THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

ODP - Q2 2016 Office Depot Inc Earnings Call

EVENT DATE/TIME: AUGUST 03, 2016 / 1:00PM GMT

CORPORATE PARTICIPANTS

Richard Leland *Office Depot, Inc. - VP of IR and Treasurer*

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

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

Mark Cosby *Office Depot, Inc.*

CONFERENCE CALL PARTICIPANTS

Matt Fassler *Goldman Sachs - Analyst*

Michael Lasser *UBS - Analyst*

Oliver Wintermantel *Evercore ISI - Analyst*

Dan Binder *Jefferies LLC - Analyst*

Mike Baker *Deutsche Bank - Analyst*

Simeon Gutman *Morgan Stanley - Analyst*

PRESENTATION

Operator

Good morning, and welcome to the Office Depot second-quarter 2016 earnings conference call. (Operator Instructions) At the request of Office Depot, today's call is being recorded. I would like to now introduce Richard Leland, Vice President, Investor Relations and Treasurer. Mr. Leland, you may now begin.

Richard Leland - *Office Depot, Inc. - VP of IR and Treasurer*

Good morning, and thank you for joining us. This is Rich Leland, and I am here with Roland Smith, our Chairman and CEO; Steve Hare, our Executive Vice President and CFO; and Mark Cosby, our North American President. On today's call, Roland will summarize the second-quarter performance and provide an update on the business, including the comprehensive business review that we announced back in May. Steve will then review the Company's quarterly financial results and outlook. Following Steve's discussion, we will 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 will use of 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 and reconciliations of the non-GAAP financial measures to the most directly comparable GAAP financial measures 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.

I will now turn the call over to Roland.

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

Thanks Rich, and good morning, everyone. Since our last call on May 16 announcing the termination of the Staples merger agreement, we have made significant progress, and I'm happy to be here today to discuss our second-quarter results and provide an update on our strategic business review.

Beginning on slide 4, our results in the second quarter of 2016 continue to be substantially impacted by the uncertainty surrounding the prolonged Staples acquisition attempt that was ultimately terminated in mid-May. Similar to the first quarter, our business solutions and international division felt the greatest impact as they experienced significant customer attrition during this period of uncertainty. Also, many potential customers took a wait-and-see approach to awarding new business pending the court's final decision on the merger.

As a result of the extended regulatory process, as well as the planned US store closures, total Company sales declined 6% in the second quarter compared to the same period last year. The US retail store closures contributed approximately 3 percentage points of this total sales decline.

Operating income in the second quarter was $253 million and included the $250 million fee paid by Staples in connection with the termination of the merger agreement, which was partially offset by $63 million of expenses related to the acquisition, OfficeMax integration and other restructuring activities. Excluding these items, our adjusted operating income in the second quarter was $67 million, compared to $73 million in the prior-year period.

Although adjusted operating income was down versus last year, our adjusted operating margin for the quarter was flat. This was primarily due to the benefits received from store closures, expense reductions and merger integration synergies that helped offset the negative flow-through impact from lower sales.

Net income for the second quarter was $210 million, or $0.38 per share, compared to a net loss of $58 million, or $0.11 per share, in the second quarter of 2015. Adjusted net income was $19 million, or $0.03 per share, compared to $32 million, or $0.06 per share, in the prior year. Adjusted net income and earnings per share were negatively impacted by a significantly higher tax rate in the quarter.

I am very pleased to report that our liquidity position remains strong, and we ended the second quarter with over $1.1 billion in cash and total liquidity of over $2.2 billion.

Turning to slide 5, we made substantial progress during the quarter on several of our critical priorities. First and importantly, our North American team has been hard at work rebuilding the sales pipeline and winning new customers. As you may recall, we recently restructured our contract organization to increase the resources focused on driving new business acquisition and growing existing customers. This focus, coupled with removal of the merger uncertainty, led to several multimillion-dollar wins during the quarter. However, depending on the complexity of the account, implementation can take from several weeks to several months before it turns into meaningful revenue.

Overall, we are pleased with our progress and expect the sales trends in our business solutions division to improve in the second half of the year, as we are now able to fill the sales pipeline and win new business.

We have also made substantial progress over the past several months migrating the legacy OfficeMax contract customers to the Office Depot platform. The migration is being managed by a dedicated internal team in order to drive productivity and accountability and ensure we minimize any potential customer disruption. We were also taking a geographically-based approach to converting customers that is closely aligned to our supply chain consolidation strategy in order to avoid any impact on customer deliveries.

Overall, customer reaction to the Office Depot platform continues to be very positive, largely because it includes a broader assortment and enhanced functionality.

We expect to have both the customer migration and supply chain consolidation substantially completed by the end of 2017.

I am also pleased to announce that during the quarter we completed phase 1 of the US retail store optimization plan and closed our 400th store under the program. This plan was completed ahead of schedule, and the Company has realized over $100 million in benefits from this initiative. Stores that benefited from the transferred sales now have higher margins and are more profitable as a result.

Internationally, we are continuing to explore strategic alternatives for our operations in Europe and have a process well underway to determine if a sale of this business can be executed on acceptable terms.

Turning to slide 6, I would like to provide an update on our comprehensive business review and share some of the opportunities that we have identified as part of this process. Recognizing that our business model must continue to evolve, we announced on May 16 that we had engaged Bain and Company to assist us with finalizing a comprehensive strategic review of the business. This review included a detailed analysis of the Company's current operating model, growth opportunities and cost structure to support our overall framework for growth.

