

THOMSON REUTERS STRETEVENTS

EDITED TRANSCRIPT

ODP - Q3 2016 Office Depot Inc Earnings Call

EVENT DATE/TIME: NOVEMBER 02, 2016 / 1:00PM GMT



CORPORATE PARTICIPANTS

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

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

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

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

CONFERENCE CALL PARTICIPANTS

Ryan Himmelberg *JPMorgan - Analyst*

Matt Fassler *Goldman Sachs - Analyst*

Simeon Gutman *Morgan Stanley - Analyst*

Dan Binder *Jefferies LLC - Analyst*

Michael Lasser *UBS - Analyst*

PRESENTATION

Operator

Good morning, and welcome to the Office Depot's third-quarter 2016 earnings conference call.

(Operator Instructions)

At the request of Office Depot, today's call is being recorded. I would like to introduce Richard Leland, Vice President, Investor Relations and Treasurer. Mr. Leland, you may 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'm 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, Steve will review the Company's third-quarter financial results and 2016 outlook. Roland will then provide a business update, including our 2017 preliminary outlook. Following Roland's remarks, 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 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, 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 our CFO, Steve Hare.



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

Thank you, Rich, and good morning, everyone. I'm happy to be here today to discuss with you our third-quarter results. Given the significant actions taken during the quarter, we thought it would be better to start with a review of the financials in order to highlight our progress and some of the differences compared to prior-period reporting.

As you saw in our press release this morning, we have made the strategic decision to sell substantially all of the operations previously included in our International division. As you will note on slide 4, the results from these businesses have been reclassified on our income statement, and are now reported on a separate line labeled discontinued operations net of tax. The balance sheet and cash flow statements have a similar separated financial reporting treatment. We believe this reclassification highlights our continuing North American business, which is the foundation of our new three-year strategic plan to achieve profitable growth and generate shareholder value.

Total Company sales declined 7% in the quarter, compared to the same period last year. As in previous quarters, this decline reflects the impact of a planned US store closures, as well as customer losses in our Business Solutions division, that originated primarily during the attempted Staples acquisition period. Excluding the impact of US retail store closures, adjusted sales declined 4% in the quarter.

Operating income in the quarter increased to \$117 million, compared to \$81 million in the third quarter of the prior year. During the quarter, the Company incurred \$40 million of operating expenses related to the Staples acquisition, OfficeMax integration, asset impairments, and other restructuring activities. Excluding these special items, our adjusted operating income in the third quarter was \$158 million, and essentially flat with the prior-year period.

The benefits from store closures, expense reductions, and merger integration synergies helped to offset the negative flow through impact from lower sales, resulting in an increase in adjusted operating margin of 30 basis points in the quarter. Despite the significant business disruption we have experienced this year, we also achieved an increase in our year-to-date adjusted operating income and margins.

Net income from continuing operations for the third quarter was \$330 million, or \$0.61 per diluted share, compared to \$42 million, or \$0.08 per share, in the third quarter of 2015. The current-year result includes a non-cash tax benefit of approximately \$240 million, offset in part by a \$15 million loss on the extinguishment of debt related to the 9.75% senior secured notes that were retired in the quarter.

The income tax benefit reported in the third quarter this year reflects the reversal of a substantial portion of our US federal and state valuation allowances recorded in prior years. Based upon the current and projected improved financial performance of our US businesses, we determined that the benefits of certain of our deferred tax assets were now likely to be realized.

Our decision to sell substantially all of the businesses in our International division resulted in recording a loss on discontinued operations of \$286 million in the third quarter, net of tax. For financial reporting purposes, the assets and liabilities of the International division are now classified as held for sale, and reported as discontinued operations.

The loss from discontinued operations reflects the current period performance, asset impairments, and a loss on classification as discontinued operations to reflect the lower of carrying value or estimated fair value less cost to sell net of tax. Excluding the after-tax effect of all of these special items, third-quarter adjusted net income from continuing operations was \$89 million, or \$0.16 per share, compared to \$92 million, or \$0.17 per share, in the prior year. For additional information on our quarterly and year-to-date results, including the discontinued operations, I encourage you to review the more detailed information contained in Note 3 of our Form 10-Q, as well as the non-GAAP reconciliations found on our Investor Relations website.

Turning to slide 5, on September 23 we announced a deal to sell our European business to the Aurelius Group, a leading European-based asset manager. The transaction is subject to regulatory approval from the European Commission and consultation with the Central Works Council in France, and we are optimistic the transaction can close by the end of 2016.

Additionally, our Board of Directors approved a plan to sell substantially all of the remaining International businesses in Australia, New Zealand, South Korea, and mainland China. These businesses generate approximately \$600 million of combined revenue and an operating loss. We are actively marketing these businesses for sale, and expect the process to be completed within the next 12 months.

