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EDITED TRANSCRIPT

ODP - Q3 2014 Office Depot Inc Earnings Call

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OVERVIEW:

Co. reported 3Q14 adjusted sales of $4b and adjusted net income available to common stockholders, excluding after-tax effect of special items of $52m or $0.10 per share.

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PRESENTATION

Operator

Good morning, and welcome to Office Depot's third-quarter 2014 earnings conference call. (Operator Instructions). At the request of Office Depot, today's call 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, and thank you for joining us. I'm 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 restructuring. And then Steve will review the Company's quarterly results and our financial outlook. Following Steve's discussion, we'll open up the line for questions.

Before we begin, I need to inform you that certain comments 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'll 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, are all available on our website at 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. I'm happy to be here today to discuss our results for the third quarter of 2014 and provide an update on our business. Tomorrow marks the one-year anniversary of the Office Depot-OfficeMax merger. We are one-third the way through our three-year integration plan, and our associates throughout the organization have done an outstanding job of implementing best practices from both legacy companies and improving execution to ensure we meet our customer's needs and serve them well. Overall, our first year as a new company has been a huge success. We are very pleased with our progress on the merger and our early work to position Office Depot for future success.

Beginning on slide 4, our results in the third quarter of 2014 confirmed that we continue to execute exceptionally well. We more than doubled our adjusted operating income to $126 million in the third quarter compared to $62 million pro forma last year. Additionally, gross margin rate and SG&A percent of sales both improved.

As we expected, total sales declined approximately 4%, with 2 percentage points of this decline driven by our planned store closings in the United States since the third quarter of last year. Sales across our entire business in the third quarter were more profitable than the prior year combined pro forma sales, because we carefully balanced sales and margin improvement.

Merger integration synergies and efficiencies more than offset continued topline pressure and higher incentive compensation expense compared to the prior-year period. Given our faster-than-expected progress on integration, as well as exceptional execution on critical priorities, we have increased our outlook for full-year 2014 adjusted operating income to a range of $255 million to $265 million.

Earlier this year, we shared with you our 2014 critical priorities and committed to update you on select priorities each quarter. Today, I'll review the priorities circled on slide 5, including four priorities -- IT platform, common assortment, marketing platform, and supply chain approach -- that have enabled key merger milestones: our European restructuring, which continues our efforts to become a more lean and effective organization; progress in optimizing our retail store portfolio; the development of our unique selling proposition, and how it fits into our framework for growth; and an update on our synergies and efficiencies.

To start, during the third quarter we achieved four significant integration milestones which are listed on slide 6. The first milestone was the completion of our first distribution center consolidation and platform conversion. We closed the Elkridge, Maryland, legacy OfficeMax distribution center and consolidated this business into our legacy Office Depot facility in Newville, Pennsylvania.

Both OfficeMax and Office Depot customer orders in this region are now being fulfilled by Newville. This was the culmination of the year of cross-functional planning and systems development work by our teams. The consolidation of our supply chain will continue, and we plan to close a total of five distribution centers by the end of the first quarter of 2015, and expect the entire consolidated supply chain footprint to be in place by the end of 2016.

The second milestone reached during the quarter was the successful launch of a co-branded website by our e-commerce team, which was completed two quarters ahead of schedule. As part of this new website launch, we recently phased out the OfficeMax.com platform after having migrated the majority of the OfficeMax sales volume to our OfficeDepot.com platform.

The third milestone was the first conversion of a legacy OfficeMax store to the Office Depot point-of-sale platform. This integrated platform is a more efficient and productive application, and accepts both legacy banners loyalty programs. We plan to convert the point-of-sale platform in all legacy OfficeMax stores by the middle of 2015.

And fourth, we successfully executed a combined banner, integrated back-to-school program in our retail stores. We leveraged our progress on common assortment to significantly reduce our marketing spend. Steve will cover back-to-school in more detail later on the call when he reviews our retail division third-quarter performance.

Several weeks ago we announced our plan to restructure our European operations. As you see on slide 7, we are moving from a country-based to a channel-based structure, focusing on the customer and responding to changing market needs. We're planning to consolidate core functions and reduce duplication, which will create a leaner and more effective business model in Europe. It will also facilitate our new selling model, and position the region for long-term, profitable growth.

This plan is the result of a thorough analysis involving every function within the European business. We anticipate that approximately 1,100 positions will be impacted in addition to 300 positions already eliminated as of October. Similar to the reorganization in North America, all impacted associates will be provided severance pay and other benefits to help them transition.

As is typical in Europe, our restructuring plans are subject to consultation with unions and works councils. In this regard, we've already held initial and productive meetings, and we are encouraged with our progress to date. We expect the reorganization of our European business to generate approximately $90 million of annualized, reoccurring P&L cost reductions by the end of 2016.

Now moving to our US retail store optimization on slide 8. As you'll recall, our store-specific closure decisions are being made through a holistic market evaluation process focused on optimizing productivity and profitability.

