outside the organization including our new CFO, Steve Hare, who is on the call with me today.

We currently have a search for two newly created key positions on the executive committee -- a President of North America and a Chief Strategy and Innovation Officer. As we fill these positions and complete the team I'm confident that we will have the personalities, talent and skills to successfully transform our business.

The leadership team initiated the plan to redesign our organization with an all-day workshop on January 6 where we the developed the design principles that would guide the process and provide the framework for how we would run our business. The five key themes for our redesign were -- fast, fair, disciplined, efficient and effective. We then began the process of restructuring our Company from top to bottom, soup to nuts, making sure we had the right people in the right jobs.

I'm pleased and proud that we accomplished the entire redesign in eight short weeks, much more quickly than anyone expected. And according to BCG, who we engaged to help us and our design and implement the restructure, our process is one of the fastest and best executed that they have been involved with.

And the way we executed the process was critically important. We started at the top by selecting our vice presidents and then enlisted them in designing and selecting the director level team. We cascaded the process down through the organization so that each level had input into designing and selecting the next Level, Therefore building ownership and commitment.

This week we are speaking with all remaining corporate associates and we will complete the reorganization process this Friday, February 28. Our new organizational structure is significantly smaller and more efficient. We reduced the Director and above positions by over 50% and reduced total corporate headcount by over 35%. As importantly, our new structure facilitates better decision-making, enhanced accountability and better communication.

I'm also very happy to report that even though we chose Office Depot's prior headquarters for our new location, going forward 30% of our director level and above executives are legacy OfficeMax Associates, which demonstrates our commitment to select the best talent from both organizations.

While we have executed our restructure at a very fast pace, we have also been disciplined to ensure an orderly transition so that we maintain business continuity. Accordingly, a number of our departing Associates will remain in place for approximately six to 18 months as we complete the transition.

In my experience, when companies begin to struggle they initiate more and more projects in an effort to succeed. However, these efforts tend to have the opposite impact as I believe focusing on fewer things and doing them well outperforms trying to do too many things.

The feedback from my first two weeks was that in fact we were trying to do too many things so I asked all our vice presidents and above what he or she believed to be the most important priorities for our Company. Then the leadership team analyzed and evaluated over 100 suggestions and established our most critical priorities for 2014. We had a lot to choose from and the team worked very hard to boil these down to only 12 which you see here on this slide.

As you can also see, we have constructed our 2014 priorities like a house, which requires a strong foundation, upon to build walls and a roof. We have two foundational priorities for 2014, a lean organization and a high-performance culture. And we're making excellent progress on both of these.

The foundation for the development of our high-performance culture is our Office Depot core values and our leadership teams operating promise. The Office Depot core values shown on this slide -- integrity, accountability, innovation, teamwork and respect -- are the non-negotiable behaviors that are the very foundation upon which we base our day-to-day interactions with each other and are the filters we use for all business decisions.

In my experience a clear set of core values, which start at the top, are the foundation for all success. The leadership teams operating promise shown on this slide, articulates our 12 guiding principles, this is the leadership teams promise to all Office Depot Associates for how we will run our business.

I will walk through all of these, but I want to highlight number nine, which is innovation. While we work to establish a long-term growth strategy we are also committed to improving profitability by significantly improving our execution on what we are already doing.

And as I've already mentioned, this week we are finalizing our organizational restructure which will result in a much more efficient and effective organization and a solid foundation upon which we can grow.

We grouped the core critical priorities into two categories -- Productivity & Efficiency and Strategy & Growth. In the area of Productivity & Efficiency, our priorities primarily support our efforts to ensure continued progress on our integration. These have been our primary focus in my first 100 days.

In the short time since I've joined the Company we've made great progress integrating Office Depot and OfficeMax as well as validating the potential merger synergies. We've completed a detailed review of the integration plans that were developed by the previous management teams and I've challenge previous assumptions in an effort to be as lean and efficient as possible.

And after a lot of hard work by many people, I'm pleased to report that we now expect to realize more than $600 million in annualized cost synergies by 2016 which is an increase from the original estimate. Also this new target excludes any benefit from rationalizing our US retail store base, which leads me to the next priority, our US retail footprint.

We have engaged Bain Consulting and launched a full analysis of our Company's real estate portfolio in an effort to construct a plan to rationalize our real estate footprint and consolidate store operations in the US. Our retail team is taking a very thorough and thoughtful approach and reviewing every store and every market.