In addition, we began an analysis of our capital structure and various shareholder return alternatives.

Based on output from this work, we have developed a three-year strategic plan designed to grow profitability and provide shareholder value. The four key pillars of this plan include accelerating growth in our contract channel, optimizing and reinventing our North American retail model, implementing a number of multi-year cost reduction initiatives across the Company, and enhancing shareholder value through a more efficient capital structure, additional share repurchases and initiating a quarterly dividend. Now I would like to highlight a few of the initiatives that are underway to support this plan.

As we have noted on slide 7, our strategic review process identified a number of opportunities to grow sales in the contract channel of our business solutions division by improving penetration into adjacent categories and increasing our share of wallet with existing customers. In this regard, we have identified a significant opportunity for growth in the facility space, which remains a large and fragmented market with desirable future growth characteristics for Office Depot. Importantly, our customers are increasingly asking us to compete in this space as they consolidate their procurement spend and vendor relationships across a variety of jan/san, safety, and other maintenance and repair products. Accordingly, we believe we have a significant cross-selling opportunity to leverage our relationships with existing customers by offering an expanded assortment.

While our current assortment has breadth, we believe there is a significant growth opportunity to increase our depth in many categories by tripling the number of SKUs we currently provide and also adding private-label alternatives. We intend to aggressively pursue this opportunity by enhancing our capabilities and increasing our selling efforts to drive penetration and growth in the coming years. We can accomplish this plan organically, but we will also investigate making select acquisitions in this space to accelerate our time to market.

Our strategic review also confirmed that education continues to be a significant opportunity. We continue to experience consistent growth in K-12. And, similar to the facilities space, we also see an opportunity in education to leverage our existing relationships and strong market presence to provide an expanded offering of services and solutions to both new and current customers. As part of our Committed to Learning initiative, we have formed a national team of education experts and partners to focus on the shifts occurring in education. This team has been successful in broadening our access within school districts.

By listening to the needs of educators, we are curating an offering that addresses the unique needs of K-12 customers and leverages our capabilities beyond school supplies and into areas such as technology, furniture and print. We believe we have a strong position in this area and remain optimistic about the future growth opportunities.

Beyond the opportunities in education and adjacent product categories, we are leveraging our omnichannel capabilities in order to reach new small-business customers in the retail and direct channels. Today, many of these customers shop at our retail stores or on our public website and use our loyalty program and other promotions to lower their overall costs. This new test program, which we call Business Select, provides these small-business customers with competitive pricing focused on a number of essential products along with an improved customer experience and enhanced e-commerce site. It is also supported by our omnichannel capabilities that allow all our contract customers to buy online at their contracted prices and pick up products at their convenience in our retail stores. We believe we have created a model that provides small-business customers with a consistent experience and improved pricing regardless of how or where they prefer to shop.

Lastly, we believe we have an opportunity to transition to a more effective sales coverage model for accounts of all sizes. Over the past several years, we have improved our customer focus by balancing the benefits of an inside and outside sales coverage model. By increasing our inside sales capacity, we believe we can further improve overall sales effectiveness so that our field team can focus on winning new customers and driving the adjacency and share of wallet opportunities that I described earlier.

In summary, we have identified several meaningful areas of growth across various segments of our business solutions division, and I believe that BSD remains an attractive platform to build on for the future.

The second pillar of our strategy involves reinventing the North American retail business model. Slide 8 highlights that during the second quarter of 2016, we completed the first phase of the US retail store optimization that was launched in early 2014. This plan resulted in the closure of 400 stores, led to the realization of over $100 million in benefits and achieved sales transfer rates in excess of 30%. Based on the success of this initiative, we are expanding into a second phase by closing approximately 300 additional stores over the next three years. While the first phase of this plan focused on unprofitable and redundant stores from the OfficeMax merger, the second phase of this plan will be focused more on consolidating trade areas that aren't large enough to support the current number of stores. As a result, most of the stores identified for closure have low sales volumes and marginal levels of profitability.

Because of our demonstrated ability to successfully transfer sales in phase 1, we are confident that these additional closures will also deliver substantial P&L and working capital benefits. We currently plan to close 25 stores in the second half of this year as part of this plan.

Beyond store closures, we have identified an opportunity to transition to a simpler and lower-cost operating model in our current retail stores. We're in the process of rolling out a new work force scheduling tool that will more efficiently distribute labor based on traffic patterns during the day, as well as taking a differentiated view of each store's labor structure based on volume. In addition, we have reviewed the functions currently being performed in our stores and identified numerous opportunities to streamline and simplify tasks based on reducing noncustomer-facing activities such as price changes and stocking.

Outside the store's four walls, we are also looking at additional efficiencies in other support areas such as supply chain, merchandising and marketing that impact profitability. Here, too, we have identified several cost-saving opportunities and have plans in place to transition to a less complex and lower-cost support structure.

Reinventing our retail business model requires a bold new customer proposition, which is why we launched our 15,000-square-foot store-of-the-future test in February. As we mentioned on our last call, this new store format incorporates elements from our work over the past year developing our unique selling proposition to capture an additional opportunity that we have identified with those customers that value quality, service and experience. Accordingly, the store-of-the-future model offers customers a more curated assortment of products that are arrayed in an easy-to-understand good, better and best display, along with increased space and trained associates dedicated to services such as copy and print and tech support.