We currently intend to retain our sourcing and training operations in Asia, and the results from these operations will be reported as other continuing operations outside of the North American segments. These retained operations generated \$6 million of sales, and were essentially breakeven in the third quarter.

Turning to slide 6, same-store sales in the North American Retail division declined 2% in the quarter, compared to the prior year. The comp sales decline was mainly driven by lower store traffic, transaction counts, and a slightly lower average order value during the period. The decline was also influenced by a comparison to a strong back-to-school performance last year, which generated a positive 3% comp growth, as well as having fewer tax-free days this year in many key states. Total Retail sales decreased 8% 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 cleaning and break room, furniture, and copy and print, compared to the prior-year period. We experienced sales declines in ink, toner, and other technology items. Excluding the decline in our technology category, Retail comp sales would have been flat to the prior year.

The back-to-school season this year was very competitive, as customers increasingly have a wide selection of options to purchase essential school supplies. Our Gear Up For School campaign, and Teacher Appreciation Days were well received, and offered customers exceptional value. As a result of these and other initiatives, we were able to achieve positive same-store sales growth for the quarter in the school-supplies category.

The North American Retail division reported an operating income of \$105 million in the third quarter of 2016, compared to \$120 million in the prior-year period. This year-over-year decline was primarily driven by the flow-through impact from lower sales, and a lower gross margin rate, as well as \$7 million in favorable legal settlements that were recorded in the third quarter of 2015. The negative impact from these two items was partially offset by lower occupancy costs, and selling, general and administrative expenses, including payroll and other store cost.

During the quarter, we closed seven stores as part of the second phase of our Retail optimization plan, announced in August. As of the end of the third quarter, the North American Retail store count was 1,506.

Slide 7 highlights our Business Solutions division, or BSD, results. Sales in the third quarter of 2016 were \$1.3 billion, a decrease of 6% from the prior-year quarter, both as-reported and in constant currency. The decline in sales was mainly attributable to the contract channel.

The sales decline in the contract channel was driven primarily by customer attrition, and fewer new-customer additions during the period of business disruption related to the Staples acquisition. We have recently seen improvements in both customer retention and in our contract customer pipeline. However, there is often an integration period necessary before new customers begin to place orders and incremental sales are realized.

In the direct channel, sales declined, mainly due to the ongoing reduction in catalog sales, and an increase in our buying online/pick-ups in store program. Although these purchases are made online, they are fulfilled with store inventory and by store personnel, and therefore get recorded in our North American Retail division. This program continues to grow in popularity, and has increased significantly over the prior year. Sales through this omnichannel program, in addition to our ship-from-store program, are expected to reach approximately \$120 million in 2016.

Looking at our performance by product category, BSD sales decreased versus the prior year across the majority of our product categories. However, we did experience positive sales growth in copy and print, and in our cleaning and breakroom category. Third-quarter sales in the US contract channel also increased in our K through 12 education customer group, compared to the same period last year. This area of our business continues to deliver positive sales growth, and strong overall performance, and is a key initiative for expansion within the contract channel.

The BSD division's operating income for the third quarter of 2016 was \$81 million, an increase of \$15 million compared to the prior-year period. The division's operating margin substantially improved by approximately 150 basis points, primarily due to lower selling, general and administrative



expenses, including payroll and synergy benefits, which helped to offset the negative flow-through impact of lower sales. The gross margin rate for the division was flat in the quarter.

Turning to the balance sheet and cash flow highlights on slide 8, we ended the third quarter of 2016 with total liquidity of \$1.9 billion, consisting of \$800 million in cash and cash equivalents associated with continuing operations, and \$1.1 billion available under our asset-based lending facility. On September 15, we utilized approximately \$262 million of cash to redeem our 9.75% senior secured notes due in 2019, reducing the Company's overall debt and providing about \$24 million in future annual cash interest savings. At the end of the third quarter, debt was \$388 million, excluding \$803 million in non-recourse debt.

For the third quarter of 2016, cash provided by operating activities of continuing operations was \$199 million. This included the spending of \$25 million in OfficeMax merger integration, \$14 million in Staples acquisition-related costs, and \$8 million in restructuring activities. Capital expenditures were \$26 million in the third quarter, \$8 million of which related to the OfficeMax merger integration.

As part of our shareholder return initiative, the Company repurchased 16 million shares of its outstanding common stock during the quarter, for a total cost of \$55 million. In addition, a quarterly cash dividend of \$0.025 per share was paid on September 15 to shareholders of record, for a total of approximately \$13 million.

Slide 9 provides some components of our 2016 outlook. We expect total Company sales in the fourth quarter to decline compared to 2015, although at an improving sequential rate, as prior-period contract-channel customer losses begin to be offset by new-customer additions. Additionally, our decision to accelerate the store closure program will have a negative impact to sales as we plan to close approximately 65 stores in the fourth quarter.