We are implementing the plans we laid out last quarter, and we continue to expect to close at least 400 US stores by the end of 2016. We expect 165 stores will close this year, with more than 100 closing in the fourth quarter. We still expect to close approximately 135 stores in 2015, and at least another 100 stores in 2016, as we sequence the store closures to maximize economics. Additionally, we are exploring opportunities to reduce unproductive retail square footage through cost-effective store relocations and downsizing.

As we discussed last quarter, we have been testing and implementing a number of customer service and marketing tactics designed to improve customer retention and increase sales transfer rates. And I'm very pleased to report that as a result of these tactics, our sales transfer rates have been higher than expected. Based on these results, we expect to achieve and maintain average sales transfer rates of at least 30%. These transfer sales will increase the profitability of our remaining stores and provide a meaningful boost to same-store sales as we close stores over the next two years.

Turning to slide 9, I'd like to review our progress to develop and test a unique selling proposition, or USP. As we've previously discussed, the USP is about employing a disciplined process to identify how we will differentiate ourselves in the office supply marketplace. We continue to make excellent progress on understanding the needs and drivers of our two large target segments, including how they view quality, service, and experience.

Our data suggests that we are underpenetrated in these segments, and no one in the industry is currently doing a great job of meeting these customers' expectations. At the same time, we know that price and convenience continue to be important drivers of purchase behavior for many of our customers, and we intend to continue to serve these customers' needs.

Through 2015, we'll continue testing and refining our USP within three broad initiatives which span all of our channels. First, we'll leverage our newly combined e-commerce platform to significantly improve the online customer shopping experience. We see plenty of opportunity to improve the content, functionality, and the overall e-commerce experience. Our intent is to significantly grow our e-commerce sales over the next several years by focusing on and meeting the needs of our two target segments.

Our second key initiative is to significantly improve the overall retail experience, and we have already begun to test individual elements of this initiative in select stores. These tests will define how we meet the needs of our target customers in the important areas of quality, service, and experience. By late summer 2015, we expect to open a store-of-the-future concept that includes a curated assortment of products and services and incorporates the successful components of these tests.

Our third initiative is to better serve small business customers that are part of our target segments. We are planning multiple tests that will help us better understand these customers' needs, their purchasing behaviors within and across channels, and evaluate optimal methods to attract, acquire, and retain them.

In addition to these three initiatives, we will continue to research and understand our target customers' needs, and implement additional market tests.

As you can see on slide 10, it is important to understand that the development of our USP is only one part of the equation to successfully transform our business and drive long-term growth.

Our framework for growth includes four components. The first two focus on improving our current business model, while the remaining two focus on product and service adjacencies and extensions and new business models. I'd like to briefly describe each component.

The first component is to continue improving our core business execution. We are in the process of defining our 2015 critical priorities, many of which will be focused on better execution to improve sales and margin, as well as continued focus on merger integration and synergy realization. And we are making some investments in the fourth quarter that should begin to benefit our results in 2015.

Second, we continue to develop our USP to differentiate ourselves in the office supply marketplace, and gain share in the underserved target segments we have identified. As I mentioned earlier, in 2015 we'll test and refine the what and how of our USP through the store of the future, an innovative e-commerce offering, and winning the small business customer.

Third, future growth opportunities could include moving into adjacent markets and/or product extensions. For example, we are exploring opportunities to add products and capabilities in education, jan/san, and print.

Lastly, we are also exploring new business models with revenue streams outside of our current core business. Through a rigorous, disciplined process, we are analyzing new business models that could include building, buying, or partnering strategies, depending on the opportunity. Overall, we believe this framework will facilitate profitable growth over the long-term.

Now I'd like to update you on expected benefits for merger integration synergies and restructuring. Turning to slide 11, we have increased our expected annual run rate merger synergies to more than $750 million by the end of 2016. This is an increase from the Company's previous estimate of more than $700 million, and reflects additional benefits we expect to receive from the merger integration.

We now expect purchasing synergies of $160 million, and cumulative merger synergies from SG&A, distribution, and occupancy costs of $490 million, both of which are increases from our previous estimates.

We also continue to expect the benefit from our retail store optimization to be more than $100 million by the end of 2016. In addition to the merger integration benefits, we also expect $90 million in annual run rate cost reduction from our recently announced European restructuring. We anticipate the majority of these savings will be realized in 2016.

So, in total, we now expect to generate at least $840 million of global annual run rate synergies and restructuring benefits by the end of 2016. In 2014, we now expect to realize merger synergies of $260 million, an increase of $40 million from our prior estimate. And we continue to expect the annual run rate of merger synergies at the end of 2014 to be at least $400 million, excluding any future benefit from store portfolio optimization.

Slide 12 provides our adjusted operating income outlook for 2014, and our preliminary outlook for 2015. Based on continued strong execution of our merger integration activities and our critical priorities, we now expect to achieve $255 million to $265 million of adjusted operating income in 2014, which is more than 2.5 times the 2013 pro forma of $99 million.

Our outlook for 2014 adjusted operating income includes a net year-over-year increase in incentive compensation, which we expect to be at least $70 million. This net increase reflects the fact that we are exceeding objectives this year, whereas targets were not achieved in 2013.

We expect total Company sales in Q4 to decline more than the year-to-date trend, primarily due to planned retail store closures and a stronger US dollar. However, we're expecting retail comps to show a modest improvement in the rate of decline from the year-to-date trend.