On slide 9, you can see that the new format is also designed to be easier for customers to shop, with lower shelf heights, better signage and a more modern look and feel. In addition to being easier to navigate, it is also a more intuitive way to shop, with better product adjacencies in order to encourage complementary purchases across categories. We expect that many, if not all, of these elements will be incorporated across our retail portfolio in the coming years.

While we are still in the early stages of the test, the initial results are encouraging, and we are expanding the number of test stores under the program. We converted three additional stores in early July, plan to expand the pilot program to a total of 24 stores by the end of 2016 and are targeting 100 stores in 2017.

The third pillar of our strategy is to continue to reduce costs across our business and become more efficient as we right-size the organization. You will note on slide 10 that the integration of OfficeMax remains on track, and we continue to expect merger synergy benefits of more than $750 million from the integration when substantially completed at the end of 2017.

As a result of our comprehensive business review process, we identified additional opportunities to further increase efficiencies and optimize the organization. Several of these I have already mentioned, such as the operating cost savings in our retail organization and the benefits from the next phase of our retail store optimization program. In addition to these, we are also launching cost-saving initiatives across other key business areas. For example, our analysis identified an opportunity to significantly reduce indirect procurement costs as well as lower our overall general and administrative costs.

In total, these cost-saving programs are expected to deliver over $250 million in additional annual run rate efficiencies by the end of 2018 and, when combined with the synergies from the OfficeMax merger, bring our total annual estimated benefits to more than $1 billion.

Based on our strong liquidity position and confidence in generating future free cash flow, our fourth strategic pillar is dedicated to enhancing total shareholder return. As detailed on slide 11 of the presentation, today we announced a number of initiatives to optimize our capital structure and return capital to shareholders. First, we have decided to redeem our 9.75% senior secured notes on September 15. By retiring this high coupon debt, we will realize approximately $24 million in annual cash interest savings.

Second, I am very pleased to announce that the Board of Directors has approved the initiation of a quarterly cash dividend. The initial quarterly dividend is $0.0025 per share on the common stock of the Company and is payable on September 15 of 2016, to shareholders of record on August 25. The annualized dividend of $0.10 per share represents approximately a 3% yield.

Lastly, we announced today that the Board of Directors has also approved an increase in our stock repurchase program from $100 million to a total of $250 million. As of last Friday, July 29, the Company has repurchased approximately 16 million shares for an aggregate cost of approximately $55 million. These actions demonstrate our ongoing commitment to returning capital to shareholders and enhancing overall shareholder value. It also demonstrates our confidence in our ability to generate future cash flow, including funding the strategic plan that I have outlined today.

Now I will turn the call over to our CFO, Steve Hare, to discuss our second-quarter results in more detail before taking your questions. Steve?

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

Thanks, Roland. Turning to consolidated second-quarter 2016 results on slide 13, sales in the quarter declined 6% compared to the prior-year period. Total adjusted sales declined 3% compared to the prior year, excluding the impact of US retail store closures in the prior 12-month period.

Second-quarter adjusted operating income was $67 million, or $6 million lower than the same period last year. The year-over-year decline was primarily due to the negative flow-through impact from lower sales and $15 million in favorable legal settlements that were recorded in the prior-year quarter, offset partly by the benefits from store closures, expense reductions and merger integration synergies.

Adjusted net income in the second quarter of 2016, which excludes the after-tax effect of special items, was $19 million, or $0.03 per share, compared to adjusted net income of $32 million, or $0.06 per share, in the same period one year ago. The tax rate in the second quarter was approximately 15 percentage points higher than the prior year and was impacted by losses recorded in certain international jurisdictions for which no current benefit can be recorded. This higher tax rate reduced adjusted net income and EPS in the current quarter.

Turning to slide 14, same-store sales in North American retail declined 1% in the quarter compared to the prior year. The comp sales decline was mainly driven by lower transaction counts, although average order value increased for the period. Total retail sales decreased 7% versus prior year, primarily due to the impact from the planned US store closures in the prior 12-month period.

Looking at our performance by product category, retail sales increased in furniture, cleaning and break room, copy and print, and in supplies compared to the prior-year period. 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 accounted for approximately 2 percentage points of comp sales decline.

The North American retail division reported an operating income of $30 million in the second quarter of 2016, compared to $42 million in the prior-year period. This year-over-year decline was primarily driven by lower volume from the planned US store closures and $15 million in favorable legal settlements that were recorded in the second quarter of 2015.

The negative impact from those two items was partially offset by lower occupancy costs and operating expenses mainly in payroll and other store costs. The North American retail store count at the end of the second quarter was 1,513. During the quarter, we closed 42 stores as we completed our first phase of the retail optimization plan that was announced back in early 2014.

On slide 15, I will now review our business solutions division, or BSD, results. Sales in the second quarter of 2016 were $1.3 billion, a decrease of 7% from the prior-year quarter as reported and in constant currency. Sales were down in both the contract and direct channels. The decline in contract channel sales in the second quarter was principally driven by the prolonged Staples regulatory process, during which time we experienced significant customer attrition and an abnormally low new-acquisition pipeline.