The Company continues to expect adjusted operating income of between \$450 million and \$470 million in 2016. This range is an increase over the prior year's comparable adjusted operating income of \$438 million, excluding the results from discontinued operations.

Capital expenditures for continuing operations are estimated to be around \$120 million in 2016. We expect approximately \$30 million of the total capital spend will be related to the merger integration. Depreciation and amortization expense this year is now estimated to be approximately \$190 million, excluding the discontinued operations.

The Company's effective GAAP tax rate will continue to be benefited in the fourth quarter by the reversal of the US valuation allowance. We are currently expecting an annual non-GAAP effective tax rate of approximately 40% for 2016. We estimate our cash tax rate will range between 10% and 15%, as we continue to utilize available tax operating loss carry forwards and credits.

Based on these assumptions, and the planned divestiture of the International division, we now expect to generate free cash flow from continuing operations in excess of \$375 million in 2016. I will now turn the call over to our CEO, Roland Smith, to give you an update on our three-year strategic plan. Roland?

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

Thank you, Steve, and good morning to everyone on the call. As you heard in Steve's remarks, our reported results this quarter were impacted by our decision to sell substantially all of our International operations, and the resulting discontinued operations accounting treatment that was required.

I am very pleased that we were able to reach an understanding with Aurelius to sell our European business, and our teams are working hard to close the transaction by the end of the year. We look forward to cooperating with them in the future to help service our customers who have European needs, as well as helping their customers who have operations in our remaining markets. Most importantly, divesting our International business allows us to streamline and focus our resources on our North America business segments that provide the best opportunities to implement our new three-year strategy.

Turning to slide 11, I want to briefly review the four pillars of our new three-year strategic plan that we announced back in August. As you have heard me say many times, one of the key reasons we have been successful in achieving significant synergies from the OfficeMax integration is that we have a detailed and clear plan of execution. After the Staples acquisition attempt, it was critically important to establish an equally clear and detailed strategic direction for the Company going forward, both for our associates as well as for our shareholders.

Our plan is the natural extension of our Framework For Growth that we developed over the past three years, and builds on the successes of the OfficeMax integration. Overall, it is focused on profitable growth and providing shareholder value, and is built on four key pillars: accelerating growth in our contract channel; optimizing and reinventing our North American Retail business model; implementing a number of multi-year cost savings programs; and enhancing shareholder return. I am very pleased with the progress we've made over the past several months executing against these pillars, and I would like to share with you some of the highlights.

Turning to slide 12, one of our most important and immediate priorities is to rebuild our contract sales pipeline that was substantially depleted during the period of uncertainty surrounding the Staples acquisition. As you can see on this page, our average quarterly new-customer commitments fell substantially in 2015 and early 2016, when compared to our 2014 run rate. With the removal of the acquisition cloud of uncertainty in the second quarter of this year, we were able to successfully compete for new business and win a number of new multi-million dollar customer accounts.

I'm pleased to report that in the third quarter, we were able to continue that momentum, and our Q3 new-customer commitments were higher than any of the previous eight quarters. However, implementation of a new customer takes from several weeks to several months, before we realize meaningful revenue. This is especially true for larger and complex customers who require more extensive levels of IT integration, and who must also use their existing stock of inventory before ramping up to full sales potential.

Earlier this year, we also restructured our contract organization to increase the resources focused on driving new business acquisition and growing existing customers. This has contributed to the improvements in our sales pipeline. We believe there are significant additional opportunities to transition to a more effective sales coverage model for accounts of all sizes 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 sales teams can focus more time on winning new customers and driving share-of-wallet opportunities. We are pleased with our initial progress in these areas, and expect the sales trends in our Business Solutions division to improve in the coming quarters, as we continue to grow our sales pipeline and convert customer commitments into revenue and profit.

On slide 13, we highlighted a number of additional initiatives underway to improve the efficiency and performance of our contract business. The migration of the legacy OfficeMax contract customers onto the Office Depot platform continues to progress and is ahead of our current schedule. As we mentioned last quarter, the migration is being managed by a dedicated internal team to drive productivity, accountability, and ensure we minimize any potential customer disruption. Approximately two-thirds of our accounts have either started or completed the process. The customer feedback and sales trends continue to be favorable, based on the enhanced functionality of the Office Depot platform, as well as access to a broader assortment of products.

In addition, we have closely aligned customer migration with our supply-chain consolidation plan, in order to avoid any negative impact on customer deliveries. Here, too, we are making excellent progress, and expect to convert all of our legacy OfficeMax distribution facilities to the Office Depot order management system by the end of the first quarter. This will be a major milestone for us, because in addition to facilitating the customer migration process, having our entire delivery network on the same system enables us to execute our initiatives around reducing inventory levels, harmonizing SKUs, and freeing up capacity to begin adding additional Jan San and other maintenance and repair products to our assortment.