Looking forward, we're still finalizing our 2015 annual operating plan. But our preliminary estimate is to deliver approximately $475 million of adjusted operating income, an 80% increase from what we expect to achieve in 2014. The expected increase from 2014 is primarily driven by realization of incremental merger integration synergies. On our Q4 call next February, we will provide more details on our 2015 priorities and outlook.

Now I will turn the call over to our CFO, Steve Hare, to discuss our Q3 results in more detail. Steve?

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

Thanks, Roland. Before I highlight results for Q3, a reminder that our 2014 adjusted or non-GAAP reporting excludes results from the recently sold Grupo OfficeMax joint venture. The prior-year comparisons that I will focus on today are to our combined Company pro forma results, rather than to our 2013 reported results. The 2013 pro forma results are posted to our IR website.

Turning to consolidated third-quarter 2014 results on slide 14, adjusted sales were $4 billion, down 4% from the prior-year quarter on a pro forma basis. The impact of US retail store closures in the prior 12 months accounted for approximately 2 points of that 4 point total decline.

Reported or GAAP operating income in the third quarter of 2014 was $49 million. Excluding special charges and credits totaling $79 million, as well as $1 million in operating income from Grupo OfficeMax, adjusted operating income in the quarter was $126 million. The special items included $55 million in merger-related expenses, $17 million in international restructuring, and $7 million in non-cash store impairment and other charges.

The $126 million in third-quarter 2014 adjusted operating income more than doubled the $62 million prior-year combined pro forma amount. Lower expenses and gross margin improvement in each division, including $90 million of realized merger synergies, more than offset the negative flow-through impact of lower sales, as well as a net year-over-year increase of approximately $20 million in incentive compensation expense in the quarter.

Adjusted net income available to common stockholders in the third quarter of 2014, which excludes the after-tax effect of the special items I mentioned, was $52 million, or $0.10 per share.

Turning to slide 15, third-quarter 2014 same-store sales in North American Retail for the combined Office Depot and OfficeMax stores declined 3%. The comp sales decline was driven by lower transaction counts and a slight decline in average order value. Total retail sales decreased 7% versus prior-year combined pro forma, and included the negative impact of US store closures in the prior 12 months.

Retail sales increased compared to the prior (technical difficulty) in furniture, copy and print, and in tech services. We experienced sales declines in ink and toner and in other technology items, including a sharper decline in computers and peripherals. The decline in our technology category contributed 2 points of the overall comp sales decline.

Retail division income was $79 million in the third quarter, a $45 million improvement over the prior-year combined pro forma. Division operating margin improved by nearly 3%. The negative flow-through impact of lower sales was more than offset by lower operating expenses, including advertising, payroll, and other store expenses, as well as gross margin improvement.

The 2014 back-to-school season was very competitive. We were pleased with our execution in this challenging environment, which contributed to the significant year-over-year improvement in retail division operating income.

We implemented best practices from our legacy companies across our US store base, and promoted a common assortment of key back-to-school products across both banners. As planned, we were more targeted in our offers, and did not repeat some low-margin, broad-based promotions from the prior year. These actions reduced sales compared to prior-year pro forma, but significantly improved profitability.

Turning now to slide 16 and the third-quarter results in our business solutions division, or BSD, third-quarter 2014 sales were $1.5 billion, a decrease of 1% from prior-year quarter combined pro forma. 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 increased slightly in the third quarter, driven by growth in our K-through-12 education and business customer segments. In direct, online sales increased and call center sales decreased, continuing the trend that we've been seeing for some time.

BSD gross margin increased slightly in the third quarter of 2014 compared to combined pro forma results in the prior-year quarter. The BSD division operating income for the third quarter of 2014 was $67 million, an increase of $17 million from the prior-year quarter combined pro forma. Division operating margin improved by approximately 1%. Lower payroll and advertising expense, as well as purchasing and supply chain synergies, more than offset the negative flow-through impact of lower sales.

Third-quarter performance for the international division is highlighted on slide 17. International division sales in the third quarter of 2014 decreased 4% in constant currencies versus prior-year combined pro forma. Sales declined in the contract and direct channels, and retail channel sales were essentially flat.

The contract channel sales decline was driven by market competition in a challenging economy, the loss of certain contracts, and the planned discontinuation of low-margin business. Lower sales in the direct channel reflect the continued decline in catalog, partially offset by online sales increases. In retail, sales growth in our European stores offset sales declines in Korea.

International division operating income was $10 million in the third quarter of 2014, which was a $3 million improvement over the prior-year combined pro forma. Division operating margin improved by 40 basis points. Gross margin rate improvement and reductions in operating expenses, including payroll and advertising, more than offset the negative flow-through impact of lower sales.

Turning to the balance sheet and cash flow highlights on slide 18, we ended the third quarter of 2014 with total liquidity of $2.1 billion, consisting of $965 million in cash and cash equivalents, and $1.2 billion available under our asset-based lending facility. Total debt at the end of the quarter was $710 million, excluding non-recourse debt.