In the direct channel, sales declined largely due to the impact associated with decommissioning of legacy OfficeMax e-commerce sites and, to a smaller extent, the ongoing reduction in catalog sales through our call centers.

Looking at our performance by product category, BSD sales decreased versus the prior year across most product categories, with the exception of cleaning and break room, which had positive sales growth.

Second-quarter sales in the US contract channel increased in K-12 compared to the same period last year. This solid performance is primarily attributable to the investments we have made to grow this area of our business.

The BSD's division's operating income for the second quarter of 2016 was flat to the prior year at $63 million. However, the division's operating margin improved by approximately 30 basis points, primarily due to a higher gross margin rate and lower operating expenses including payroll and advertising, which helped to offset the negative flow-through impact of lower sales.

Turning the slide 16, second-quarter reported sales for the international division decreased 4% versus the prior year and 2% on a constant currency basis. Sales declined in both the contract and direct channels but increased in retail. The contract channel sales decline for the quarter was driven primarily by the continued business disruption from the Staples acquisition attempt and the related European divestiture process, as well as the exit from unprofitable business in Asia. Lower sales in the direct channel reflect the continued decline in catalog sales and ongoing competitive market pressures experienced in our largest markets.

In the retail channel, sales growth was attributable to higher transaction counts and average order value.

The international division reported an operating loss of $10 million in the second quarter of 2016, compared to operating income of $2 million in the prior-year period. This decline primarily reflected the negative flow-through impact of lower sales and a lower gross margin rate partly due to the initial margin impact usually experienced with new contract wins. Partially offsetting the lower gross margins were reductions in our selling, general and administrative expenses in the quarter including payroll and support costs.

Turning to the balance sheet and cash flow highlights on slide 17, we ended the second quarter of 2016 with total liquidity of $2.2 billion, consisting of $1.1 billion in cash and cash equivalents and $1.1 billion available under our newly extended asset-based lending facility. Total debt at the end of the quarter was $654 million, excluding $808 million in nonrecourse debt.

For the second quarter of 2016, cash provided by operating activities was $287 million. This included the $250 million termination fee paid by Staples, partially offset by $37 million in acquisition-related expenses, $31 million in OfficeMax merger integration costs, and $16 million in international and other restructuring costs. Capital expenditures were $23 million in the quarter, $6 million of which were related to the OfficeMax merger integration. As part of the approved stock repurchase program announced in May, the Company repurchased a total of 7 million shares of its outstanding common stock during the quarter for a total cost of $26 million.

Slide 18 outlines the components of our 2016 outlook. We experienced a significant negative sales impact in the first half of the year from the business disruption surrounding the extended Staples acquisition attempt. The regulatory review process lasted longer than we had originally projected. And while we are making good progress rebuilding the pipeline and winning new business, it has taken longer than we anticipated. We expect sales pressure to continue throughout the remainder of the year, but at a decelerating rate as we make further progress in these areas.

In addition, sales will also be reduced by the additional store closures announced as part of a phase 2 retail optimization plan, the impact of our exit of unprofitable business in Asia and continued softness in the international markets. As a result, we maintain our sales outlook that total Company sales in 2016 will be lower compared to 2015.

Based upon this lower sales outlook, we now anticipate the Company's adjusted operating income to range between $450 million and $470 million in 2016, which is essentially flat to the prior year. We continue to be on track to achieve more than $750 million in total annual run rate synergy benefits from the OfficeMax integration, with the integration expected to be substantially complete by the end of 2017. The additional cost savings initiatives that we announced today are supplemental to the OfficeMax merger synergies and will begin to be realized late in 2016 and eventually build to the $250 million estimated annual run rate by the end of 2018. We are still developing cost estimates, but our initial projections are for approximately $125 million in one-time costs to achieve these savings.

As Roland mentioned earlier, we have now commenced phase 2 of the retail store optimization plan and expect to close about 25 stores in the second half of 2016 as part of this plan. We expect to incur approximately $100 million in merger integration expenses in the 2016 to 2017 period, with approximately $70 million of this spend occurring this year. Our capital spending estimates are lower, and we now expect to spend approximately $175 million in 2016. Approximately $50 million of this year's capital budget is related to the merger integration.

Depreciation and amortization expense this year is estimated to be approximately $215 million.

We are forecasting to generate free cash flow of approximately $200 million in 2016 and expect this to build to about $300 million in 2017 as one-time spending on merger and integration activities abates.

The Company's effective tax rate for both GAAP and non-GAAP will continue to be affected by losses in foreign jurisdictions with valuation allowances. The actual rate will depend substantially on the mix and timing of income across the Company's jurisdictions, but we are currently expecting an annual non-GAAP effective tax rate of approximately 45% for 2016. We estimate that our cash tax rate will range between 10% and 15% as we are able to utilize available tax operating loss carry-forwards and credits.

I will now turn the call back over to Roland.

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

Thank you, Steve. I am very encouraged by the progress we are making in moving our business forward, and I believe our reduced 2016 guidance is primarily a timing issue due to the extended regulatory review process.

We are beginning to win new business and have a strong start to rebuilding our sales pipeline now that the uncertainty of the Staples merger has been removed. We have completed our comprehensive business review and developed a three-year strategic plan designed to grow profitability and providing shareholder value. Our plan includes aggressively pursuing several attractive growth initiatives and delivering substantial incremental cost savings.