We are developing a plan to maximize sales transfer rates from closed stores to existing stores and beginning next month we will begin to test these tactics on a handful of stores. Store specific decisions will be made through a holistic market evaluation process and a focus on unprofitable stores. Any closures will be orderly from a lease obligation and cash flow standpoint.

Approximately 75% of our domestic store leases expire over the next five years which provides is a good flexibility to make changes. Our goal is to create a more economically sound foundation while maximizing revenue and profits. We expect to finalize the plan by the end of the second quarter and begin executing in the back half of 2014.

In addition, we will be working this year to define our store of the future, this will require some experimentation and testing in order to get the right product and service mix, but this is critical to our long-term success particularly given the evolution in our industry and the changes in how customers shop.

Our information technology platform is the backbone supporting our business processes and migrating efficiently and effectively to a platform that supports the needs of our customers is of critical importance. We are leveraging the Office Depot technology platform because as a whole it offers advantages and capabilities and costs and lowers the overall business risk associated with the conversion.

In 2014 we will identify which key IT applications from the OfficeMax platform to include in our future IT roadmap and begin implementing plans for a smooth transition. Achieving a common merchandise assortment is a key priority as this will allow us to simplify our supply chain, facilitate our retail for print work and more efficiently and effectively advertise and sell to our customers across all channels.

For example, by the end of the second quarter we will begin using a single common circular for both store brands in the US. We are also working towards a single marketing approach and platform to better understand, engage and retain our customers. A single platform will allow us to be more efficient while providing better customer service and better targeting of specific customer segments.

Our final productivity and efficiency priority is defining a single supply chain approach that lowers costs, better serves our customers and enables growth. The supply-chain integration planning is focused on theory key strategies -- network and distribution, transportation and inventory management. All have unique characteristics and provide opportunities to drive significant synergies.

As you can see on this slide, we have three key priorities in the area of strategy and growth. Managing our businesses to improve profit margins is pretty self-explanatory. However, this goes beyond executing our merger synergies and a key driver is significantly improving execution. We are addressing profit margins in four channels -- retail, contract, e-commerce and International. In Europe, for instance, we are reorganizing to a channel-based management structure from a country based structure.

Improving profit margins also requires excellent vendor relationships the right assortments and the right cost structure. To achieve this we held a vendor partnership summit in Boca Raton in early February. The summit was attended by over 400 vendor representatives and provided our leadership team and merchants with an excellent opportunity to leverage our combined purchasing power and accelerate programs. Net, our vendors left the summit fully engaged.

This year we will also work to create and implement our unique selling proposition, or USP. To be candid, we currently do not have a meaningful USP and this has negatively impacted revenue growth. The foundation of a successful long-term growth strategy is a meaningful USP. This will enable us to truly differentiate ourselves from our competitors and will drive our product assortment, our branding and how we go to market.

In conjunction with our USP we will develop a vision and strategy to stabilize and grow revenue. As I mentioned earlier, I've established a newly created position of Chief Strategy and Innovation Officer. This role will be instrumental in developing the strategies to grow top-line revenue across our business.

We believe that the work we have done to establish a solid foundation, together with executing our critical priorities, will enable us to deliver our 2014 annual operating plan and generate not less than $140 million of adjusted operating income which is a 30% improvement versus 2013 pro forma.

Finally, let me elaborate on the status of the overall synergy opportunity. As I mentioned, we have reviewed all of the work streams developed by previous management to determine whether the synergy numbers were high, low or in the right place. As a result of this work we have made changes to the previous estimates and some work streams are now lower than original expectations while others have increased.

As we stated in our press release, we now expect to achieve an annual run rate on cost synergies of more than $600 million by the end of 2016, before considering any additional benefits from rationalizing our US retail store base. This is an increase from the Company's previous estimate and I'd like to break this down for you.

First, as you know from our press release, revenue declined in 2013 versus the prior year and we expect that trend to continue in 2014. Because COGS purchasing efficiencies are dependent upon revenue levels, and we are now using a 2013 pro forma as a baseline versus the previous higher baseline of 2012, we expect to generate purchasing synergies at the low end of the previously communicated range of $130 million-$200 million.

However, we expect our new organizational structure will significantly reduce SG&A expense over time and we are now expecting to achieve more than $470 million of annualized savings in addition to purchasing synergies by year three. This will more than offset the lower expectations for purchasing synergies on COGS.

Because of the timing of when Associates will exit, our SG&A savings will be weighted towards the second half of this year. That said, we still believe that we will capture approximately $170 million of synergies in the 2014 P&L ending the year at an annual run rate of approximately $340 million and lower costs.