We spent $82 million in merger-related cash payments in the third quarter of 2014. Capital expenditures were $24 million. As I noted earlier, we sold our interest in the Grupo OfficeMax JV to our joint venture partners in August, and received $43 million in net cash proceeds in the third quarter.

Slide 19 includes the components of our 2014 outlook. As Roland noted earlier, we expect to achieve $255 million to $265 million of adjusted operating income for 2014, compared to $99 million last year, on a pro forma basis.

We continue to estimate that $400 million of cash integration costs will be required to substantially complete the merger integration, with approximately $300 million of these expenses incurred in 2014. These costs exclude store closing expenses.

We expect approximately $200 million in merger integration capital spending over the 2014 through 2016 period, with approximately $25 million of that amount in 2014. We anticipate that the majority of the remaining integration costs and expenditures will be incurred in 2015.

In 2014, we expect total capital spending to be approximately $150 million, and depreciation and amortization to be approximately $300 million. We expect free cash flow to be negative in 2014, 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.

Finally, our preliminary estimate for 2015 adjusted operating income is approximately $475 million, and we expect to generate positive free cash flow.

Overall, we are very pleased with the progress we have made in our first year as a new company.

Now, I will turn the call back over to Mike.

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

We've reserved the remainder of the hour for Q&A. We ask that you limit yourself to one question so that we can get to as many of you as possible. In addition to Roland and Steve, Mark Cosby, our President of North America, is in the room with us. And on the phone from Europe is our President of International, Steve Schmidt.

Operator, please open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Mike Baker.

Mike Baker - *Deutsche Bank - Analyst*

So, I'm just going to ask one question -- there's obviously a lot to ask -- but I'll ask about the tax this quarter; seemed a little strange. In your reconciliation, $56 million in tax on an operating income number -- it was an adjusted operating income number of $126 million. Is that the kind of number that we should expect going forward, as we think about the $255 million to $260 million in operating income this year, and $475 million next year?

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

Yes, Mike, this is Steve. I think the tax rate we show on a non-GAAP basis was higher than I had expected this year. It came in at 52%. Going forward, on a normalized basis, the non-GAAP tax rate really ought to be closer to 40%; 40% to 42%.

But, again, we've got some unusual items in there, and it gets down to where we've got some tax credits, and where we cannot recognize certain tax benefits against losses that causes the rate to be a little bit higher. So a little bit unusually high this quarter; but going longer-term, as you look at, say, 2015, I still think a 40%, 42% tax rate for non-GAAP purposes is about right.

Mike Baker - *Deutsche Bank - Analyst*

Okay, thanks. I'll respect the one-question rule, and turn it over to somebody else.

Operator

Brad Thomas.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Good morning and congratulations. I wanted to ask about the initial 2015 guidance, and see if you could just provide a bit more color, perhaps directionally if not quantifying it, in terms of your expectations for the synergies that year, as well as the core business performance, as well as perhaps what you would model in terms of incentive comp for next year.

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

Morning, Brad, and thanks for the compliment. As you know, this is preliminary outlook for 2015. This is earlier than we would typically provide an outlook. But because of the significant complexity and changes in our businesses, and the fact that the consensus is too low and that the range is too large, we decided that we wanted to give you a peek into 2015.

As you know, we suggested that we will deliver approximately $475 million of adjusted operating income. I can't provide you a lot more color on it because we are working on our 2015 plan as we speak, but we are certainly comfortable providing that guidance as of now.

We do expect sales decline to continue in 2015, based predominantly on the closures that we have planned in our retail business. But we also expect some modest improvement in same-store sales as it relates to retail. So we're working to finalize our plan. As we get back with you in February and talk about our full-year results, we'll give you a little bit more color on what we expect to build the $475 million. And we'll also, at that point, tighten that $475 million to a range for the year.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Great. And if I could squeeze in a housekeeping item for Steve. You're standing behind that $300 million in cash costs for restructuring for this year. Where do we stand, year-to-date, on that number?

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

Well, in terms of total expense, if you look at our year-to-date, everything that we've got included in merger restructuring expenses, that's a $276 million number, but that does include the restructuring cost for our international business as well. So, I think when you strip the international piece out, I think we're still tracking to about $300 million for the year, on a cash basis.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Great. Thank you so much.

Operator

Dan Binder.

Dan Binder - *Jefferies & Company - Analyst*

It's Dan Binder with Jefferies. My question was around how you think about price investment and competition, relative to the synergies that you're achieving. How much of that do you think is needed? Or do you plan on reinvesting back into price to get -- so, some of the online pricing more competitive, with some of the others on the Web?

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

Thanks, Dan. Let me talk a little bit about pricing. And I don't think our view has changed at all from the last time we spoke with you after the second-quarter results. Net, we believe we are very competitive on a price basis, specifically as it relates to our promotional pricing. We regularly review and adjust our pricing to ensure that we provide our customers good value across all of our channels. But I think it's important to understand that we are not an EDLP player -- an everyday low price -- like Amazon and some of our competitors.

We do use promotional pricing on a regular basis to bring down the overall price of our products. And we think that if you look at pricing on just a one-time, single snapshot of a single hour in a single day, you don't get a relative picture of how we are priced over a broader timeframe, which includes our promotional pricing.