Finally, based on our confidence in generating future cash flow, we are enhancing shareholder return through a combination of debt retirement, increased share repurchases and the implementation of a dividend.

I'm excited about the opportunities ahead, and I look for to updating you as we make progress on our new strategic plan. Operator, please open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Matt Fassler, Goldman Sachs.

Matt Fassler - *Goldman Sachs - Analyst*

Two quick questions here. The first one relates to the cost reduction efforts, that $250 million. You have operated pretty lean and you have taken a lot out in terms of OfficeMax synergies. Where would you say in the organization the opportunities lie for that kind of cost reduction at this point?

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

Good morning, Matt. It's Roland. As I mentioned in my prepared comments, we think that there are four areas where we will be able to take this $250 million of cost reduction out of our business. And as I mentioned in my prepared comments, we believe that our run rate will be greater than $250 million by the end of 2018. Those areas are a lower retail cost model where I highlighted several of the initiatives that we have in our retail business to reduce costs. We will also close in phase 2 of our optimization plan another 300 stores. We also have identified some significant reduction in indirect procurement, and we also think there are some lower G&A costs across the Company, which would include both G&A and being more efficient in how we are operating the Company.

What I would say is we've been very, very successful in bringing the merger synergies and the OfficeMax merger to the bottom line, as you know. As of the end of 2015, we had generated approximately $600 million in savings. And while the disruption from the Staples acquisition attempt caused us to delay this overall progress by about a year, we continue to be very confident that we're going to be able to generate $750 million of savings now by the end of 2017 when that is substantially complete.

Based on these four additional areas as I have highlighted today, that we will begin to put plans in place as we speak. We will receive a minimal benefit in 2016. We think the substantial benefit, as Steve mentioned, will be in 2017 and 2018 and probably balanced evenly between those two years. We will add that $250 million until the total ability to generate benefits by the end of 2018, as I mentioned, is right at $1 billion. I would say that our success in generating the savings in the OfficeMax merger ought to give you great comfort that we can in fact bring this additional $250 million to the bottom line.

Matt Fassler - *Goldman Sachs - Analyst*

That's very helpful. And then a second quick question. If you could talk about the environment for new business in BSD and the contract arena, obviously with the deal in process and then on hold for a lengthy period of time, presumably customers are hesitant to make decisions. Are you seeing a series of decisions essentially that were deferred already being made? Is the pitch-and-bid effort now in process with more accounts than is typical? What's the cadence of some of those decisions and presumably changes in the marketplace today?

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

Yes, Matt, I want to address that a little bit, and I'm going to repeat a few of my comments from my prepared statement. But let me go back and just reiterate that in the first half of the year, we did experience some substantial impact by the prolonged Staples regulatory review process. As Steve mentioned, the process ultimately took longer than we anticipated, and we experienced a couple of things that had a direct impact on our business. First of all, we have higher customer attrition. We had historically low new-acquisition pipeline. And we had a general wait-and-see attitude by customers to signing new business.

So to your question, I believe that disruption is now behind us. We are making very good progress. We are engaging with customers. Our sales force is excited. As we mentioned on our call on May 16, we have retooled our model slightly, and we now have more hunters in the field. So we are filling our pipeline and we are winning new business. And I mentioned that we had won in this quarter some new business in the area of millions of dollars.

That all being said, it is taking a little longer than we anticipated primarily based on the length projected -- the protracted Staples regulatory review process. Also understand that once you actually sign a new account, it can take from weeks to months before it actually produces a significant amount of material revenue.

But all that said, I think we're making good progress. It's taken a little longer to rebuild this business. In fact, I would say we are probably about a quarter behind where we would expect to be at this point based on the length of the process. That was reflected in our reduction of guidance. But as I mentioned and Steve alluded to, we believe it's primarily a timing issue, and we think we will be back on track as we get into the third and fourth quarter.

Matt Fassler - *Goldman Sachs - Analyst*

Thank you so much.

Operator

Michael Lasser, UBS.

Michael Lasser - *UBS - Analyst*

Roland, do you think you could size or quantify the impact to your contract business from this disruption associated with the Staples failed merger?

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

Morning, Michael. We talk about that a lot. As a matter of fact, over the last week or so, we have had some significant conversations about -- hypothesizing how much do we think that is going to really hurt us. I don't know that we can put an exact number on it.

What I can say is this, Michael. It was a long 18 months while we went through the process of attempting the Staples acquisition. As I mentioned in Matt's question, we have higher customer attrition. We had a depleted pipeline. We had the inability to sign new business. Our European business was under a sales process. We had a one-year delay in our synergies and efficiencies, which you know are back on track. And we had higher associate attrition, which was impactful on our business, and we were unable to hire for some of the positions that we would have liked to.

That all being said, I am pleased to say we stayed completely focused on our critical priorities. Even during that time, we launched a couple of exciting new initiatives like our store-of-the-future tests, which are now in the market. We now have five that are out there and working. And the Business Select opportunities that we also talked about our prepared comments.

And in light of all that, our adjusted operating income from 2015 to 2016 is projected to be flat, which I would say, in light of this situation, we are relatively pleased with. So I can't give you an exact number of what it cost us. What I can say is that if this process didn't happen, we would be delivering significantly more profit in 2016 than we are. But I can also say we are very excited about our three-year strategic plan, which has the four pillars that we talked about today. And we believe that by implementing this plan, we are going to be back on track in 2017 to growing our profitability and providing shareholder value.