We estimate approximately $400 million of integration expenses and approximately $200 million to $250 million of capital spending will be required to achieve these synergies during the three year period of 2014 to 2016. The integration expenses are frontloaded largely due to employee severance and consequently we expect approximately $300 million to impact 2014. We also expect up to $50 million of capital expenditures related to merger integration in 2014.

The bottom line is that I'm confident that the actions we have taken over our first 100 days have put us into great shape to execute on and achieve our critical priorities for 2014. Before I turn the call over to Steve Hare to take you through our numbers, I'd like to make a brief comment about our Q4 results.

While Q4 results were nearly disappointing they shouldn't be a big surprise. Through early November Office Depot and OfficeMax were competing companies and the previous management teams were spending significant time on completing the merger which diverted the attention of management and associates from day-to-day operations. I compliment both of the legacy teams on their commitment to serving our customers during this difficult period.

But as you know, it is very difficult to focus on the business when your personal future is uncertain. And this was a major consideration for why we moved to so quickly to restructure and select talent. I feel very good about the organizational structure and teams we now have in place and we are focused on our 12 critical priorities as one unified Company.

I have confidence not only in our ability to achieve our synergy targets, but also in our ability to ultimately generate top-line growth. I will not in the call over to our CFO, Steve Hare, to discuss our results for the quarter and the full year.

Steve Hare - *Office Depot, Inc. - EVP & CFO*

I'm excited to be here to help drive this integration and long-term transformation opportunity. After a very short period of time on the ground I believe we can generate value for shareholders by realizing a significant amount of merger integration synergies.

Before I get into the results a reminder that fourth-quarter and full-year 2013 financial information for Office Depot includes the OfficeMax stub period only since the November 5 merger close. Therefore many current year results that I will be presenting are not comparable with prior periods.

We recognize the importance of providing everyone with a baseline for comparison of our future results. At a later date we intend to provide you with quarterly adjusted pro forma income statements for 2013. To help you put our 2014 outlook comments in context, this morning we posted on our Investor Relations website a preliminary full-year view of certain pro forma income statement information for 2013.

Now let's talk about the results. Fourth-quarter 2013 sales were $3.5 billion, up 33% primarily due to the contribution from the legacy OfficeMax business since the merger closed. Excluding the impact of the OfficeMax stub period sales declined 2.9% four Q4. Gross profit increased $180 million from the prior year, helped by the stub period, while gross margin was down 56 basis points.

Fourth-quarter reported operating loss and net loss included pretax charges totaling $123 million comprised of $108 million in merger-related expenses, $12 million in asset impairments and $3 million in restructuring and other charges. Additionally, we incurred $22 million in expense related to the redemption of our preferred stock.

Excluding the items I just mentioned, fourth-quarter adjusted operating income was $5 million and the adjusted net loss attributable to common stockholders was $14 million or $0.03 per share. Full-year 2013 sales were $11.2 billion, an increase of 5% due to the inclusion of the OfficeMax stub. Excluding the impact of the stub period sales declined 3.7% for the full year 2013.

The reported operating loss and net loss include the $382 million gain on sale of Office Depot's Mexican joint venture in July as well as pretax charges that included $180 million in merger and other costs, $70 million in goodwill and asset impairments and $21 million and International restructuring and other charges.

Also we incurred $45 million of expenses related to the redemption of our preferred stock during the year. Excluding those items, adjusted operating income for the full year was $66 million and the adjusted net loss attributable to common stockholders was a $36 million or $0.11 per share.

Now before we discuss results of the division level let me describe a few changes we've made to our financial reporting. The first involves the alignment of the reporting segments for the merged Company. The Office Depot reporting segments now include OfficeMax businesses aligned to that structure. North American Retail now includes each company's in US retail business.

Business solutions includes legacy OfficeMax US. contract and Canada as well as the OfficeMax.com and reliable.com e-commerce websites. The International division includes a legacy OfficeMax, Australia and New Zealand business as well as the legacy OfficeMax 51% owned Mexico joint venture which we report on a consolidated basis.

Also, we modified the measure of divisional operating income to exclude the impact of asset impairments and restructuring and other charges which are separately reported on the asset impairments and merger restructuring and other operating expense lines of the P&L.

Additionally, we have aligned product category reporting for the merged Company the most significant change is for ink and toner to be classified within the broader technology category which is consistent with the legacy OfficeMax approach. Also, we synchronized various Office Depot and OfficeMax accounting policies as noted in our Form 10-K.