So, we do not have any plans to make any significant investments in pricing in the fourth quarter or into 2015. As I mentioned, we believe we are competitive. We will continue to be a promotional price player, and we'll continue to provide our customers as much value as we can.

As I talked about our USP today, one of the things I spoke about, again, is our desire to grow our share in two segment targets that we believe are less sensitive to price. And those are two segment targets that we spoke about the last time, which are really much more driven by quality, service, and experience. And I took you through a number of market initiatives that we believe will help us understand, across all our channels, how this USP will play, and provide us the ability to grow share in this important two targets.

I'll just remind you that these two targets represent about $60 billion of a $160 billion industry. And we believe, if we can get our representative share, that that could represent another $1 billion in revenue, which is certainly significant, and certainly willing to -- something important to go after.

I also mentioned that we do have many customers that clearly are also very interested in price and convenience. And these are customers that we will continue to provide great value, so that we can continue to have them as part of our enterprise. But from an overall pricing standpoint, we think we're in pretty good shape.

Dan Binder - *Jefferies & Company - Analyst*

Okay, thanks.

Operator

Michael Lasser.

Michael Lasser - *UBS - Analyst*

Thanks a lot for taking my question. It's on the retail segment. Presumably, you have a good sense of the stores that you are going to close over the next couple of years. So, if you take those out of the equation, how did the rest of the portfolio perform? Were you able to achieve a positive comp?

The reason why I ask is because it will allow us to benchmark what you are able to transfer from those stores that are closed, versus what's happening in the underlying store base. Thank you so much.

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

Morning, Michael. Yes, we have a fairly good idea of the stores that we will close in the short-term. As you know from my prepared comments, we do expect to close a total of 165 stores this year. The predominance of those will be closing in the month of November, later on this month, and into December. And we are planning to close 135 in 2015, and we are still planning to close at least 100 in 2016.

From a competitive standpoint, we are not yet talking about where those 135 or 100 stores will be. And quite honestly, from an economic standpoint, we have probably more candidates for certainly 2016 than the 100 stores that we are suggesting. And we will learn things as we close these stores, specifically in the area of sales transfer, which you know from our comments today are also progressing quite nicely. And we are exceeding our target of 30%, and comfortable saying that we will deliver sales transfer of at least 30%, and maintain that as we close these stores.

But from the standpoint of the remainder of our portfolio, obviously these sales transfers will have a positive impact on comp sales for our remaining stores. We're quantifying that as we speak. And certainly as we talk to you in February, and talk about our 2015 outlook for adjusted operating income, we'll give you a little bit more color there.

But I think, preliminarily, we would expect in 2015 somewhere in the neighborhood of 2 points of comp sales improvement, based entirely on the benefit from our closed stores for this year and the ones that we will close throughout 2015.

Michael Lasser - *UBS - Analyst*

And will you already start to see that in the fourth quarter? Is that why you're expecting your retail comps to be down better than the minus 3% that you did through the first three quarters of the year? Or is that just because of the comparison is a little bit easier? Thank you.

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

Well, our sales transfer, Michael, actually ramps up over a period of time. And so because we're closing the majority of these stores fairly late in the year, I expect it to have a very minimal impact on same-store sales in the fourth quarter. My comment that we expect a modest improvement in the same-store sales trend in the fourth quarter is really about some investments that we are making in promotions, in staffing, and in marketing, so that we can be as competitive as possible in the important holiday season. And we think that the benefits of these investments are going to pay out in some modest improvement in the same-store sales trend.

Michael Lasser - *UBS - Analyst*

Thank you very much. That's helpful.

Operator

Simeon Gutman.

Simeon Gutman - *Morgan Stanley - Analyst*

Good morning, and nice results. Roland, you mentioned with respect to next year's guidance, that the Street numbers were low, and you obviously were looking at a better outlook. I think the disconnect is not in synergies. I think the Street, I think, largely embraces that the synergies are good, and they are going to be realized. I think it's in the core business.

And so the guidance effectively implies that the deleverage, I guess, or the core stays intact, and that the deleverage doesn't continue or doesn't happen. Is that fair? And is that more a function of how you are executing, how the sales transfers are going, or is it also a function of the environment?

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

Morning, Simeon. Thanks for your question. As we look at 2015, we do not believe that the secular headwinds that we are currently facing are going to abate. And we still expect that we're going to have to deal with those secular headwinds and declining revenue in some of our key categories.

We have baked that assumption into our forecast for 2015. We do believe that our execution is improving. We do believe that some of the things we're doing around our USP is going to have a positive impact. Many of those things will take time to actually learn and actually roll out. But some of the early learnings we think we'll be able to implement in a smaller way across several of our businesses.

And that's why I also mentioned that we think we'll have some modest improvement in the decline of same-store sales also in 2015. As I mentioned, similar kind of expectations for the fourth quarter of 2014.

We do expect that there will be some continued deleverage in 2015 because overall sales will continue to decline. But we do expect that we will realize the merger and reorganization synergies that we have highlighted today.