Improving our penetration in adjacent categories, and increasing our share of wallet with existing customers is an important part of our growth plan. We continue to believe there is significant cross-selling opportunity to offer our customers an expanded assortment of Jan-San, safety, and MRO products. Most importantly, our customers are asking us to expand our capabilities in this space, as they consolidate their vendor relationships.



We are aggressively pursuing this opportunity, and developing plans to build out our capabilities. We are also surveying the marketplace and speaking with several Jan-San companies to investigate if making select acquisitions in this space could provide us with an enhanced platform to significantly accelerate our growth in this market.

Lastly, we are continuing to evaluate the results of our small business initiative, which we call Business Select. This test program is designed to bridge the gap between our traditional loyalty program and our contract-pricing model by providing our small business customers with competitive pricing on essential products, along with an improved customer experience and an enhanced e-commerce site. It also leverages our omnichannel capabilities, as many of these business customers shop in both our retail stores, and on our public website, and they are now able to enjoy improved pricing regardless of how or where they prefer to shop. The early results have been encouraging, and we expect to launch Business Select nationwide in 2017.

In summary, our contract business is recovering from the disruption caused by the attempted Staples acquisition, as evidenced by the significant improvement in pipeline commitments we have experienced over the past two quarters. Importantly, I am very pleased that, in this environment, we were able to successfully generate year-over-year improvement in operating income for the BSD division, both in Q3 as well as year to date. Our team remains focused on executing against the initiatives I've outlined, and we continue to believe that BSD remains an attractive growth platform.

Optimizing and reinventing Retail is the second pillar in our strategy, as highlighted on slide 14. On our call last quarter, we announced the closure of approximately 300 additional stores over the next three years as phase 2 of the US retail store optimization plan.

Based on our overall success in phase 1, including sales transfer rates that exceeded 30%, and the timing of future lease expirations, we are accelerating our phase 2 closure plan. During the third quarter, we closed 7 stores, and we now anticipate closing approximately 65 additional stores in the fourth quarter. In total, we will close approximately 125 stores in 2016, which will result in a reduction of about 2.8 million square feet of retail space.

We continue to implement a very effective process to maximize the benefits of store closures, including having brand ambassadors at closing locations to encourage customers to visit our other stores in the area, as well as marketing and promotional materials to drive future purchases. As a result, we have been successful in retaining customers, and our sales transfer rates continue to exceed our expectations.

In addition to the store closure program, we are also optimizing the retail operating model inside the store to make it simpler and more efficient. As I mentioned last quarter, we are implementing a new workforce management tool that will accomplish two main goals. First, the tool will allow us to evaluate each individual store, and recommend the optimum labor schedule for that location. This will in turn free up time for store managers to focus more aggressively on customer-facing activities.

And secondly, the tool will enable us to allocate labor needs more efficiently, based on customer demands. The software uses transaction data, such as customer traffic patterns, number and size of transactions, and sales by product category. With this data, we will match associate labor hours and skills to ensure we meet customer demands as efficiently as possible. We are in the process of rolling out this tool across our store base, and expect to experience the benefits beginning in 2017.

In conjunction with the workforce tool rollout, we are streamlining and optimizing store tasks, such as price changes and restocking. This will allow our associates to spend more time selling to customers. Combined, these actions will place the right associate on the sales floor, at the right time, to match customer demand. We are excited about the productivity benefits these new tools and processes will provide, and are confident that the lower cost will further improve the profitability of our North American Retail division.

Turning to slide 15, we are also working to reinvent our Retail business, with our ongoing Store of the Future test. We began developing our unique selling proposition for this format over a year ago to provide an improved retail experience to those customers that value quality, service, and expertise. With a footprint of approximately 15,000 square feet, the new store format is a significant reduction in size, compared to our more traditional 20,000- to 30,000-square-foot formats. We converted our first store back in February, and we now have 15 stores open across the country.



The map on this slide shows the locations of our test stores that are currently open. We selected these locations based on a number of criteria, including the timing of lease expirations, negotiations with the landlord, current square footage of the store, product sales mix, customer demographics, and purchasing behavior. We also selected these locations to ensure broad market diversification, and results based on a true representation of our customer base.

The Store of the Future model incorporates numerous improvements versus our traditional format, which include changing approximately one-third of the products in the store by removing slower-selling and lower-margin SKUs, and adding a more relevant assortment, including higher-quality and commercial-grade products; curating the assortment of products in a good, better, and best arrangement to help our customers more easily select the right product for their needs; improving product adjacencies, in order to encourage complementary purchases across categories; lowering fixtures, improving signage and navigation, and adding a wide center aisle to allow customers to more easily find their way around the store; and, most importantly, dedicating a considerable amount of space to expand our key service offerings such as copy, print, and tech services, provided by specially trained associates.