Now let's walk through the fourth-quarter performance of our combined reporting divisions. My discussion of division profitability will largely focus on the legacy Office Depot business results excluding the stub period. fourth-quarter 2013 sales in North American Retail increased 31% versus the prior year period to $1.4 billion.

Stub period revenues of $384 million for the legacy OfficeMax US retail operations accounted for this increase. Comparable store sales for the legacy Office Depot store base were down 4% in the fourth quarter driven by lower average order values and a low-single-digit decline in traffic and transaction counts. OfficeMax store comps were generally in line with the Office Depot store trends.

For the Office Depot stores the supplies and furniture categories declined low-single-digits and we saw a mid-single-digit decline for the technology category. A sharp decline in tablet revenues was a significant driver of the tech category decline. Significantly lower pricing on tablets during the holiday season depressed the average order value.

Additionally, we also experienced weakness in software and certain technology peripherals. Bright spots in the quarter were mobility products and Copy & Print, each comping positive. The retail division operating loss for Q4 was $8 million or 0.6% of sales which was approximately in line with the prior year period loss of $8 million or 0.8% of sales.

Deleveraging due to lower sales volumes and an unfavorable inventory adjustment was offset by lower operating expenses including payroll and legal. The OfficeMax stub period was accretive to operating income. Fourth-quarter 2013 sales in the North American business solutions division increased 54% versus the prior-year quarter. Stub period revenues of $422 million from the legacy OfficeMax US and Canada contract business have been added to business solutions operations.

Excluding the stub period, fourth-quarter sales for the legacy Office Depot business declined 1.7%. Contract channel sales were down low single digits, and direct channel sales were up low single digits. The sales trend for the OfficeMax stub period was similar to the legacy Office Depot business.

In our legacy Office Depot contract business, we saw significant sales declines with our federal agency customers, arising from the government shutdown and general budgetary constraints. Enterprise sales declined low single digits. We experienced increased sales with our small and medium business customers, as well as education and state and local businesses.

From a category perspective, we had continued sales pressure in traditional supplies, partially offset by sales increases in Copy & Print, cleaning, break room and school supplies. Legacy Office Depot sales in the contract channel for the fourth quarter were relatively consistent on a sequential basis, with the overall decline principally arising from the federal government sales decline, as well as previously announced technology sales restructuring efforts from which we anticipate improved operating efficiencies.

In our legacy Office Depot direct channel, sales increased low single digits in the fourth quarter. We continued to see the transition from catalog and call center sales to web sales. And web sales increases exceeded call-center declines in the quarter. We expect this trend to continue as web enhancements have led to better conversion rates.

Technology sales increased in Q4 and supply sales were down. Fourth-quarter business solutions division operating income was $16 million or 1.4% of sales, a decline of $17 million or 300 basis points. Significantly higher operating expense driven by increased legal cost and lower gross margins drove the decline. The OfficeMax stub period was accretive to operating income. In 2014, we are focused on bringing in and retaining business that meets our margin thresholds, and aim to drive profitable growth in this division in 2014.

Now to International. For International sales comparisons by channel, I will use constant currency. Fourth-quarter 2013 sales in the International division decreased 4.6% in constant currencies versus the prior-year quarter, excluding OfficeMax stub period revenues of $133 million. Sales in the contract, direct and retail channels in Europe each declined mid-single digits in Q4 2013.

Sales declines were impacted by country closures, unprofitable customer exits, as well as continued declines in catalog sales which were partially offset by growth in web sales. Fourth-quarter 2013 division operating income was $26 million or 2.9% of sales, an improvement of $10 million or 80 basis points from the prior-year quarter. A higher gross margin rate and reduced payroll and advertising expense were primary drivers.

The OfficeMax stub period was accretive to operating income. The International team continues to focus on streamlining the business and cost reduction.

I would like to provide a brief summary of the details around the merger transaction that closed on November 5th. All 92 million OfficeMax common shares were converted to Office Depot common stock, resulting in the issuance of 247 million additional Office Depot shares. At the $5.65 share price of Office Depot on November 5, the fair value of consideration was just under $1.4 billion.

As of the end of 2013, Office Depot had approximately 530 million common shares outstanding.

Now let's turn to the balance sheet. We ended 2013 with total liquidity of $2.1 billion, comprised of nearly $1 billion of cash and $1.1 billion available from our asset-based lending facility. Total debt at year end was $725 million, excluding $859 million of nonrecourse debt related to a prior OfficeMax Timber Notes securitization transaction.