We've done a great job in the first year of our merger of actually not only realizing more than anyone thought was reasonable, but also we have realized it faster. And so we certainly have baked that into our expectations for our 2015 outlook.

And that is why we have also highlighted for you today what we're calling our framework for growth. The first two categories of that framework really are around things that we are focusing most of our time and attention on now, which is improving execution across our businesses, which we think will have a positive impact ultimately on sales and profitability.

And we're working on our 2015 critical priorities that we will share with you when we get back together in February, just like we shared with you our 2014 critical priorities earlier this year. And you'll see from those some of the things that we think will ultimately benefit our ability to stabilize and grow our revenue.

We also continue to test and refine our USP, as I highlighted today; and three pretty exciting market tests that we are in the process of beginning to implement and learn from. And then a couple of opportunities to explore the ability to move into maybe adjacent markets or product extensions. I highlighted a couple that we're already investigating to include education, jan/san, and print.

Jan/san is an area where we are underpenetrated and have a smaller share than what we believe we should have. And we're in the process of understanding and focusing on how we can grow that. And print is another area where we think we have a fairly big opportunity.

And then we're also looking, as I mentioned, at some new business models which we think can provide revenue streams which are outside of our core business. And the combination of our two ladder buckets, I will call them, and our four components of our framework for growth, we think will be able to have an impact on that continued secular decline, and cover the revenue that we would be losing based on our expectation that that would continue for some time.

Now, these last two concepts are things that we are being very methodical about. We have a disciplined approach. We're analyzing all the numbers. And we are clearly not going to invest until we are certain that this investment would be accretive, not only in the longer-term but in the shorter-term, so that we can continue to bring the majority of our synergies and efficiencies down to the bottom line on an annualized basis.

A lot of these we believe we will learn and test in 2015, with the expectation of by the time we get to 2016, we'll be able to enjoy some improved revenue based on these actions, whether they are actions that help us improve our execution, actions that help us target segments that we believe that we can grow revenue in, or actions that will allow us to add adjacencies, or maybe even a different revenue stream than our current core business.

We'll give you more color, Simeon, on our 2015 expectations in February when we get back together and talk about our full-year results.

Simeon Gutman - *Morgan Stanley - Analyst*

Okay. Thanks for the color.

Operator

Christopher Horvers.

Christopher Horvers - *JPMorgan - Analyst*

So, you seem like you're going to build a very healthy amount of cash next year as you drive the improvement in operating income, and then cash flow, as well. How do you think about capital allocation as you get into next year? And the optionality to invest next year, as you reference -- would you consider any larger-scale acquisitions, say, over $100 million? Or do you think -- where does share repurchase line up in your capital allocation priorities?

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

Yes, Chris, this is Steve. Let me take a crack at that. I think in terms of the outlook, from a cash generation standpoint, I think consistent with the 2015 outlook on a preliminary basis that we've shared today, I think adding the expectation for core CapEx and then the scheduled decline in the amount of merger cash expenses we'll need to incur next year -- a big step will be getting $300 million of the $400 million of merger cash expense behind us this year -- that will enable us to go back to being cash flow positive from a free cash flow standpoint next year.

So, you're right -- we will start to build up our cash balances again for next year. I think it's important, though, that for 2015 we retain that kind of financial flexibility. Because we've got a lot of work going on, as Roland has highlighted, around, what do we do to drive the top line over the longer-term? This work around the unique selling proposition may lead us to opportunities where some capital investment would be a required to help build the foundation for future sales growth and profitability growth.

And I want to make sure that, from a balance sheet standpoint, we've got sufficient flexibility so that if we want to begin to increase the amount of capital we invest back into the business, we've got that flexibility. And I think our strong balance sheet today gives us that flexibility, so I would want to maintain that kind of flexibility throughout 2015.

Acquisitions today are not on the front burner of our thinking. But, again, I want the flexibility -- if we see an attractive opportunity which is likely to be smaller rather than larger, then I want to be able to fund that.

And I think, again, our cash position allows us to do that, which is the kind of position I'd like to be in down the road, when you think about returns to shareholders and forms of a dividend or stock buybacks. Again, I put that down the road. We've got a refinancing opportunity for our higher-cost debt that comes up down the road. I think we can achieve some interest savings through that, and give us the flexibility to think about returns to shareholders. But I'd put that farther down the road as a possibility for us.

Christopher Horvers - *JPMorgan - Analyst*

Understood. And then, one of the questions that we got from investors this morning was the performance in BSD. If you look at what your sole large competitor out there is doing in their North American contract business, that was up, I think, 4% in local currency in the second quarter. So, the big question I think out there is, how is customer retention? And what's driving the topline performance gap?

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

Let me start by saying that we think our customer retention is good. And from a large-format standpoint, we believe that we have added more customers than we have lost over the quarter.

But let me turn that over to Mark Cosby, who is, as you know, our new President of North America, and let him talk a little more about BSD as it relates to the third quarter. Mark?

Mark Cosby - *Office Depot, Inc. - EVP and President of North America*

Thanks, Roland. We do believe that we are executing well on integration plans as we have combined these two businesses together. We are winning new customers, and we are retaining the vast majority of the business that we had before the merger. In fact, we are winning customers from our primary competitors. And we believe that we've won more business than we've lost over the course of the last few months. So, it's a strong business for us. It's a high priority business for us. And we do believe we have a good growth future in front of us with this business.