Michael Lasser - *UBS - Analyst*

Understood. I guess directionally, do you think that the disruption from the uncertainty got worse from the first quarter to the second quarter this year, or did you see a modest improvement from that effect?

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

I would say it's a combination, Michael, of two factors. First of all, because the decision was not made until the middle of the second quarter, basically the middle of May, up until then, the attrition continued, the pipeline got drier and our ability to sign new business did not improve. And the -- I would say the summary of the impact from the entire 18 months gets greater as you get greater into the process.

That being said, we did get back to work in the second quarter. We did begin to engage in customers. We did sign new businesses. And so while we are excited about what we have been able to accomplish, you don't really see it show up in the numbers in the second quarter yet because that revenue takes some time before it actually makes it to the bottom line and turns into profitability.

So, I think it continued to erode through the second quarter. And again, the process took longer than we originally had expected. I would say that we are out of the cloud of the disruption at this point, and we are excited about our ability to get back to work in the third quarter, not only filling our pipeline, but getting back to the process of moving our Company forward by beginning to implement the three-year strategy that we took you through today.

Michael Lasser - *UBS - Analyst*

That's helpful. My follow-up question is on the gross margin -- was down considerably year over year, it sounds like, from both the retail business and the international segment. Can you give us a little more detail on what drove the decline? Was it due to temporary factors? Was it due to a timing -- some mix in the quarter? Or is this the run rate we should expect from here on out?

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

Mike, this is Steve. When I look at the gross margin trends and what we delivered in the quarter, I think retail, when you go through that, was really relatively flat. BSD overall actually improved, which is encouraging. We are seeing some pressure, I would say the pressure even more so on the direct channel then on the contract channel. So, notwithstanding all the issues that we've got in building that pipeline that Roland just talked about, we are maintaining price discipline in that business, which I think is favorable for the future. Really, where the problem on gross margin is is international. So, with the extended process over there, the cloud over our contract business there with the business publicly known to be on the market, I think that we have seen the biggest impact on that business.

And then one other individual factor for international that is different than the market conditions we've got here or the pressures from the Staples deal is the fact that we did bring in a fair number of large new accounts that are outside of our core office supplies business. And those contracts will take some time to get to profitability. So, we are absorbing low margins on those wins, which I think over time will pay off, but that is adding pressure to the international results, and you're seeing that in the overall margins.

Michael Lasser - *UBS - Analyst*

Understood. Thank you so much for the color.

Operator

Oliver Wintermantel, Evercore ISI.

Oliver Wintermantel - *Evercore ISI - Analyst*

I had a question regarding inventories. It looks like inventories were slightly up or flattish. With the sales flow-throughs and sales down, I would have expected over the last two quarters that inventories are coming down. Can you maybe explain why inventories are still at this level?

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

Oliver, this is Steve. Yes, the store closure program has produced a reduction of inventories in the retail business. So, obviously going into a phase 2 program as we look ahead, we do see opportunities and are focused on further reducing the inventory. But I think your point is a valid one. We are not satisfied with the level of inventories we have got in the business today. Part of that is by design. With all the moving parts we've got here, as we consolidate our supply chain in order to maintain service levels for our customers, and especially during a time when we are under pressure because of all the issues we have talked about with the Staples merger, we have, I think, maintained a higher safety stock level in order to maintain, I think, better deliveries as we stabilize the supply chain going forward.

So, some of that inventory build is by design. And we do think -- and we are working -- in addition to the cost reduction program that we talked about, we do see an opportunity. And as we talk about our free cash flow and our cash flow generation capability, we do see the ability to run this business at a lower level of inventory and improving overall terms. That will take some time to get there, but we've got a program in place to tackle that opportunity.

Oliver Wintermantel - *Evercore ISI - Analyst*

Okay. Got it. Thanks. And I also had a question around international. Would you sell that business in two different pieces like retail and commercial, or do you think it has to be sold as a whole? And maybe if you could, maybe some progress on the review there. Thank you.

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

Oliver, in terms of what we're doing internationally, right now, as we talked about on the last call, there was a sale process that was related to the Staples acquisition that would've been required to get European commission approval. What we've done since the deal was turned down was go back to the people that have been contacted and expressed interest in that process and are trying to reassess from our own perspective whether any of that interest in the business is something that would make sense for us going forward. So, we have got that process and that evaluation underway. That would be for the entire European business.

Now, going beyond that, in terms of the ability to sell that business by the segments or by countries, I think that's a possible way. And if that was a way to increase the value of a divestiture, I think we certainly would be open to exploring that as well. But I think for now we're just trying to make a fundamental decision: is there sufficient interest in the business today that would make a sale of that business or divestiture of that business make sense for us as part of a new strategy going forward.

Oliver Wintermantel - *Evercore ISI - Analyst*

Okay. Thanks very much.

Operator

Dan Binder, Jefferies.

Dan Binder - *Jefferies LLC - Analyst*

My question is related to the integration activity. I was wondering if you could give us a little bit more detail on where you are with the systems and supply chain integration specifically and where you ultimately think the warehouse count will get to, and if you are seeing any disruption or service-level issues as you go through that process.