Significant items impacting cash were capital expenditures of $137 million, the sale of the Office Depot de Mexico joint venture, merger-related cash costs and the Office Depot redemption of preferred shares.

As Roland mentioned, we now estimate annual run rate cost synergies of more than $600 million by the end of year three following merger close. Purchasing synergy expectations are now expected to be approximately $130 million based on lower domestic sales volume. This savings opportunity will vary based on sales.

Other large opportunities continue to be supply chain, advertising and other SG&A savings. Combined these buckets are expected to contribute more than $470 million of annual run rate synergies by the end of year three following the merger. These savings are now based on a comparison to pro forma combined 2013. Previous synergy estimates were based on a 2012 base line.

The opportunity to capture real estate and operation synergies for our US retail store base has not yet been quantified. This comprehensive strategic financial analysis is now underway and we will provide updates as we move ahead to rationalize the store base. This rationalization will also unlock working capital and lead to capital spending reduction.

We are guiding to adjusted operating income of not less than $140 million for the full year 2014, which compares to preliminary combined 2013 pro forma operating income of $108 million or an increase of 30%. Our guidance is based upon an assumption of continuing declines in total sales because of market trends in some of our key product categories and overall competitive activity.

These lower sales will produce a negative deleverage of our adjusted operating income. We believe that our merger synergies of approximately $170 million, along with core operating improvements, will more than offset this sales deleverage in 2014.

To summarize, we expect to generate adjusted operating income of not less than $140 million, which includes depreciation and amortization of approximately $300 million. Additionally, we anticipate that our capital spending needs for the year will be approximately $150 million excluding integration related CapEx of up to $50 million.

Merger cash expenses are expected to approximate $300 million in 2014 which includes employee severance resulting from the organizational redesign. As a result we will likely use some of our balance sheet cash to meet our funding needs in 2014.

Over the next three years we expect our total liquidity to be more than adequate to meet integration needs as ongoing cost synergies increase each year and front-end merger expenses are eliminated. And with that I will turn the call back to Roland.

Roland Smith - *Office Depot, Inc. - Chairman & CEO*

Thanks, Steve. As I stated at the beginning of the call, I'm truly excited to be part of our newly created Company. We understand that the office supply industry has significant challenges and traditional office products are in secular decline.

Also, as you know, the industry is transitioning from certain products that have been big generators of revenue and profit in the past to products and services that will likely be generators of revenue and profit in the future. All the while our customer base is evolving in their workplace needs and how they shop for products and services.

Our path to transformation began in November, and by the end of this week our teams will have completed our organizational restructure and we will soon see the benefit being delivered in our SG&A line.

As Steve mentioned, we expect total Company sales in 2014 to be lower than 2013 pro forma. Further, sales deleverage will offset some of the operating improvements and merger synergies we expect to realize during the year. Therefore we will be working on a strategy to stabilize sales which will increase the flow through of synergy benefits to the bottom line.

We will also carefully consider any investments in our business and make no investments until we have a very clear understanding of the ROI.

Finally, we are also working to develop a profitable long-term growth strategy for our new Company, one that is focused on positioning the Company to win by pursuing both evolutionary improvement and revolutionary solutions for growth.

This merger creates a leaner more efficient and truly global organization that will have the critical mass and financial strength necessary to take advantage of opportunities across all our customer segments.

We will seize the opportunity this merger has created to redefine ourselves in the marketplace and ensure we are providing our customers with products, services and solutions that are unique, relevant and innovative.

We realize we haven't left much time for questions. However, as this is our first opportunity to speak with you we wanted to ensure we provided you a thorough overview of our plans. I encourage you to contact our Investor Relations team with any questions that we don't have time to cover. now I'll turn the call back over to Michael.

Michael Steele - *Office Depot, Inc. - VP of IR*

As Roland mentioned, we have limited time for Q&A, so I'm asking you to limit yourself to one question so that we can respond to as many participants as possible. Operator, please open up the phone lines for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Brad Thomas. Please state your company name.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Brad Thomas with KeyBanc Capital Markets. Good morning, Roland and Steve, and welcome to the team. My question would be about the financial outlook that you've provided here this morning, both in terms of the specific 2014 guidance and maybe at a higher level how you're thinking about some the secular headwinds and reinvestments.

As we try to bridge the 2013 EBIT that you reported about $108 million to your guidance of at least $140 million for the coming year, it would appear there are some pretty big reinvestments or secular headwinds that you are facing. Can you just help us think about what you are baking in for 2014 and how you are thinking about those headwinds and reinvestments in the coming years?

