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ODP - Q2 2014 Office Depot Inc Earnings Call

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OVERVIEW:

ODP reported 2Q14 adjusted sales of $3.8b and adjusted net loss available to common stockholders of $12m or $0.02 per share. Expects 2014 total sales to be lower than prior year combined pro forma sales.

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PRESENTATION

Operator

Good morning and welcome to Office Depot's second-quarter 2014 earnings conference call. (Operator Instructions). At the request of Office Depot today's call is being recorded.

I would like to introduce the Vice President of Investor Relations, Michael Steele. Mr. Steele, you may now begin.

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

Good morning and thank you for joining us. I am here with Roland Smith, our Chairman and CEO, and Steve Hare, our Executive Vice President and CFO. Roland will summarize the quarter and provide an update on select critical priorities for 2014 and our progress on merger integration. And then Steve will review the Company's quarterly results and outlook for 2014. Following Steve's discussion we will open up the line for questions.

Before we begin, I need to inform you that certain statements made on this call include 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.

During this call we will use some non-GAAP financial measures as we describe business performance. The SEC filings, as well as the earnings press release, presentation slides that accompany today's comments, reconciliations of the non-GAAP financial measures to the most directly comparable GAAP financial measures, as well as 2013 pro forma results for combined Office Depot and OfficeMax, which were updated and furnished to the SEC on Form 8-K today, are all available on our website and investor.officedepot.com.

Today's call and slide presentation is being simulcast on our website and will be archived there for at least one year.

Now I will turn the call over to Roland.

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

Thanks, Mike. And good morning, everyone. It is good to be here today to discuss our results for the second quarter of 2014 and provide an update on our business. We are very pleased with the progress we are making on the integration of Office Depot and OfficeMax as we create a culture focused on achieving our critical priorities.

Over the past few months, our associates at all levels of the organization have been working hard to bring to life our new values and culture, and our teams are aligned and excited about the future of Office Depot.

Turning to slide 4, in the second quarter of 2014, we executed exceptionally well which enabled us to capture merger synergies more quickly than we anticipated in both cost of goods and in SG&A. Gross margin rate and SG&A percent of sales both improved in the second quarter compared to the prior year pro forma. We delivered adjusted operating income of $18 million in the second quarter of 2014 compared to a pro forma loss of $6 million last year, an increase of $24 million.

As expected, we saw continued negative sales trends across our three operating divisions, but our focus on lowering the cost base of our business more than offset the flow-through impact of the sales decline.

Based on the results we have achieved year to date, including accelerating the realization of merger synergies and improving operational executions, we are raising our 2014 adjusted operating income outlook to be not less than $200 million for the full year. This is an increase of $40 million or 25% above our previous outlook of $160 million that we communicated last quarter. This outlook excludes operating income from our Mexican joint venture, which is pending sale.

In the second quarter, we finalized our analysis to optimize our US retail store portfolio. We continue to expect to close at least 400 stores, but have increased our expectation of additional annual run rate synergies from these closures to be at least $100 million by the end of 2016. Accordingly, we are raising our target for total annual run rate synergies, including retail store portfolio optimization, to more than $700 million by the end of 2016.

In February we introduced our 2014 critical priorities. Shown on slide 5, these are the priorities that we believe will enable us to deliver our annual operating plan and begin the transformation of Office Depot. We committed to update you each quarter on selected key priorities and today I will provide an update on the following.

The recent executive appointment that completes our leadership team; the plan to optimize our retail store portfolio; our progress on operating efficiencies and synergies; and an update on the development of our unique selling proposition. Later on the call, Steve Hare will update you on divisional initiatives to improve profit margins.

Two weeks ago, Mark Cosby joined us as President, North America. Mark oversees our Company's retail, contract sales, e-commerce, merchandising, marketing, supply chain, and real estate functions across North America, which account for more than three quarters of our consolidated Company revenues. Mark brings to Office Depot over 30 years of leadership experience at large and complex retail operations, including serving as Division President of three leading multiunit retailers.

We are all excited to welcome Mark to the team. He is with us here today and will be participating on future calls.

Moving on to our US retail store optimization. Last quarter, we shared with you a preliminary overview of our plan to optimize the retail store portfolio. We have completed our analysis in the second quarter and I am pleased to share the results of this analysis with you today.

As you'll recall, our store-specific decisions are being made through a holistic market evaluation process focused on optimizing productivity and profitability which is outlined on slide 8. Our analysis included a market by market and store by store evaluation looking at the following six factors: store performance, sales transfer rate, the impact of fixed cost on the remaining stores, store closing costs, including lease obligations, expected impact on other sales channels, and our overall go-to-market strategy.

The next stage of our approach is to maximize the profitability of the ongoing retail store portfolio. We will leverage our larger combined market presence to negotiate more favorable lease terms and continuously monitor performance of store locations, particularly those approaching lease expiration.

The final stage is to define and implement our store of the future, to closely align with our unique selling proposition. This will include defining and testing the optimal store size, product assortment, and service mix.