Christopher Horvers - *JPMorgan - Analyst*

So is that just some of the adjacent category growth, where you have smaller exposure to, let's say jan/san, and print services, in the faster growing versus Staples? And your core part of the business is operating more in line with theirs?

Mark Cosby - *Office Depot, Inc. - EVP and President of North America*

Yes, we would -- our core business is strong. And we believe it is very much in line with the way Staples would be performing today.

Christopher Horvers - *JPMorgan - Analyst*

Okay, thanks very much.

Operator

Greg Melich.

Greg Melich - *ISI Group - Analyst*

Congrats on getting ahead of the --.

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

Hey, Greg, sorry, good morning. Could you speak up? We're really having a tough time hearing you.

Greg Melich - *ISI Group - Analyst*

Sure, no problem. Is that better?

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

Yes, a little. Thanks.

Greg Melich - *ISI Group - Analyst*

Okay. So, I'll keep it short. In terms of the cash costs of the stores closed, do you have an update as to how many leases you had to break of the first 65? And what you expect for next year and the year after, in terms of just leases that will roll off, and ones where you may actually have to buy it out? Thanks.

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

Yes, Greg. Nothing has really changed I think since the last time we talked about this. The predominance of the closures this year will include a significant amount of stores where the leases come to expiration. We did mention last time that we did think we would accrue about a $40 million reserve for future lease costs where we would close a store this year and have some remaining rent obligation that we would look to negotiate with the landlord, or look to sublease to help minimize the cash cost of that future rent obligation. That number is still good as of the third quarter. A very small amount of that had been accrued, so most of that would be in the fourth quarter.

So, again, I think what we're looking at is very similar to what we've talked about, is that we will focus on trying to minimize that ongoing rent obligation. When we talked about maximizing the economics of the closures, that's a key element of it. And, fortunately, we have a number of our stores that are on the target list for potential closures where the leases come due this year or next year. And those will be higher on the list of priorities to close as we go forward.

Greg Melich - *ISI Group - Analyst*

And so, if we think about cash restructuring costs next year -- fair to assume that it will be much, much less than what we see this year?

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

You're talking about on the store closures, or you're talking about overall?

Greg Melich - *ISI Group - Analyst*

Yes, and more (multiple speakers).

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

So, if you think about it, we've said -- excluding the real estate, we've said about $400 million of cash costs going through the P&L. $300 million of that will be incurred this year; most of that $100 million will be next year. Some will trickle into 2016, so it will be a significant decline in cash expenses.

And then you will incur some real estate expenses related to the closures. But again, they are going to be offset by some of the cash flow benefits as we close those stores. The working capital pickup, for example, offsets a lot of the cash closure cost.

Greg Melich - *ISI Group - Analyst*

Right, thanks a lot.

Operator

Matthew Fassler.

Matthew Fassler - *Goldman Sachs - Analyst*

The question I want to focus on relates to synergies. If you could give us a sense of the split of synergies by business across your three divisions, and/or by line item as you look at cost of goods and SG&A?

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

What I would say is, as a rule of thumb, about 30% of our synergies are coming from purchasing initiatives that will flow through the cost of goods sold line. About 70% will flow through SG&A. And that's a pretty good mix that I would expect it will be in effect this year, and over the longer term, as we get to the kinds of run rates that Roland has highlighted for you.

By business, we don't break that out. But just to be directional, I think roughly in North America, about half of the benefits flow through the retail side, and about half the BSD division.

Matthew Fassler - *Goldman Sachs - Analyst*

And to date, is it safe to say that most of the synergies are domestic rather than international?

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

Yes. Well, when we talk about merger -- yes, merger synergies -- when we try to identify merger-specific, that's only North America. Now, we've introduced with the recent announcement of the international restructuring, there will be an additional $90 million we've identified specifically related to their cost reduction program that is just getting started. And most of those benefits will begin to flow more in 2016. So that will be on top of the merger-related benefits that we've got.

Matthew Fassler - *Goldman Sachs - Analyst*

Great. And then one very quick one on the -- a little more creative question, hopefully. As you think about the store of the future, any sense as to how that store will be different in terms of size, staffing, decorum, presentation, categories? Just at a very high level, what you think we should look to see there.

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

Well, Matt, I think my answer is yes, because I believe that all of those things will be somewhat different than if you went into one of our stores today. Clearly the intent of the store the future is to improve the overall retail experience, specifically for the two target segments that we have talked about; those segments that are much more interested in quality and service and experience. But we also believe that there will be kind of a halo effect on other customers that are also interested in price and convenience.

We're already testing a number of specific elements as it relates to quality, service, and experience in individual stores, so that we can gauge how they work individually before we ultimately put these together in what we're calling our store of the future, or our concept store; which we, as I mentioned earlier today, expect to open up late summer of 2015. And that will include the benefit of everything we learn over the next number of months as it relates to better quality and better service and better experience.