We are still in the testing phase of this program, but so far, customer feedback has been very positive, and we are encouraged by the financial results. As we continue to convert more locations into our Store of the Future format, and evaluate the longer-term performance of these stores, we will obtain a better understanding of the financial returns this format can provide. Our current plan is to have approximately 25 stores open by the end of this year, and we are targeting to expand the test to 100 stores in 2017.

The third pillar of our strategy is the implementation of a number of cost-saving programs across our business. But before I review our new savings initiatives, I'd like to remind you that we still have additional savings to realize from our OfficeMax integration. As presented on slide 16, we fully expect to achieve the more than \$750 million in synergy benefits from the merger.

As I mentioned earlier, the remaining integration activities are focused on customer migration, supply-chain consolidation, and consolidation of our IT systems, as we convert our entire North American business onto the legacy OfficeDepot platform. These initiatives are well underway, have detailed project plans and governance, and we continue to expect the merger integration to be substantially complete by the end of 2017.

As you may remember from our last call, our comprehensive business review process identified several additional opportunities to reduce costs across our organization. These opportunities include the efficiencies and cost savings from the streamlining of our retail store operating model, and the benefits derived from the second phase of our store optimization closure plan that I mentioned earlier. In addition, we have reviewed our general and administrative costs, and identified opportunities to simplify operations, remove redundancies, reduce unnecessary expenses, and combine responsibilities in our support functions.

In the third quarter, we also realigned our organization to create a more focused omnichannel structure, including promoting Troy Rice into the newly created position of Chief Operating Officer. We believe this structure will create a more efficient organization that is focused on delivering a consistent and unique selling proposition to customers of all sizes, regardless of what channel they prefer to shop.

Finally, we have engaged Bain and Company to assist us with reducing the Company's indirect procurement spend. We currently spend approximately \$2 billion across a variety of categories, including areas such as warehouse, packaging, transportation, facilities, travel, and professional services, just to name a few. We are developing a prioritized list of [tactical] initiatives and a detailed work plan to reduce these costs.

In addition, many of the vendor contracts these categories represent have not been renegotiated since the combination of Office Depot and OfficeMax. Overall, we expect that this initiative will generate substantial savings in the coming years. 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 integration, bring our total annual estimated cost-saving benefits to more than \$1 billion.

Our fourth strategic pillar is dedicated to enhancing total shareholder return. As detailed on slide 17, we redeemed our 9.75% senior secured notes for \$262 million on September 15. By retiring this high-coupon debt, we will realize approximately \$24 million in annual cash interest savings going forward. Second, we declared and paid our first quarterly cash dividend to shareholders in September, and the Board has approved our next

dividend to be paid on December 15. The quarterly dividend rate is \$0.025 and represents an annualized dividend of \$0.10 per share, or approximately a 3% yield.

Lastly, through the end of the third quarter, we have repurchased a total of approximately 23 million shares of common stock, for an aggregate cost of approximately \$81 million. We have approximately \$170 million remaining on our current authorization, and we accelerated our repurchase activity in October. Since announcing our new strategy just a few months ago, we have dedicated over \$350 million, or approximately 95% of our year-to-date free cash flow, to improving shareholder returns. 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 continue to grow profitability and generate future free cash flow.

Building on our 2016 successes, we are providing a preliminary outlook for 2017, as detailed on slide 18. While we anticipate total Company sales will be lower in 2017, due to the continued challenging environment and additional store closures, we expect that the improvements we are making in our contract pipeline will result in improving sales trends for our BSD business as we move through the year. We also expect to realize additional merger synergies and cost savings benefits in the year, and as a result, we are forecasting continued growth and profitability. Our preliminary outlook is to generate approximately \$500 million of adjusted operating income in 2017, which is an increase of nearly 10% over the midpoint of our 2016 guidance.

Lastly, we expect continued improvement in operating cash flow in 2017, as we begin to move beyond the one-time costs related to the OfficeMax integration. Based on a capital expenditure forecast of approximately \$200 million for the year, we anticipate that free cash flow from continuing operations in 2017 will be in excess of \$300 million.

Overall, I am very encouraged by the progress we're making in moving our business forward, and I believe we are positioned to make significant additional progress in 2017. We have a clear and detailed strategic plan that is focused on profitable growth and providing shareholder value. We are beginning to win new business and have a strong start to rebuilding our contract sales pipeline. We are aggressively pursuing several attractive growth initiatives and expect to deliver substantial incremental cost savings. And finally, our solid liquidity position and ability to generate future cash flow allows us the flexibility to explore all opportunities to enhance shareholder return. I will now ask the operator to open the lines, and we will be pleased to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Your first question comes from Christopher Horvers.