As highlighted on slide 9, consistent with the preliminary analysis that we shared with you in May, we expect to close at least 400 stores by the end of 2016. We expect approximately 165 of those stores to close in 2014, 44 of which we closed in the first half of this year. Of the remaining 120 stores expected to close this year, most will close late in the fourth quarter after the back-to-school season. We expect to close approximately 135 stores in 2015 and at least another 100 stores in 2016. We anticipate annual run rate synergies of at least $100 million by the end of 2016 from the store optimization, an increase from our preliminary estimate of $75 million. Steve will share details of our store closure assumptions later on the call.

Now I would like to spend a few minutes discussing sales transfer rates, which are a key driver of the synergies in our store optimization plan. As you can see on slide 10, prior to the merger the sales transfer rate from a closed Depot store to another Depot store or a closed Max store to another Max store averaged approximately 20%.

In Q2, we initiated an 18-store sales transfer test where we implemented a number of customer service and marketing tactics designed to increase sales transfer rates. We believe these efforts resulted in better customer retention and our sales transfer rates have increased. Also, the opportunity to transfer sales to either a Depot or a Max store is a significant advantage of our combined Company. Based on the early results of this test, we are now targeting an average sales transfer rate for future store closings of 30%.

Now I would like to update you on the status of achieving our planned synergies. As I have already stated, during the second quarter we significantly accelerated the realization of cost synergies, thereby giving us greater confidence in our ability to meet our longer term targets.

Turning to slide 12, we are increasing our expected annual run rate synergies to more than $700 million by the end of 2016. This is an increase from the Company's previous estimate of more than $675 million and reflects the additional benefits we expect to receive from the optimization of our US retail store network.

In addition to at least $100 million of annual run rate synergies from store optimization, we continue to expect synergies of at least $130 million in cost of goods and at least $470 million primarily in SG&A.

In 2014, we expect to realize approximately $220 million of cost synergies, up $40 million from the $180 million we communicated last quarter. We realized $73 million of synergies in the first half, $59 million of which were in the second quarter. And we now expect to end the year at an annual run rate of approximately $400 million, excluding the benefit from the retail store portfolio optimization.

Now I would like to discuss the progress we are making on our unique selling proposition or USP. The foundation of our successful transformation and long-term growth strategy is a meaningful unique selling proposition. While the USP is not a silver bullet or a quick fix, a clear and meaningful USP will enable us to differentiate ourselves from our competitors and ultimately grow our business. The USP will drive our messaging, our product assortment, our new product and services selection, and how we go to market.

As you'll see on slide 14, we are taking a methodical and systematic approach to the development and implementation of our USP.

First, defining the who. That is, who we are going to target in the marketplace. Who we see as profitable customer segments and who we need to attract for growth.

Second, defining the what, or what unique and differentiated proposition across price, product offering, and customer experience will attract and motivate these segments to increase their total spend with Office Depot.

And finally, defining the how, or how we will redefine our business channels, products and services to fully deliver this unique proposition. These last two stages include significant end market testing to validate the concept and optimize USP execution before rolling out more broadly.

To date, we have completed the first phase of identifying our target customer segments. Through extensive, qualitative, and quantitative customer segmentation work, we have identified key behavioral need states that drive how customers purchase and use office products and services. These need states include convenience, price, service, quality, selection, and experience. Understanding how these needs drive purchasing behavior has allowed us to define target segments and design actionable plans.

Based on the data we have gathered, we have identified two large customer segments where we are significantly underpenetrated versus the market. The purchasing behavior of these two customer segments is driven primarily by quality, service, and experience; and we believe a significant opportunity exists to capture our fair share of the market by providing an offering that meets their needs.

Additionally, these target segments generally have higher profit and growth potential, based on what they buy and how they shop. In total, we believe these two large customer segments represent approximately $60 billion in annual sales and, as I mentioned, we are underpenetrated in these segments. We believe the sales potential of capturing our representative share of these customer segments is approximately $1 billion.

We understand that this will be difficult and take time, but the sales potential is significant even if we capture only a portion of this opportunity.

With our USP customer segment defined, we are moving into testing and refinement. We have identified 20 independent market tests that address different combinations of products, services, channels, experience, and other go-to-market elements. Through these tests, we will learn more about what these target segments want and what drives their behavior and then refine our strategy to attract and grow share from these customers. We will begin testing and refining our USP this year and into next year. We expect to build our rollout plan in late 2015, with full implementation throughout 2016.

As the secular decline continues in our core categories, we believe that growing our share in these large customer segments where we are underpenetrated will enable us to stabilize our business, stem the revenue decline, and set the foundation for profitable revenue growth. We will continue to keep you updated on our progress.

Now I will turn the call over to our CFO, Steve Hare, to discuss our Q2 results in more detail. Steve?

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

Thanks, Roland. Before I highlight our results for Q2, I would like to explain a financial reporting change we made this quarter.

In June, we executed an agreement to sell our 51% interest in the consolidated Grupo OfficeMax joint venture in Mexico to our JV partners for cash. The sale is expected to close in Q3. Consequently, the 2014 JV operating results have been reclassified from the international division income statement to other and are excluded from our adjusted or non-GAAP reporting to provide comparability.