Steve Hare - *Office Depot, Inc. - EVP & CFO*

Yes, Brad, this is Steve. I think the building blocks that we go through to build off of the pro forma operating income from last year or the $108 million we think is a good base to start. Clearly I think the secular headwinds that you talk about are there.

We have not laid out a specific sales target primarily because as we pull everything together it becomes very difficult to get precise there. But we recognize and we build our forecast and our business plan for the year assuming that the kinds of sale pressures that we saw both in the fourth quarter of 2013 and really for the year in total will continue.

And so when you look at our forecast of $140 million of operating income it assumes that we are going to have some fairly significant deleverage again for next year. Now we're all working very hard to minimize the impact of that, but I think recognizing the results we had in Q4 we are digging out of a bit of a hole here.

And so I think our plan is trying to be a conservative look at next year where we will clearly have the opportunity to realize the cost synergies we talked about, but that more than we would like of those synergies are going to be consumed by the sales deleverage.

Michael Steele - *Office Depot, Inc. - VP of IR*

Next question, please.

Operator

Michael Lasser, please state your company name.

Michael Lasser - *UBS - Analyst*

Good morning, it is UBS. So Steve I was hoping you could (technical difficulty) a little bit further into that because we have seen, if you look at a pro forma combined company over the last few years, there has been a lot of sales pressure, but operating income between the two companies has been relatively stable. And maybe that has been due in part to some cost rationalization, some restructuring activities.,,, that I think were expected to go on into the next few years.

And the guidance now would imply that there will be a significant step function down in the profitability of the core businesses. So are you expecting that to come at all from the gross margin or is it entirely due to the deleverage associated with negative sales?

And then a quick follow-up, as you guys proceed on this path of turning around the Company, what are you going to be measured against? I think in the proxy there were some short-term incentives that were outlined, but longer-term can you give us a sense for how the Board is going to be holding you accountable and what they're going to be looking at to measure your performance? Thank you so much.

Roland Smith - *Office Depot, Inc. - Chairman & CEO*

Thanks, Michael, it is Roland. Let me start with your second question and then I will turn it over to Steve and he can talk a little bit more about 2014.

Clearly what we've shared with you today in our lengthy comments upfront I think lays out what we expect to be measured against by the Board. Clearly the two big metrics that we relate today that we feel very good about, one being that we will deliver more than $600 million of synergies and efficiencies, obviously we have broken that down by what we expect in 2014 which is $170 million. And then what we expect to be at a run rate standpoint as we complete the year, which is $340 million, which I think is pretty exciting news.

Secondly, obviously from an operating income standpoint we suggested that we would deliver not less than $140 million; Steve has talked a little bit about some of the factors that we put in place to understand and be comfortable delivering that number.

And then as I laid out in some detail, we have spent a large part of our first 100 days not only reorganizing our Company, soup to nuts, which, as I mentioned, will be completed by this Friday. But we have also laid out what we think are the 12 most critical priorities that we should ensure that we are spending our resources against to make sure that we not only put ourselves in a position to realize our synergies and efficiencies, but we put ourselves in a position, as Steve mentioned, to stabilize our revenue and ultimately to grow it.

I won't go through those 12 again, they are on the slides and I can elaborate on some of them if you would like. But I think clearly those specific targets along with the two metrics are what we're going to be measured against in 2014. Steve, do you want to comment a little bit more as it relates to operating income in 2014?

Steve Hare - *Office Depot, Inc. - EVP & CFO*

Yes. And I think if you look at Q4 and as we went through our comments we tried to highlight some of the I would say unusual items that were in the various division results. And so, when I think you look at the decline overall in Q4, there were clearly some items that we don't think would be recurring in nature.

If you look at the retail side of the business we did take a fairly large inventory adjustment. If you look at business solutions business there was a legal expense charge there, as well as some vendor programs from a timing standpoint that did not hit as would ordinarily be seen in the quarter.

So I do think you have a context of some additional charges and frankly the distraction of coming through the merger that Roland highlighted I think had an impact on the business in Q4. Having said that I still think we have significant headwinds in terms of our sales and top-line performance that are likely to extend into 2014.

So as a result our forecast for the year assumes a fairly significant deleverage that obviously goes against the beginning position of the $108 million of operating income going forward.

But I think going forward, I don't want to miss the point, but I think, again, as we just start to run the business on a consolidated basis we continue to see significant opportunities for the retail business as we get both brands under a common management system, a common experience that will be delivered to customers.