Ryan Himmelberg - JPMorgan - Analyst

This is Ryan Himmelberg on for Christopher. We just wanted to get some color around the existing customer retention trends, you talked about the new customer trends. Could you talk about what you are seeing relative to the acquisition now on the existing customer side too, please?

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

Ryan, it's Roland. I'm going to start off, and I think I'm going to pass it over to Mark. As you know from our prepared comments and one of the slides. We are pretty pleased with the way the pipeline has progressed over the last couple of quarters. And as I mentioned, we are now at a higher level of commitment in our pipeline than we have experienced in the last eight quarters.

You also know from our prepared comments that turning those commitments into revenue and profitability takes a little bit of time. It can take from a couple of weeks to a couple of months, based on complexity of the customer, and also how much product they might currently have that they need to sell through. So we think we will see sequential improvement in our BSD business in the fourth quarter, and we hope to see that also sequentially improve in 2017. Mark, do you want to add more color to what's going on in the pipeline?

Mark Cosby - Office Depot, Inc. - President, North America

The big thing is, we have been able to successfully compete for this business, since the removal of the acquisition uncertainty back in May. In fact, our new customer commitments, as Roland said earlier, in Q3, these were the best they've been in a couple of years. Keep in mind, as Roland said earlier, that the implementation of these new customers takes several weeks to several months, before it turns into meaningful revenue, especially for the large and complex customers who requires several levels of IT integration, they must use their existing stock of inventory before they are able to ramp up towards us.

We will also benefit in the coming months by a much reduced pace of customer losses versus what we lost during the Staples cloud. It's also important to note that we always have had customer attrition, but we have historically been able to offset that attrition with new business. In addition, we are implementing action plans to bring several elements of the strategy that Roland discussed to light, including increasing the capacity of our inside sales team, to further improve our overall sales effectiveness, so that our field teams can focus on winning new customers, and driving share of wallet opportunities.

We will also continue to expand our dedicated sales hunting to help us acquire new customers, and of course the expansion of a our jan-san business will also contribute to improving our contract sales results. As a result of all of these efforts, we expect the sales trends to improve sequentially in the coming quarters. We anticipate our BSD sales trend to continue to improve throughout 2017, ideally getting back to flat sales.

Ultimately, though, our goal is to return to positive growth, as we continue to execute against our three-year strategic plan. As a footnote, and an important one, our BSD business back in 2014 was flat, in terms of sales, before the Staples acquisition announcement. So, we do believe we are poised to deliver future growth as we continue down our path.

Ryan Himmelberg - JPMorgan - Analyst

Great, thank you. That's really helpful. Just one quick follow-up on that. On the cash flow guidance for next year, did that include any potential charges going forward really to mergers, or anything else? Other merger charges?

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

Steve?

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

Ryan, that would be all-inclusive. That free cash flow guidance is based on whatever restructuring-type charges we would incur next year.

Ryan Himmelberg - JPMorgan - Analyst

Okay. Thank you.

Operator

Your next question comes from Matt Fassler.

Matt Fassler - *Goldman Sachs - Analyst*

A couple of questions. First on the decision to divest the Asian businesses and your international businesses outside of Europe. You had shared directionally your expectations for proceeds from the European sale. What is your thought process on whether you will be extracting from any cash from divesting the other \$600 million in revenue?

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

We will start out with that, Matt, and I'll let you ask the follow-up question that it sounds like you have, and I will turn that over to Steve to talk a little about our business outside of Europe, and what we might expect to happen this year.

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

Matt, we put out, we gave you some detail around the aggregate financials around these other, the non-European international businesses we've got. So in the aggregate, it's about a portfolio of \$600 million in sales, that in the aggregate is operating at a slight operating loss today. So the overall expectations of proceeds should reflect that current performance. But we've got more work to do there before we can realize, get closer to seeing what we will be able to realize in terms of proceeds.

Matt Fassler - *Goldman Sachs - Analyst*

Great. And then one follow-up on the international sale. As we think about, beyond any proceeds you do or don't get for some of these businesses. As we think about the way the balance sheet will change, after you do these deals, particularly with regards to cash, should we assume the cash you've included in discontinued ops is probably going to stay? Cash and liabilities that you included in discontinued ops is likely to stay with the businesses as you saw them?

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

Yes. I think that is a fair assumption. The breakout of what you see on the balance sheets, the \$800 million of cash, that is cash related to the continuing operations. And then separately there is cash that is attributed to the European business and the other international businesses. But as you said, is likely, for the most part, to go as part of the transfer.

Matt Fassler - *Goldman Sachs - Analyst*

Great. Then just one final follow-up to the prior question that was asked on the BSD account wins. What are the margin implications of getting some of this business? As you think about what you are bringing to market to get these, do you find that these are price driven initially? Or is there another element to the value proposition that you're marketing that you think is helping you win some of this business?

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

Matt, are you referring specifically to the margins in our BSD division?