We have also updated the quarterly 2013 combined pro forma income statements, which are posted to our Investor Relations website to exclude the Grupo OfficeMax JV results. The prior year comparisons that I will focus on today will be versus those combined pro forma results.

Now turning to the consolidated results on slide 16. Second quarter 2014 adjusted sales were $3.8 billion, down 2% from the prior year quarter on a pro forma basis. Adjusted gross profit decreased $17 million from the prior year pro forma, but gross margin improved by 13 basis points, partially due to synergy capture in the quarter. Gross margin improved in the retail and international divisions and was down slightly in business solutions. SG&A expenses in the second quarter of 2014 were $41 million lower than prior year pro forma representing a 54 basis point reduction as a percent of sales.

The reported or GAAP operating loss in the second quarter of 2014 was $185 million. Excluding special charges and credits totaling $205 million, as well as $2 million in operating income from Grupo OfficeMax, adjusted operating income in the quarter was $18 million. The special items included $92 million in merger-related expenses, an $80 million legal accrual, $22 million in non-cash impairment charges related to our web platforms and stores, and $11 million in international restructuring.

The $18 million in second-quarter 2014 adjusted operating income was a $24 million improvement over the prior year pro forma. The improvement is largely attributable to $59 million in merger synergies realized during the quarter. The expense reductions more than offset the deleverage impact of lower sales versus prior year pro forma as well as lower incentive pay in the second quarter of 2013.

We reported an adjusted net loss available to common stockholders in the second quarter of $12 million or $0.02 per share. The adjusted net loss excludes the after-tax effect of the items I just mentioned as well as a credit of $9 million in interest expense related to a tax settlement and $3 million in other nonoperating charges.

Turning to slide 17, second-quarter 2014 sales in North American retail decreased 5% versus the prior year pro forma. Same-store sales for the combined Office Depot and OfficeMax stores declined 3%. The comp sales decline was driven by lower transaction counts, partially offset by higher average order values. We experienced sales declines in ink and toner, laptops, and peripherals. Sales increased in desktop computers and in copy and print. Retail reported a division operating loss of $6 million in the second quarter, which was a $16 million improvement over the prior year pro forma. The division operating margin improved by 98 basis points. Deleveraging, due to lower sales was more than offset by lower operating expenses including payroll, advertising, and other store expenses, as well as gross margin improvement.

Slide 18 outlines some of the operational highlights from the retail division, focused on improving profit margins. During the second quarter, the one store operating model was fully implemented across both Office Depot and OfficeMax retail stores. Components of this integrated approach include an optimized staffing and labor model, an enhanced selling model, a streamlined logistics process, divisionwide key performance indicators and standardized reporting as well as consistent bonus and incentive plans.

Last month in the US, we launched our new year-round price match guarantee and 90-day return policy. We price match items sold by any retailer selling products in both retail stores and online under the same brand. Additionally, customers can return any product purchase on our websites to our stores.

Also our retail teams have combined to prepare for the first joint Office Depot and OfficeMax back-to-school selling season with our robust go-to-market plan. For this back-to-school season, we expect a very competitive environment and we are committed to delivering value and convenience to our customers, no matter which channel they choose to shop with us. We believe that we are well-positioned this year due to implementing best practices from our legacy companies across our US store base.

As you can see on slide 19, we continue to address this market opportunity by talking to our three key target groups: parents, students, and teachers. We are leveraging Office Depot's effective campaign message from last year across both banners. Online and broadcast advertising and promotions are staged for weekly flights to align with racial differences in school starting dates to more effectively utilize our marketing budget.

We are targeting teachers with our Teachers Change Lives program, via our inserts and direct mail pieces which also simultaneously reaches our parent target group as well.

Through our broadcast media, we feature key back-to-school items targeted at parents while through our online and social efforts, we target the student segment to deliver a strong and well-rounded back-to-school marketing plan. We have also collaborated with our vendors and direct sourcing team to promote compelling deals to drive customer traffic on must-have technology items and offer stylish supplies for great values. In fact, we are offering more than 1,000 items for $5.00 or less. A $5.00 minimum purchase restriction is in place to preserve our margin on baskets that include these highly promotional items.

We have also aligned product assortment for key back-to-school items across both banners and secured great deals for teachers, parents, and students looking to fulfill their shopping list with affordable and attractive products. Back-to-school represents an important season for us and we are excited at this first opportunity to address this market with the strength of both the Office Depot and OfficeMax banners.

Turning now to slide 20 and the second-quarter results in our business solutions division, or BSD, second-quarter 2014 sales were $1.5 billion, a decrease of 1% from the prior year quarter pro forma sales. Sales in the contract channel within BSD were down slightly and direct channel sales were up slightly. The year-over-year decline in BSD sales as well as in the contract channel overall was driven by Canadian sales declines in our Grand & Toy operation and negative currency translation.