The business solutions, the additional clout we have in the marketplace and the beginnings of a cost savings program flowing through there and the International business, which did have a good performance in Q4, continuing to drive a cost reduction program and the restructuring that they are going through. We think over a longer term period we continue to be optimistic that we will be able to see some significant operating income improvement.

Roland Smith - *Office Depot, Inc. - Chairman & CEO*

And I will just add to that quickly. Clearly as we have looked at our 2014 expectations of operating income we've tried to factor in everything we have learned in the first 100 days and we have been relatively conservative in what we have provided from a guidance standpoint.

As Steve points out, we are now focused clearly as a unified Company for the first time in well over a year on our 12 critical priorities and we are putting all of our time and attention against those. And I believe that a portion of the improvement that we will see in 2014 will be around the concept of executing better what we already know how to do, but just haven't been doing it as well as we really know how to do it.

That will I think provide us some benefit not only in the revenue area, but it will also provide us some benefit in the margin area. And then as that comes to fruition, as I mentioned, we will begin to work hard on our unique selling proposition, something that we think is very important and will set the stage for the future which will clearly differentiate us from the competition.

That will drive where we are going in products, that will drive where we are going in services, that will drive where we're going in solutions, that will also be a big driver of ultimately what we choose as our long-term growth strategy. So I think that is probably the detail that we can provide you at this point for 2014. Next question.

Operator

Greg Melich, please state your company name.

Greg Melich - *ISI Group - Analyst*

Hi, it is Greg Melich with ISI. I had a quick follow-up and then my actual question. The follow-up was on this year's guidance. Steve, you mentioned that this year the synergies will offset the deleveraging of the core business. Is that deleveraging of the core business in gross margin or SG&A?

Steve Hare - *Office Depot, Inc. - EVP & CFO*

Yes, no, it really runs through both line items when you think of the cost that we have that would be -- when we think about deleverage, rent, for example, so it would be in both buckets.

Michael Steele - *Office Depot, Inc. - VP of IR*

Thanks, next question.

Operator

Dan Binder, please state your company name.

Dan Binder - *Jefferies & Company - Analyst*

Hi, it is with Jefferies. My question was with regard to the stores and the brand. Is there going to be a point at which you redefine what the Company stands for and the brand name beyond Office Depot and OfficeMax?

And you mentioned transfer rates or trying to maximize transfer rates. Historically they've been fairly low when stores have been closed. I'm just curious if you could elaborate a little bit on what the work is you are doing there to maximize it?

Roland Smith - *Office Depot, Inc. - Chairman & CEO*

Sure. Two very important questions that quite honestly I probably could speak for 30 minutes on. So let me start with your question as it relates to our retail stores and our brand both at the retail level and at the corporate level.

Clearly we have two brands today, but regardless if or when we decide to change either one of those brands or both of those brands, what we are focused on right now specifically at the retail level is to move towards a common customer experience.

As you know from my comments, by Q2 we will have a common circular in our retail business. We are moving towards common store logistics. We are also at today a common store management structure and by the year-end, as I mentioned in my comments, we will have a common assortment.

And so while the size may be different, still by the end of the year the customer experience will be the same and that will give us the opportunity obviously to be much more efficient and much more effective.

Ultimately as we do the work this year that will kind of be around the concept of our unique selling proposition and how we're going to differentiate ourselves from our competition, both in the area of products and service and solutions, I believe that will give us a large indicator of what we would like to do from a branding standpoint both in our retail stores and also at our corporate headquarters.

One thing that we won't do based on the significant cost that it would take to change our signs is just change the signs for the benefit of changing them because of the cost of that would certainly not return. We will look at changing those signs when we believe we have a reason to do it and it is meaningful to the customer.

Now the second question you asked had to do with one of our second -- or one of our other key priorities that has to do with our retail footprint. As I mentioned in my comments, we have already engaged Bain Consulting. We are well underway in evaluating from a strategic standpoint every store, every market and how we're going to move forward from the standpoint of rationalizing our retail footprint.

We expect to complete this work by the end of the second quarter and then we expect to start implementing this plan in the second half of the year. I will start by saying that while we have not forecasted today the benefit that this will provide in synergies and efficiencies, we believe that it will provide material benefits from the bottom line of our profitability and we will talk about that later on this year as we finalize our strategies and plans and we can begin to implement them.

It is not just a simple, however, as looking at two stores that might be close to each other and saying we're going to close one down. We're going to be much more strategic and holistic than that. We're going to be looking at our store of the future at the same time and looking at the size of the footprint that we think makes sense going forward. And as you can imagine, our USP is also going to have a big impact on the size of the store and ultimately what we will carry in the store.