Matt Fassler - *Goldman Sachs - Analyst*

I guess I'm speaking specifically about the new contract wins, to the extent that you're moving that in the right direction. Is the value proposition primarily price, and how do we think about the margin implications? And as you market Office Depot to prospective new customers, is there another element to the proposition that you think is helping you win some of this business?

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

I think you could see from Q3, from the standpoint of where our margins netted out, overall margins improved in BSD, even though sales declined, but our gross margins stayed flat. So I think what that suggests is that, while we are being competitive, we are winning new business. We are doing it in a very disciplined manner, and we would expect we would continue to be able to maintain the margins that we have enjoyed over the past couple of quarters.

Matt Fassler - *Goldman Sachs - Analyst*

Great, thank you so much.

Operator

Your next question comes from Simeon Gutman.

Simeon Gutman - *Morgan Stanley - Analyst*

First question, the EBIT guidance for next year, for 2017, initial -- it implies anywhere between about a \$30 million to \$50 million improvement versus where you may end up this year. You have some cost saves. I think you mentioned half of the \$250 million, so \$125 million, and then there are some additional O&X synergies. Not surprised there's some clear core business erosion. I guess, just trying to get a clear picture of what that core business erosion, that run rate. How did that look relative to prior years? I'm assuming it should improve, but it's hard, because there's a lot of moving pieces, so just curious how you see it?

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

Obviously that erosion, Simeon, is going to be driven by what we are able to realize in revenue next year. And as you know from our comments, we are still projecting that revenue will decline, based on the continued secular decline in this industry, and also the inclusion of another 300 stores in retail, that we obviously plan to shut down. That being said, we've also forecasted that we expect our revenue decline to sequentially improve, starting in the fourth quarter of this year, and moving through 2017.

So while we still do see leverage in 2017, we would hope that new leverage would also begin to sequentially improve from what we've seen before. Obviously, as we continue to talk about the savings, synergies and efficiencies from the merger integration and also additional \$250 million of savings that we expect to generate over the next two years, those are continuing to cover those declines that add to leverage, with the ultimate plan being that we, in fact, initiatives working we continue to grow our revenue, and the benefit of those cost-savings go directly to the bottom line.

Simeon Gutman - *Morgan Stanley - Analyst*

Okay. And my follow-up, I think in the release, it talked about there was a little shift in business from I think it was BSD to retail given buy online pickup in-store. Did you quantify? I may have missed it. Did you quantify what the impact may have been?

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

No. What we did say is that initiative, along with the ship from store, the total of those two programs is growing fairly rapidly for us, so we are pleased with that. And in total, that will be about \$120 million in sales this year.

Simeon Gutman - *Morgan Stanley - Analyst*

Okay, thank you.

Operator

Your next question comes from Dan Binder.

Dan Binder - *Jefferies LLC - Analyst*

My understanding was that when the deal was blocked you had a lot of positions at headquarters is still needed to be filled. Think there were still probably some challenges during that period to hire people. I'm just curious where you are on that front? And I have some follow-up questions.

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

Dan, I could talk at length about our cost-saving programs. I'll try to go straight to your question, and then if you would like me elaborate that, I'd be happy to do that. You are absolutely correct. During the 15 or so months when we were going through this process of the Staples acquisition attempt we certainly lost some associates due to the uncertainty, and were able to fill some of those jobs similarly because of the uncertainty.

As we came out of the attempted merger, and we began to look at our four pillar strategy, obviously one of those pillars is the cost savings programs that we think we need to put in place, to continue to cover the leverage that I mentioned a few minutes ago. As we put also into place some of the pillars that will ultimately provide growth in revenue as we go forward.

But as we looked in particular at our G&A costs, we took the opportunity from the fact that we had some open positions to reorganize the Company around a number of things that we believe will allow us to continue to achieve our key priorities, but be more efficient in doing it. From a G&A standpoint, we worked with our teams, and over the last couple of months we simplified our operations.

We've reduced redundancies, we've combined responsibilities, and we've eliminated unnecessary costs. So the net benefit was that while we have taken some headcount reductions, we were able to take some of the open positions that were in effect, as we came out of the attempted merger, and not fill those, and use those as cost savings as we move forward.

Dan Binder - *Jefferies LLC - Analyst*

So at this point, you are fully staffed the way you would need to be?

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

Yes. We believe that we currently have an organization and structure that will allow us to accomplish the four pillars that we have highlighted. As you know, we announced a couple of months ago a reorganization, particularly at headquarters. We've also done some reorganizations in the field. We have established a new position of a Chief Operating Officer, which I mentioned in my prepared comments, Troy Rice has taken that position. We believe that provides us an opportunity to be more omnichannel focused.