Contract sales in the US were flat in the second quarter. In direct, online sales increased and call center sales decreased, continuing the trend that we have been seeing for some time. On our product category basis within BSD, sales of technology and furniture items in the second quarter or lower than the prior year pro forma while sales of cleaning and breakroom and copy and print increased.

BSD gross margin declined in the second quarter of 2014 compared to combined pro forma results in the prior year quarter, driven largely by our Canadian business. US contract gross margins were down slightly compared to prior year pro forma and the decline improved sequentially from the first quarter. Direct gross margin improved.

The BSD division operating income for the second quarter of 2014 was $59 million, an increase of 12% versus pro forma in the prior year quarter. The division operating margin improved by 45 basis points. Lower payroll, which included sales for synergies, lower advertising expense as well as purchasing and supply chain synergies more than offset the deleverage from lower sales and slight gross margin rate decline.

Next on slide 21, are a few of the BSD operational highlights from the quarter. In US contract, the legacy Depot and Max sales organizations have been fully integrated and the channel is aligning its go-to-market approach to include common pricing, assortment, and customer incentive strategies.

In the second quarter, the inside sales organization was consolidated into our Austin, Texas facility. Throughout the remainder of this year, we will continue to roll out and expand sales tools for the legacy OfficeMax sales teams. In direct, the e-commerce team made a number of website enhancements in the second quarter on both the consumer and business sites, including enhanced personalization and an integrated Office Depot and OfficeMax store locator that directs you to the nearest location of either banner. Integrating the websites and launching an improved customer experience across both banners will be a key focus area in the second half of the year.

Let's turn to the international division's second-quarter performance on slide 22. International division sales in the second-quarter 2014 decreased 5% in constant currencies versus combined prior year pro forma. The timing of the Easter holiday had a negative impact of about 1% on European sales in the second quarter when comparing 2014 to pro forma 2013. Sales declined in all three channels, contract, direct, and retail.

The contract channel sales decline was driven by market competition, the loss of certain contracts and the planned discontinuation of low margin business. Lower sales in the direct channel reflects the continued decline in catalog, partially offset by online sales increases. The Company continues to focus on improving online sales in the direct channel.

In retail, sales growth in our European stores was offset by sales declines in our franchises and in Korea. International reported a division operating loss of $2 million in the second quarter which was a $4 million improvement over the prior year pro forma. Division operating margin improved by 41 basis points. Significant reductions in operating expenses, including reduced payroll and advertising as well as gross margin rate improvement, offset the negative deleverage of lower sales.

Slide 23 outlines some of the operational highlights from the international division focused on improving profit margins. We've completed the design phase for a new pan-European operating model which will shift from a country-specific or regional focus to a channel focus. This is designed to reduce duplication, provide greater opportunities for topline growth, and move to a lower cost to serve model.

In the second quarter, we enhanced our Viking websites in a number of European markets, utilizing upgraded functionalities such as faster and friendlier registration for new customers, improved site navigation and better product search capabilities with clearer product pages. Also, we've partnered with a global leader in sales performance and completed an assessment and begun training on an improved and integrated selling methodology.

Turning to the balance sheet and cash flow highlights on slide 24, we ended the second quarter of 2014 with total liquidity of $1.9 billion consisting of $768 million in cash and $1.1 billion, available under our asset-based lending facility. Total debt at the end of the quarter was $714 million.

We spent $73 million in merger-related cash payments in the second quarter of 2014. Capital expenditures were $27 million. We expect free cash flow to be negative this year as we continue to incur significant merger integration expenses in the short term that will lead to a more profitable and efficient organization over the long term.

In the second quarter of 2014, we sold all remaining shares of Boise Cascade Company common stock that we received in a first-quarter distribution related to a legacy OfficeMax equity investment in Boise Cascade holdings. Total proceeds were $43 [billion] with $20 million realized in the second quarter.

As I noted earlier, we expect to complete the sale of our interest in the Grupo OfficeMax JV in the third quarter with after-tax proceeds of approximately $46 million. In the second quarter of 2014, we also recorded an $80 million legal accrual, relating primarily to a potential settlement arising from a lawsuit filed in 2009 in California state court.

This matter related to contracts implemented in 2001 and 2006 and which expired several years ago. This settlement was a business decision. The Company defended the matter vigorously for several years, but the case was likely to go on for several years longer including a jury trial and potential appeals by the parties. A settlement is not an admission by Office Depot of any wrongdoing, avoids the cost and risk of protracted litigation, and allows us to focus on our business priorities.

Because the settlement concerns a number of parties, it remains subject to formal approvals and we anticipate paying a settlement no earlier than Q4. The $80 million accrual also contemplates payments for all known related cases.

As Roland mentioned earlier, we now expect to achieve at least $100 million in synergies by the end of 2016, related to our store closures. On slide 25, we have highlighted some of the key assumptions for store closures. These stores produce an average of $2.8 million in annual sales, which is below our system average. While not all of these stores are unprofitable, on average they generate a negative operating margin. Closures are also driven by overlapping locations from the merger and in some cases unattractive leases or trade areas.