From a transfer rate standpoint, obviously as we decide to close down stores then we will look very hard at the unprofitable stores because obviously that would provide in the short term the best benefit. We are going to do that in a way that is accretive and those transfer rates are obviously very important in that regard.

What we might have accomplished in transfer rates in the past I don't think is indicative of what we can accomplish in the future, the new management team, it's a new plan, and we will have a new strategy as we go forward. And I think that is going to help us improve those transfer rates.

And as I mentioned, we have a number of projects around the concept of transfer rates that we have in the marketplace now and we will begin to also put other tests in the marketplace so we can validate what those transfer rates will be and obviously the higher they will be the greater the profitability increase that we will enjoy.

But as we have a chance to talk to you in the next months and quarters we will have a much more clear understanding of this very important part of our 12 critical priorities which is a retail footprint and how we rationalize that and improve profitability as we go forward.

I think we probably have time for just one additional question. Again, I apologize for not being able to spend more time in questions, but, as you know, we are going to be spending time with many of you today and over the next couple of days. And so, operator, if we could take one last question that would be great.

Operator

Michael Baker. Please state your company name.

Michael Baker - *Deutsche Bank - Analyst*

Thanks. Mike Baker from Deutsche Bank. Let's see, I guess a couple of things. One, what are your customers, your delivery customers, or your contract customers in particular telling you right now? What were your net wins versus your net losses? And then I want to think about that whole synergy number of $600 million or higher.

Some of that is being offset this year so your $170 million synergy number will maybe translate into about $40 million to the bottom line. How do we think about that over the next three years? How much of that $600 million synergy number you think gets competed away, how much goes to the bottom line? Thanks.

Roland Smith - *Office Depot, Inc. - Chairman & CEO*

Okay, Michael, let me start with the first one. As it relates to kind of our BSD business and our contract customers, clearly what they are telling us is make sure you continue to provide us the products that we need at a price that is competitive and that is likely what we're going to do.

We're certainly still going to have two brands and two sales forces out there, but certainly we are not going to -- I should say we are going to work our hardest so that we don't lose a single customer in the process. To ensure that we provide them the products in the services, the solutions in the pricing that they need. The second question I will turn over to you, Steve.

Steve Hare - *Office Depot, Inc. - EVP & CFO*

Yes, Mike, I think the way we look at it is the opportunity for us and why we highlight the run rate is we will pick up the $170 million on a gross basis in terms of our P&L, we are expecting a fair amount of that, as you indicated, would be lost to sales deleverage for this year.

But going into next year where we have now a run rate from the synergies already achieved that gives us an opportunity for $340 million carried into next year obviously as we move along in our transformation and to the extent we could keep sales flat, than all of that would drop down.

So the opportunity to go from a fairly small flow-through this year to I think a more significant amount of flow-through next year is really there for the taking. Obviously we have to improve execution as Roland has said.

It would be great if we got any help in the marketplace in terms of competitive pricing activities or demands. But that would be certainly a tailwind that would help us as well. But it comes back to I think running the combined business as effectively as possible and as quickly as possible.

Roland Smith - *Office Depot, Inc. - Chairman & CEO*

Thanks, Steve. And thank you all for your participation with us this morning. I'm very excited to be here, as you know from my comments. I believe this is an opportunity to really leverage my 17 years of leading companies in turnarounds and mergers so that we can really do something very special with these two very important brands.

As I mentioned, we made excellent progress of the first 100 days, I could not be more proud of the team and how they have gone after our reorganization and also helped us define our 12 critical priorities. We're going to be focused on those 12 critical priorities and you are going to hear about them every single time we talk to you this year because that is the discipline I think as required to actually get this Company back on track and growing into the future.

I'm incredibly excited today that we've been able to relate to you that our synergies and efficiencies will be greater than $600 million. As you all know from your experience, in most instances where companies merge and talk about synergies and efficiencies I think the statistics are 75% to 80% of them never deliver what they initially talked about.

Not only are we going to deliver what we initially talked about, we're going to exceed them. I've done this before and I'm terribly confident that we can do this again. I am also optimistic about our future we've got a great team and as we begin to hack away at our 12 priorities I believe we're going to be able to stabilize our revenue and then ultimately grow it. So again, thank you for your time. I look forward to talking to you individually and out of the marketplace. Have a great day.

Operator

That concludes today's conference call. Thank you for your participation. You may disconnect at this time.