And we have built around that particular organizational structure, so that now we believe we have the right structure in place. We have the right people in place. Like any company, we have vacancies, and we'll always have a percentage of vacancies because that is life in the big company environment, but we are pleased with the organization we have now. We are pleased with where our vacancies generally have fallen out, and think that is no longer an issue that would keep us from being successful.

Dan Binder - *Jefferies LLC - Analyst*

Okay. My second question is related to the business solutions part of the company. You mentioned that two-thirds of the OfficeMax customers are in process to be migrated to the ODP platform. Can you give us a sense today how many have been fully migrated? And what percentage of revenue that represents?

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

Dan, we have those numbers because we track this on a very disciplined work stream as I mentioned. We have biweekly meetings where we actually talk about the targets and the metrics, and we have a number of customers, both on contract and off contract, so that we are able to complete the migration by the end of 2017, which we have confirmed yet today that we expect to do. But we don't get into those particular numbers, and what those dollars represent. Although, I can tell you that is clearly something that we look at on a regular basis.

Dan Binder - *Jefferies LLC - Analyst*

Okay, thank you.

Operator

Your next question comes from Michael Lasser.

Michael Lasser - *UBS - Analyst*

Can you parse out your expectation of decelerating declines or sequential improvements in your BSD business, between better retention of your existing customers, new customer wins, and how you see the environment playing out?

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

Michael, we obviously look at that on a regular basis. And as Mark relayed a few moments ago, with our business, if you go back over the last number of years, we always experience some loss or some customer attrition, as we go through the year. Fortunately, we have typically been able to replace that attrition with even more customers that we signed into the business.

So the net benefit, as Mark mentioned, in 2014, before we announced the deal with Staples was flat to approaching positive. So that's the way our business typically proceeds. We do expect sequential improvement in the fourth quarter, based on the strength of the pipeline that we shared with you today.

Also, based on Mark's comments that we expect less attrition from customers, as we roll over some of the large attrition that we had during the cloud of the staples attempted acquisition. But we are not going to break that out specifically at this point. We will just have to leave you with the fact that we do believe in sequential improvement in the fourth quarter, and our goal would be to get to flat, and ultimately grow this business as we close out 2017 and get into 2018.

Michael Lasser - UBS - Analyst

So Roland, do you have to see improvements in your new customer wins and the environment to get to flat over the next few quarters?

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

We don't need improvement in what is going on with secular decline. We certainly need improvement in converting the commitments we have seen in our pipeline into revenue and profitability, and we need to see an improvement in decline in attrition. But we are seeing that decline in attrition, and we are seeing improvement in our pipeline, so that's why we are comfortable in suggesting we are going to see sequential improvement.

Michael Lasser - UBS - Analyst

Okay. And then, are you also assuming that the promotional environment, the promotional intensity remains the same, to get to that improved EBIT expectation for next year?

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

Well now you're talking about both our BSD, our contract and our retail business. Our retail business is much more promotionally driven obviously. We are a high-low price provider, which means on a regular basis, we believe that our price is competitive, based on the fact that we have promotions and coupons, rebates, and loyalty programs. So when you add those all up our net price, we think, is highly competitive and we will continue to be a high-low promoter, and we will continue to be aggressive from that standpoint to make sure that we are having a nice balance of promotion versus revenue.

From the contract stand of our business, obviously it's about negotiating new contracts with customers, based on not only the pricing that we provide them, which is incredibly competitive, but also the additional services and value that we provide them, with the dedicated sales force and desktop delivery, and the customized catalog, and IT integrated systems and things like that, that continue to provide great services to our customers.

We also, as you know, in the beginning phases, although we are making great progress, and we like the results so far, of our small to medium business test, called Business Select. That has been in the market now for a couple of quarters, and we are seeing that progress nicely. I think as we mentioned in our prepared comments, we would anticipate, or expect to roll that out nationally in 2017.

Michael Lasser - UBS - Analyst

Okay, thank you so much.

Operator

I have no further questions in queue. I will turn the call back over to the Company for closing remarks.

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

Thank you all again for participating with us this morning. I think I would just like to highlight a couple of comments. First, we do have a detailed strategic plan focused on profitable growth and providing shareholder value. We are, as we mentioned and talked about quite a bit on the call, winning new business, and rebuilding our sales pipeline.



We all, and I want you to remember this, aggressively pursuing several attractive growth initiatives to include moving into jan-san, MRO, and our Store of the Future. We do expect to deliver substantial incremental cost savings. As I mentioned, the combination of the integration of OfficeMax and our new cost-saving program by the end of 2018 will generate, on an annualized basis, over \$1 billion of savings.

We also have a solid liquidity position and the ability to generate future free cash flows. And we continue to be committed to enhancing our shareholder returns. So thanks again, and we look forward to talking with you in the very near future.

Operator

Thank you, everyone, for your participation in today's call. This concludes the call, you may now disconnect.

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2016, Thomson Reuters. All Rights Reserved.