We expect to achieve a sales transfer rate of at least 30% on average. The incremental profits from these transferred sales are reduced by the portion of shared overhead costs that are not eliminated after a store closes and will be reallocated to the remaining open stores in the market.

Net, we expect to produce average annual operating income of at least $250,000 for each closed store. From a cash flow perspective at closing, the working capital reduction is primarily due to eliminating the store inventory, net of payables and is expected to roughly offset the one-time closure and transfer expenses.

In addition, at the time of each store closing, we expect to accrue for potential ongoing rent payments in cases where the store lease has not fully expired. This potential obligation will be mitigated through negotiations with landlords and, in some cases, subleasing. For 2014 store closures, we expect the accrual to be approximately $40 million.

Turning to our 2014 outlook on slide 26, we continue to expect market trends will remain challenging and anticipate total Company sales in 2014 to be lower than the prior year combined pro forma sales. The expense deleverage from lower sales is expected to offset a portion of the merger synergies and operating improvements anticipated during the year.

As Roland mentioned earlier, based upon our results for the first half of the year, with earlier than expected realization of cost synergies and improved operational execution, we are increasing our adjusted operating income outlook for the full year to not less than $200 million. This outlook includes the elimination of the consolidated amounts of both actual and projected operating income from the Grupo OfficeMax JV due to the pending sale.

We continue to gain better visibility into our combined business operations. Therefore in November, we expect to transition our adjusted operating income guidance approach from a floor to a range. We continue to estimate that $400 million of cash integration costs will be required to substantially complete the integration with approximately $300 million of these expenses incurred in 2014. We continue to expect between $200 million and $250 million in merger integration capital spending over the 2014 through 2016 period with up to $50 million of that amount incurred in 2014. In 2014, we expect capital spending for core operations to be approximately $150 million and depreciation and amortization of approximately $300 million.

In summary, we are very pleased with the progress we have made since the merger especially in the second quarter. Now, I will turn the call back over to Mike.

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

We have reserved the balance of the hour for Q&A. We ask you to limit yourself to one question so we can get to as many of you as possible. Operator, please open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Brad Thomas.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Good morning, Roland, Steve, and Mike and congratulations on the quarter.

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

Thanks, Brad.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

My question is about reinvestments in the business. I think it was, Steve, in your prepared remarks you referenced the retail segments putting into place price match program and an enhanced return policy. Clearly under your leadership there is a great focus on reducing costs and it is obviously going to be a focus going forward. But I guess my question really is what is the appetite and timing with which we can start to see some reinvestments to accelerate sales?

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

Brad, what I would say to that is I think the significant amount of reinvestment in the business really will match to the progress we make on the USP. I think as we define, as Roland outlined in his remarks, the target markets that we want to go after, those customers, and go through our testing process, I think that is going to identify the opportunities that we want to fully invest in.

But I think you'll see us ramp-up the level of reinvestment into the operations as we get better visibility on the USP.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Great. Thank you.

Operator

Matthew Fassler.

Matthew Fassler - *Goldman Sachs - Analyst*

Good morning. I was hoping you could give us some visibility on synergies by business and by line items. Some of this might have come out on the call. I know you gave us an aggregate synergy number, but if you have synergies for gross margin, store expenses and then corporate and then if you have them by division it would be very helpful just to get it all in one place.

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

We haven't really broken out how we are allocating the synergies. Obviously, they are flowing through each of the division numbers as we go through. So, but we really haven't gone through that. We are driving that as a Company wide process going forward.

What might be helpful is if you think about the mix of synergies. We have said that of the $220 million, for example, that we will realize in 2014, you should expect about $60 million of that would come from our purchasing initiatives that will benefit and help offset some of the sales deleverage around COGS. And then the rest would flow through our SG&A line. And I think that mix flows through and then I think each of the businesses sort of share in that overall cost reduction and purchasing efficiencies.

Matthew Fassler - *Goldman Sachs - Analyst*

Got it. Thank you so much.

Operator

Oliver Wintermantel.

Oliver Wintermantel - *ISI Group - Analyst*

Good morning.

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

Hey, Oliver. It is Roland. Could you speak up a little, we are having a tough time hearing you.

Oliver Wintermantel - *ISI Group - Analyst*

Sure. You said that gross margin increased in retail and international down in BSD. Could you maybe give us some detail that drove the gross margin rate there? Was it more a mix shift or was it really the product margin? Thank you.

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

What you are seeing on the gross margin overall, though, is some contribution. Again, coming back to the purchasing efficiencies, what we were pleased with in the second quarter, I think, was the ability to move through our process around leveraging the increased volumes of both banners and get contracts in place and really be operational under a number of contracts that are helping us to reduce our purchasing costs going forward. And I think that is what you are seeing flow through on the gross profit side.

The other aspect I would say from an operational standpoint is that, given the emphasis we are putting on margin improvement, I think each of the business leaders has established a more rigorous approach to pricing and acceptable pricing in each of the businesses and then making sure that we follow that consistently across both banners. I think if you look at our profitability in 2013, there was more inconsistency of pricing approach between the two banners. And I think we are trying to stabilize that going forward and in-force that across both businesses and I think that is also having a positive influence on our gross profit really across all the business divisions.