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

Good morning, Dan. It's Roland. I think I'll handle that one. As I think you know, the continued integration of OfficeMax continues to be a top priority for us. I mentioned a few moments ago and I will repeat that we were well on track. But as the Staples acquisition opportunity and the regulatory review process took a significant amount of time, it's certainly disrupted that integration. The primary disruption, quite honestly, had to do with migrating customers that were on the OfficeMax platform to our Office Depot platform. Because as you can imagine, customers were unwilling to convert during the time frame when they thought that ultimately they would have to convert against a Staples.

So we put that on hold, and that also had an impact on our supply chain consolidation because, as you can also understand, the migration of customers from one platform to the Depot platform also has to be done in sync with how we are consolidating our supply chain facilities so that we can ensure that we don't have disruption.

As I mentioned, I think, on our last call, and as I think we have also published in our ongoing press releases, we did have some disruption in our supply chain predominantly in 2015. We brought in new leadership. We retooled the work stream. And I'm pleased to say that, as we speak to you this morning, our supply chain consolidation is back on track. Our migration of customers from OfficeMax platform to Office Depot is back on track. We think both will be substantially complete by the end of 2017. And the disruption in our supply chain is that it had to do with on-time and accuracy of customer deliveries has now abated, and we are back to our historical level of metrics that we would track to ensure that our customer satisfaction is good.

So, I am pleased that we have made significant progress in that particular area. I will just reiterate that we fully expect to deliver more than $750 million of merger synergies by the end of 2017 as a run rate when it will be substantially complete. We clearly are in the process of consolidating, closing down additional distribution facilities. We are not going to get into this morning the exact number of where we are and where we're going, but be comfortable that that is back on track and is not negatively impacting our business.

Dan Binder - *Jefferies LLC - Analyst*

There's two other items. If you could give us a sense of how the early back-to-school business is going, that could be helpful. And then finally, in terms of the contract business, as you do expand that business and try and grow it, could you give us a sense of the number of sales people that you will be hiring in terms of net additions to pursue those opportunities?

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

Hey, Dan. It's Roland again. I'm sorry; I missed your first question. Could you repeat that? Oh, back-to-school. (multiple speakers) We would love to talk about back-to-school. We are well into that program. I hope you have seen some of our new commercials which we are pretty excited about. Mark Cosby, the President of North America, is here with us today. And Mark, why don't you handle the back-to-school question?

Mark Cosby - *Office Depot, Inc.*

The short answer is we feel good about the back-to-school season. We know it will be competitive, but we feel like we have all the tools in place to win at the end of the day. We actually started the development of our back-to-school program a year ago after the completion of our successful program last year, where we delivered a favorable comp sales result. We looked at what worked last year and we looked at what didn't work last year, and we have put together a very comprehensive plan to address both the strength and the opportunity.

The result, we feel, is a very strong program. We have a number of new products. We have aggressive promotion programs in place. We have improved our store service and selling capabilities as we focus our sales organization in our stores on selling versus just tax. And we also feel like we have a compelling TV campaign really focused around getting back to great and getting our folks and our kids off the couch, back into our stores, and off to a great school season. Hopefully you've had a chance to see our commercials which bring that to life.

We're also excited about a new program that we started this year where we were partnering with schools to help them raise money as we provide them with a percentage of our sales results. And then we also provide discounts to teachers to help with their school supply needs. This is a new program where we are participating with a number of schools across the country, and the early results there are favorable.

So, short answer to your question is we feel like we have a very good program, and we are off to a good start with back-to-school.

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

Thanks, Mark. Let me see if I can address your question as it relates to our contract sales organization, Dan. As you know from our last call, we began to look at our organization and optimize that structure when we spoke to you on May 16. At that point, we announced that we had added a significant number of sales reps so that we could more focus on hunting. As we completed our comprehensive strategic business review, that was an area that we looked at in depth. We have a very capable and a large sales force that does a great job of interacting with our customers.

We do believe, however, based on customer feedback that we can begin to shift some of the activities that our field sales folks do right now to our inside sales folks, which is more efficient and effective. And then we can refocus those field sales folks on things like hunting new business, expanding into the adjacencies that we talked about today -- and I should mention that we are very excited about this jan/san opportunity. I know we have talked about jan/san for many years, but, quite honestly, we have a very small percentage of our revenue that really is jan/san these days. It's a big and growing category. It's $24 billion. It's highly fragmented. Our customers are asking us regularly why don't we help them consolidate their own purchases and vendors and provide them more jan/san products.

I mentioned today that we're looking to triple the number of SKUs and add private-label. We are also looking at making some selective acquisitions and to allow us to get to market more quickly. Net, we believe that the facilities business in general is a big opportunity that extends beyond jan/san, as I mentioned. But just the jan/san business in and of itself, we think, is a $1 billion opportunity for us if we are able to garner somewhere between a 3% to 5% share, which is very reasonable. And so that's why we think that is a big opportunity. And clearly by looking at our operating model within our sales organization and focusing some of the tasks inside, we believe that we can refocus many of our field sales reps to actually going out, hunting new business to include, being able to represent a much broader line of jan/san products that we can bring to our existing customers.

Dan Binder - *Jefferies LLC - Analyst*

Great. Thank you.

Operator

Mike Baker, Deutsche Bank.