And you can envision things that certainly would be included in those types of improvements. But it will also include a curated assortment of products and services along with those successful elements. And I guess what I would highlight the entire concept by saying is we expect it to probably be a smaller store from a footprint standpoint. And we expect it to be a very different experience than what we are providing our customers today, obviously in a very positive way.

Matthew Fassler - *Goldman Sachs - Analyst*

Thank you for the color. Appreciate it.

Operator

Gary Balter.

Gary Balter - *Credit Suisse - Analyst*

I'll have two follow-ups. First of all, congratulations on a very solid quarter, Roland and Steve, and everybody who's there. It's not an easy thing that you're doing, combining these two companies. Hopefully people appreciate the effort (multiple speakers).

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

Thanks, Gary.

Gary Balter - *Credit Suisse - Analyst*

Let me start with the question that -- I think it was Horvers who asked originally on the contract business, and the difference that we're hearing from your competitor in Framingham is claiming that they're gaining share, and your commentary that you're not losing share. You had an issue with pricing from some of the OfficeMax legacy contracts. Is that starting to wear off? And is that helping a little bit at the margin?

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

Well, Gary, we mentioned in that last couple of quarters in our calls that, in fact, some of the pricing of legacy OfficeMax was below what the profitability hurdles that we would expect our business to be today. And that was put in place largely right before the merger actually came to fruition.

And so we're living with the majority of that now. And the majority of it has not burned off; but it will over a period of time, kind of a longer period of time. And as that happens, our margins will improve.

But our current results, our expectations for 2014, and our outlook for 2015 still does expect that we will have some reduced margins based on some of those previous agreements that were signed, that would not be signed if we were negotiating on them today.

Gary Balter - *Credit Suisse - Analyst*

So that's built into the numbers, so that's not something that we should be focused on (multiple speakers). Then the second question, which is a follow-up to what Matt just asked on the state of the future -- it doesn't sound like you want to be too specific on the test. But one of the things that we do see, as we see companies like Best Buy essentially have said, hey, Samsung or Sony, you could pay for this part of the store because it's going to be your store.

And you guys have a technology area that sometimes looks somewhat dead, [to be polite]. And there's areas like home automation or others -- and maybe you don't serve the small businesses as much as you would like, but is some of that being tested? Are there any agreements being worked on with third parties to give them a piece of the store and let them manage it, to basically take the cost away from you?

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

Okay, that's a great question. The concept of a store inside of a store is something that we have contemplated and talked about at some length. At this point, we have not found a concept that we believe makes sense in that particular regard. But it is not a concept that we would rule out, out of hand, as we look at future opportunities as it relates to maybe adjacencies or other products that could provide certainly that target customer some of the quality and some of the service, and experience for that matter, that they might expect.

And so, I don't have plans at this point to include that concept inside of our store of the future. But it would certainly be something that we would continue to keep on our radar screen as we look for opportunities to grow our revenue.

Gary Balter - *Credit Suisse - Analyst*

That's great. Thank you very much.

Operator

Kate McShane.

Christopher Weng - *CITI - Analyst*

Hi, this is Chris filling in for Kate. Could you just talk a little bit about -- give a little color on your new selling model in Europe, and I guess when you expect to see results on that end?

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

Hey, Steve, are you on the line? Steve Schmidt from Europe?

Steve Schmidt - *Office Depot, Inc. - EVP and President of International*

Yes, Roland, I'm here. Chris, what we're doing in Europe, as we announced, is we're really moving from a country structure to a channel structure. And the reason we're doing that is several-fold. First of all, believe that we absolutely must operate our business at the lowest possible cost. But more importantly, we've got to focus on the needs of our customers. And so the restructuring that we're putting in place in Europe is all focused around how we can go forward more effectively against our three channels of business that we operate in, in Europe.

We're very confident in it. It's also designed to have us think, act, and behave as one. And as we looked at our European business, what we found was we had silos in each of the countries that were basically running the business differently. And so we're creating European common processes and practices, and doing everything we can to standardize the business where it makes sense to drive efficiency, but still keep a laser focus on the local customer, which resides at a local country level.

Christopher Weng - *CITI - Analyst*

All right, great. Thanks for taking my question.

Operator

That concludes the Q&A session for today.

I'd like to turn the call back over to Roland Smith for any closing remarks.

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

Thank you all again for your questions, and I'd like to close by just reiterating a couple of points. First of all, as you know, we're very pleased with our performance in the third quarter and our progress on achieving our merger synergies and executing against our critical priorities, which has obviously enabled us to raise our outlook for 2014 adjusted operating income to between $255 million and $265 million; which, as we mentioned, is 2.5 times more than last year's pro forma results.

Second, our continued progress gives us confidence to provide a preliminary estimated for 2015 adjusted operating income of approximately $475 million, which is an 80% increase over our 2014 outlook.

Finally, and I think maybe most importantly, our expected 2014 and 2015 adjusted operating income growth I believe is a true testament to the dedication and the hard work of all our associates, and I'd like to take this opportunity to personally and publicly thank them.

Thanks again for joining us this morning, and we look forward to updating you on our next quarterly call.

Operator

Again, thank you for your participation. This concludes the call. You may now disconnect.