Oliver Wintermantel - *ISI Group - Analyst*

Okay. Thank you.

Operator

Michael Baker.

Michael Baker - *Deutsche Bank - Analyst*

I wanted to ask about the store closures and a couple of questions there. One, on the synergies that you are going to earn, can you break out how much of that is from the sales transfer and how much is from the costs that you are actually going to save from taking the expenses out? I am going to guess we can figure out the sales transfer amount, but how much is the --? How much of the recaptured sales flow-through in new stores and again how much of these synergy savings is just from taking out the costs from the existing stores?

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

Yes, good morning, Michael. Let me first talk about sales transfer. As we mentioned and Steve highlighted in his scripted comments, we implemented in the second quarter, an 18-store test where we did a lot of work to improve customer service and marketing tactics so that we could improve the sales transfer. And we believe that the benefits of all of our work are in fact improving our sales transfer and we also had the benefit of being able to transfer sales from a Max or a Depot to either a Max or a Depot, which is certainly different than we have had the opportunity to do in the past.

The net of all that is that our results are encouraging and, as you know, we have raised our expectations to our sales transfer rates of 30% and we will continue to test and try to drive those higher. From the second question, we continue to believe that those sales transfers will actually flow down to the bottom line at about a rate of 25%.

Michael Baker - *Deutsche Bank - Analyst*

Okay and then we can back into the remaining synergies then or cost you would save from taking out the SG&A from a closed store. If I could ask one follow-up, then, in terms of the banners, you are closing more Depot stores, more Max stores? Is it a mix? Are there specific markets that you are coming out of?

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

Well, it is a mix and at this point it is geographically diverse across all of our markets and at this point we would not want to go into more detail because from competitive reasons we would want to wait until we are closer to actually closing the stores to announce where they are going to take place.

Michael Baker - *Deutsche Bank - Analyst*

Okay, fair enough. Thank you.

Operator

Michael Lasser.

Michael Lasser - *UBS - Analyst*

Good morning. I may have missed this early in the call, but you did speak to the two customer segments that you will be going after as part of your USP. In order to help us understand and analyze the probability of success, could you identify those two customer segments?

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

Let me talk, Michael, a little bit about the USP. I know I talked a little bit about it in my comments, but this is a very important initiative and a critical priority for us.

As I mentioned, I think we are making excellent progress. It is not a quick fix. It is not a silver bullet. It is not something that is going to take effect in the next couple of months. It is a process that is very disciplined and methodical. It is similar to the process that we use to identify and begin to achieve our synergies and efficiencies.

So in that regard you know that we identify very different phases, the who, the what, and the how and, today, we were pleased to be able to relay that we have completed the first phase which is really identifying who or what target segments that we think that we should go after. And this really gets to your question.

Those segments we have identified through some very detailed quantitative and qualitative testing. We have named them. We clearly understand their demographics and [cycle] graphics in the building, but as you can imagine from competitive standpoint we do not want to go into that detail certainly as we are early into the process of verifying, testing, integrating and ultimately rolling this out.

What I can say is that these segments' purchasing behavior is driven much more by quality, by service and experience. And I can also say that these segments are also higher profitability from the standpoint of what they shop and how they shop. We mentioned that we are underpenetrated in these segments. We also mentioned that we believe that these segments represent approximately $60 billion in annual revenue and that we believe that if we could get our representative share that that would allow us to improve our sales in the neighborhood of about $1 billion.

Now we know we have a lot of work to do, and clearly this is not something that is going to happen overnight and we might not get the full $1 billion, but I can tell you that even if we get a portion of it, it is a meaningful increase to our ability to grow sales.

We are now moving into the second and the third phase. Those phases are really about the what and the how. The next steps include testing and refinement. We will then iterate. We will learn, we will iterate, we will test and ultimately we will build a rollout plan and roll this out to our markets.

I have also -- today relayed that we have identified 20 market tests that we are in the process of finalizing and then putting to the market. These address the combinations of -- different combination of products and services and channels and experience just like you would expect to go after and understand and get a better share of the segments that I just talked about which are segments that are clearly concerned about quality, service, and experience.

And then as I mentioned we will finalize this in 2015, and we will begin the implementation for 2016.

Ultimately, our USP definition will drive our messaging, our product assortments, our new products, and our services and we think that in the 2015, 2016 timeframe as we learn things that we know are going to work and we will implement immediately will help us stabilize our revenue and then ultimately set the foundation for profitable revenue growth in the future.

Michael Lasser - *UBS - Analyst*

Okay. Let me ask one quick follow-up on that. As part of your comments, you didn't necessarily allude to pricing and interestingly your price match policy focuses on both retailers who are both an online and a retail presence. I think what a lot of us are trying to understand is how much of the growth savings that you are going to see from this merger will then need to be reinvested back in the price because most surveys indicate that you are probably 20% above some of the online only players out there. So, (technical difficulty) it sounds like as part of your initial [diligence] on there, (technical difficulty) need to narrow that full gap to (technical difficulty) big portion of the savings could fall to the bottom line. Is that a fair assessment?