Mike Baker - *Deutsche Bank - Analyst*

Two quick ones. One, you talked about closing 300 more stores. What do you think the -- how are the benefits compared with those 300 store closings versus the 400 that you just did? I know you talked about some of the differences in terms of the relative profitability. But should we expect diminishing returns from the next 300?

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

Yes, Mike. This is Steve. I look at the program, one, I think we go with the advantage, frankly, of tackling phase 2 with a very well-defined process and resources that are trained in how to do this right. And we were very pleased with the success of phase 1. And, frankly, that has encouraged us, I think, to be aggressive here in phase 2. Because, as we've seen, a focused effort around really marketing to the customers of these closed locations and working hard to increase the sales transferred to our other stores in the area pays off.

So, this time as we look at it, I would say the difference in the profile of the 300 this time does lack some of the stores where we had Max and Depot stores right next to each other. So, the contiguous locations where you had very high sales transfers because of the geography, we will see less of that in phase 2.

So my guess will be that the sales transfer rates will be slightly lower than what we saw in the first phase. But other than that, I think, again, we think it will be very favorable overall. And with the process we've got in place, we think we can move these -- move a good chunk of these sales into the remaining stores. And, again, what we're really looking at is these key trade areas where over time, they've been overbuilt. And what we're trying to do is rationalize these markets to the right number of stores. And that way, we think the remaining stores will be at higher sales levels. Their unit profitability will be higher. And we think it will allow us over time in conjunction with the store-of-the-future initiative to really provide a much better customer experience for all of our customers.

Mike Baker - *Deutsche Bank - Analyst*

Okay, that makes sense. Thanks. If I could ask one more follow-up, you said you are still working on the exact numbers, but expect maybe about $125 million in one-time costs associated with the $250 million ongoing cost savings program. I'm wondering if those one-time costs are included in your free cash flow expectations of $200 million this year and $300 million next year.

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

Yes, they are. That's meant to be an all-inclusive number. So as we look at it, because of the falloff that we will see on the Max merger one-time costs, as that number goes down, we will increase some of this CapEx -- some of this cost related to getting these cost reductions will add to that number. But net net, that is included in the projections we have provided to you.

Mike Baker - *Deutsche Bank - Analyst*

So if we use our (multiple speakers) -- sorry, I was just going to ask, if we use that $125 million as the estimate, should we assume that it works pro rata to the $250 million savings? In other words, not much in 2015 and then split between 2017 and 2018?

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

Yes, and we've got more work to do there. But I think for now, that's a good assumption to make.

Mike Baker - *Deutsche Bank - Analyst*

Okay. Thanks very much for the color.

Richard Leland - *Office Depot, Inc. - VP of IR and Treasurer*

I think we now have time for one more question. So I think our last question is from Simeon.

Operator

Simeon Gutman, Morgan Stanley.

Simeon Gutman - *Morgan Stanley - Analyst*

Hey Roland, can we talk about the nature of competition? I know the judge and the FTC felt like there weren't enough options in the marketplace today. With regard to the loss momentum that you called out, or in general, are you seeing encroachment from some of these online players or a bigger push from some of the industrial suppliers?

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

You know, Simeon, I think competition is pretty intense in our category and our industry, and I certainly don't think it has abated at all over the last 18 months as we've gone through this process. Every day, someone is trying to get in and take our business, whether it's from our retail stores or from our online capability or, lately, a little more into our B2B contract business.

That being said, I think we have good positions in all three of our segments. And I think now that this disruption is behind us, Simeon, I think we are back on track and we're energized about moving our business forward.

In order to be successful, we're going to have to provide our customers with selling propositions that are unique and meaningful to them, and I think our three-year strategy is all about doing that. You remember the framework for growth that we have been talking about for the last couple of years -- our three-year strategy is really an iteration of that. It really talks about a number of the elements in our framework for growth to include optimizing our business, to moving into adjacencies and to ensuring that we extend our USP. Our store of the future, which we're very excited about, which we've seen here in our Margate store which is in Florida, has been open the longest. It's getting great customer feedback. It's also kind of the -- has improving revenue trends. And so we optimistic about being able to take some of those elements and move them into the future.

So, we are certainly looking at and are very cognizant of the competitive marketplace, but I believe we will continue to strengthen our position and be able to compete effectively.

Simeon Gutman - *Morgan Stanley - Analyst*

And then following up to the question earlier on the $250 million in incremental cost savings, you described -- I think you broke out the different buckets of them. How much of it would you characterize as more delayering or simplifying versus a couple of them that it's more optimization type work?

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

I think it's a combination of both, Simeon. We are not breaking that out piece by piece until we begin to roll this out in the organization and talk to our associates about it. But what I would say is it's a pretty balanced approach across our business that includes simplification and optimization and, of course, the retail store closings that we mentioned, which we expect will be about 300 million by the end of 2019.

Simeon Gutman - *Morgan Stanley - Analyst*

All right. Thanks. Best of luck.

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

Well, thank you all for participating with us today. Let me just say that I think I speak for the entire organization when I say that we are very happy that this Staples acquisition process is behind us. We are certainly excited that we are re-engaged in moving our business forward. I hope you can tell from both our comments earlier on the call and the questions that we are optimistic about our three-year strategy. We think it's a very good balance around cost initiatives or reductions, growth initiatives and shareholder returns, and we certainly look forward to getting back out in the market and updating you as we make progress. Thanks a lot.

Simeon Gutman - *Morgan Stanley - Analyst*

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