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

Repeat the last part of your question, Michael. I understood the first part, but repeat the last part.

Michael Lasser - *UBS - Analyst*

So, it sounds like (technical difficulty) early analysis and diligence, you (technical difficulty) fully close the pricing gap with the online only retailers. You may have to become a little tighter, but you won't have to go all the way there suggesting that a big portion of the (technical difficulty) synergies that you are expecting from this transaction could actually fall to the bottom line.

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

I think I understood the question. You are breaking up a little bit, though. Let me see if I can answer that. First of all, we clearly have identified a couple of segments as I've mentioned that we believe their purchasing behavior is more about quality, service, and experience. That would not suggest that we are walking away from other drivers of purchasing behavior that would consist of pricing and convenience. It just means that we are not going to, in the future, based on this analysis expect to own the area of pricing, and I think if we tried to do that, we would fail. That does not mean that we don't need to be competitive and we will still be competitive. But let me talk a little bit about pricing.

I know you mentioned that in some of the analysis that you have done or that you have read that we are at a pricing disadvantage to some of our competitors.

Let me tell you this. We review our pricing and adjust it on a regular basis to ensure that we continue to be competitive. But we are not an EDLP player and so we don't offer everyday low prices like some of our competitors do. Including, namely, Amazon. And when you measure pricing, at one point in time we believe that if you don't also consider a longer period of time that includes promotional strategy that it is not particularly accurate. And when we look at our pricing over a period of time that includes our promotional activity, we feel like they were very competitive and we are providing the consumers what they need in order to come in and shop with us.

We also, as you mentioned, have recently updated our price match policy and our return policy, which we think are very good things for our competitors. Steve went through that in greater detail in his comments. But if you are a retailer or online, we will price match, to include Amazon. We now have a 90-day return policy that allows even folks that buy products on our website to return them to store which is a big advantage that we have over some of our competitors.

From the last part of your question, I think what you have asked is the increased synergies that we are expecting throughout 2016, which now, as Steve mentioned to you and I highlighted, are at least $700 million. How much of those will fall to the bottom line?

Well, at this point a significant amount of them are certainly falling to the bottom line. As you know, we continue to expect sales will continue to be soft and difficult this year. We are in a secular decline, although I do believe that our USP strategy is something that will help us be able to deal with that.

We will cover the deleverage that we see in our business in the future and still generate what we think is a significant amount of adjusted operating income over a period of time.

What we would expect to do as you have looked at our transformational strategy is to complete the merger and enjoy all of the synergies that we have expected. And I think you know, from our results in the first two quarters of this year, that we are overachieving against what we expected. We are gaining our synergies earlier than we had contemplated and that gives us great confidence that we will be able to achieve all the synergies that we have relayed to you.

As Steve mentioned, as we look at our USP and as we start to find data in the marketplace that would suggest that some of these USP products and services and strategies will help us stabilize and grow revenue, we will begin to invest in that and that revenue growth, obviously, will have an impact on where we are now deleveraging. And so, we expect to believe that a significant number of the synergies and efficiencies that we are generating will be able to go to the bottom line over the period of time that we've talked about.

Michael Lasser - *UBS - Analyst*

Okay. That's very helpful. Thanks, Roland.

Operator

Gary Balter.

Gary Balter - *Credit Suisse - Analyst*

I have one question and it relates to the synergies, but it relates and may have a few parts. You didn't mention and maybe you did the impact last year you got hurt by OfficeMax and their ability to manage to give away product below their costs or whatever happens in contract and you have been anniversarying that. And you mentioned gross margin was down again in Q2. When do we start to see that anniversary so that we don't have that impact anymore? And I know some of it is two years, but is there a way to quantify how much that is one year versus multiyear?

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

Yes, Gary, I think as we look at it, we did as I think we mentioned last quarter, we did retain some what I would say unfavorable contracts that were originated on the legacy Max side as part of what we are working through. And partly what I was referring to when I talked about discipline around pricing that the business leaders now are enforcing across both brands as we consolidate, is to avoid creating those kinds of unprofitable contracts.

We also mentioned we are doing that in the international business as well. Some of the sales declines you are seeing there are us walking from unprofitable business that was originated over time.

So I think you will see that impact over the next year or two phase-in as we are able to wean our way off of these contracts and work with those customers, hopefully to retain the business, but at that pricing that makes more sense for us and meets our guidelines. So I think you will see the BSD part of our business improve the margins as a result of being able to reduce the percentage of our business under these unfavorable contracts that we have inherited.

Gary Balter - *Credit Suisse - Analyst*

Okay, that's great. That's helpful. And then my follow-up and then I will get off. On the retail synergy slide you showed some math that basically equated to about $336 million of sales when we did the 2.8 times the 400 stores, whatever. That -- looking at the synergies you assume of $100 million that seems about either a 30% gross margin or these stores are losing money already. Is there a way to quantify because you say that some of them have negative margins? Is there a way to quantify how much those were losing versus is there an assumption built in that there is a 30% gross margin transfer? And then now that you have had more time to look at it and, again, this may have been asked already, so I apologize, is 400 too low a number or should we be thinking a bigger number?

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

Yes, let me deal with the profitability question first, Gary. As we look at the 400, as I said, not all of those 400 are losing money. But on average, the group that will close are operating at a negative operating margin. So that will be part of the $100 million will be the elimination of those ongoing operating losses that we are incurring today at those 400 locations.

I would estimate that it is a low single-digit negative operating margin on those 400 overall. So that, if you want to try to look at the components of the 100, that is the part of the operating losses that will go away as we close those locations. And that has really been part of the overall analysis. In terms of the question around is 400 the right number, Roland, you probably should address that one.

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

Yes, we talked to you at our last earnings call about the 400 number and then we went back and finalized our analysis and, again, today reiterated that we believe that 400 is the right number. We have given you the breakdown year by year. As you know, we have increased the number for 2014 up to 165 and then we have laid out the number for 2015 and 2016.

I would say this, as we continue to look at our business; as we continue to test and improve our sales transfer, as we continue to look at those factors, those factors that we quite honestly use in our first analysis to include individual store performance and transfer rates, as I mentioned, and stranded costs and store closing costs, expected impacts on other channels and then, obviously, our go-to-market strategy and what happens with the competition, we could vary that number. And certainly that number could go up, but clearly at this point we think 400 is the right number.

But that is why we put the little plus mark after the 400 to give you the indication that we will continue to look at this as we go forward.

Gary Balter - *Credit Suisse - Analyst*

Okay and finishing up on that and there's still no assumption of any benefit from the 225 that Staples has announced, is that correct?

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

No. I would say no to the extent we don't have full visibility on the locations of those closures, but I would say where we do have indications that was part of our market by market evaluation. So that was their actions are factored into the extent that we have visibility into our decision-making.

Gary Balter - *Credit Suisse - Analyst*

Okay. Thank you very much.

Operator

Dan Binder.

Dan Binder - *Jefferies & Company - Analyst*

Good morning. My question was just for a little bit more clarification on the USP. Is this new products and services or existing products and services that you already offer, but you are just focused on a customer that maybe you [remarked] as focused on before?

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

I would say it is a little bit of both. We certainly have some products and services that we believe would certainly be applicable to the target segments that I have mentioned today and that is why we actually have those target segments as part of our business. But we believe that they are -- we will need to add new assortments and new products and new services that quite honestly really attract these customers to purchase from us at a greater percentage or a greater share as we go forward.

Dan Binder - *Jefferies & Company - Analyst*

So are these essentially business products, office products, is it just extending the lines, or any additional color you can provide on that?

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

Well, of the 20 identified tests that I mentioned, some of them span both, certainly office products, but there are also some business products and services that we will add. And, again, and that is why we are taking the disciplined and methodical approach that we can test this and ensure that ultimately when we invest behind it, it will have a high probability of success.

Dan Binder - *Jefferies & Company - Analyst*

Okay, since I am the last question, I hope I can do one follow-up here. Separate question though. With regard to the initiatives around getting the sales transfer rates up, can you describe for us the cost of those customer service and marketing initiatives? Obviously you believe they are repeatable, but trying to factor in how much more cost to get that and as you close these stores in aggregate what are you expecting the total store closure cost to be, recognizing it is one-time in nature, I and just curious if you have got a number on that.

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

Yes. What we are estimating at closure right now is a combination of the actual liquidation of the inventory and the physical closing of the office, which we have traditionally done. And then on top of that, this new push around increasing the sales transfer which incorporates a number of marketing initiatives, advertising in that local market, and things that have been in our 18-store test in the second quarter.

In total, we think that the total cost of the marketing initiatives, plus the liquidation of the inventory is a $150,000 investment that we make per store in total. And as I said earlier, the cash impact of that, we think, will be about a breakeven with the savings that we will get as we also are able to liquidate and reduce our overall inventory.

So, net net about $150,000. And we will adjust that going forward as we see the full results from the test, but as Roland said, so far those marketing initiatives seem to be driving better sales transfer results, which provide a very attractive return on that investment.

Dan Binder - *Jefferies & Company - Analyst*

Okay. Thank you.

Operator

This concludes the Q&A session for today's call. I would like to turn the call back over to Roland for any closing remarks.

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

Thanks and thank you all for participating today. Quickly, in summary, I am very pleased with the progress our teams have made since the merger especially in the second quarter. We completed our leadership team. We significantly accelerated synergies, improved our execution, finalized our retail optimization plan, and made excellent progress on defining our USP.

We have also increased our 2014 adjusted operating income guidance 25% to not less than $200 million. We increased our expected cost synergy run rate at the end of 2014 to $400 million. We increased our expected real estate synergy to at least $100 million and increased our annual run rate synergies by the end of 2016 to at least $700 million.

Obviously we have a lot of hard work ahead of us, but I believe we are off to an excellent start. Thank you again for participating today and we look forward to updating you on our progress.

Operator

Again, thank you for your participation. This concludes today's call. You may now disconnect.
