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PRESENTATION

Operator

Good morning, and welcome to the Office Depot's Second Quarter 2017 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 now begin.

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

Good morning, and thank you for joining us. This is Rich Leland, and I'm here with Gerry Smith, our CEO; and Steve Hare, our Executive Vice President and CFO.

On today's call, Gerry will summarize the second quarter results and provide an update on the business. Steve will then review the company's quarterly financial results and outlook. Following Steve's discussion, we'll have some closing comments and then open up the line for your 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 U.S. Securities and Exchange Commission.

During the call, we'll use some non-GAAP financial measures as we describe business performance. The SEC filings, as well as the earnings press release, presentation slides that accompany today's comments 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 1 year.

I'll now turn the call over to Office Depot's CEO, Gerry Smith.

Gerry P. Smith - *Office Depot, Inc. - CEO & Director*

Thank you, Rich, and good morning to everyone on the call. I'm happy to be here with you today to discuss Office Depot's second quarter results.

Beginning on Slide 4. Total sales in the quarter were $2.4 billion, a decrease of 9% from the second quarter of 2016. The planned U.S. retail store closures accounted for approximately 3% of this total sales decline. Excluding store closures, adjusted sales were down 6%. Operating income in the second quarter was $46 million compared to $271 million in the prior year. Please remember that the 2016 results include the impact of the $250 million Staples termination fee.

Adjusted operating income in the second quarter was $68 million, a decrease of $10 million compared to the prior year. Adjusted operating margins in the second quarter decreased roughly 10 basis points to 2.9% compared to the same period in 2016. The negative flow-through impact from the lower sales in the quarter more than offset the benefits realized from store closures, expense reductions and merger integration synergies.

Earnings per share from continuing operations in the second quarter of 2017 were $0.04 per share compared to $0.41 per diluted share in the second quarter of 2016, which also benefited from the Staples termination fee. Adjusted earnings per share in the second quarter were $0.06 per share, flat to the prior year. Also, we benefited in the quarter from a lower share count and lower interest expense as a result of our shareholder return initiatives.

For the first half of 2017, both adjusted operating income and adjusted earnings per share were on track with our internal expectations and performed ahead of the prior year.

We have also made great progress on divesting our international businesses and are very close to being completed. We recently finalized the sales of our businesses in South Korea and in Mainland China and are now awaiting final regulatory approval in order to conclude our sales in Australia and New Zealand. The proceeds from the international divestitures will further enhance our financial flexibility as we focus on growing our businesses in North America.

Turning to Slide 5. I've spent a significant amount of time recently working with my executive team and talking with customers and key vendors about how we can change the company's landscape and position Office Depot for the future. Our objective is to grow top line revenue, both organically and inorganically, through: A competitive omni-channel/integrated channel offering; building a world-class business platform that offers services, products and solutions for consumers, small and medium business and enterprise customers; leverages all routes to markets, including last mile delivery; and drive a focus on operating income and free cash flow through productivity gains and expense management.

In some ways, we're also returning to our roots. You may have seen that we've recently launched our new Taking Care of Business advertising campaign. This brand message was used effectively by the company for many years and we've been told by customers that this slogan truly speaks to our company's mission of helping customers take care of business in the office, in the classroom and on the go.

But delivering on this brand promise today is much more than just a competitive selection of products. I believe Taking Care of Business today means finding ways to leverage our integrated business channels, retail stores as last mile points of distribution and a growing portfolio of services to provide real solutions to our customers.

Whether you're a new business who needs help getting started or a small or medium-sized business looking for furniture or copy and print or technology solutions or even a large business looking for purchasing efficiencies, Office Depot is the ideal business partner to provide you with the solutions you need either on the web, in our stores or through our dedicated sales teams, on both a local and nationwide basis and with offerings that can scale to meet your business needs.

I believe this integrated model is a key differentiator for us against competitors, and we are one of the few companies focused on taking care of this business opportunity. Now clearly, we still have some work to do in order to achieve this vision, and I have the internal teams focused around a number of initiatives to strengthen our core while identifying opportunities to transform our business as we build out our capabilities to deliver relevant business services and products to customers, and lastly, to disrupt traditional ways of thinking and find innovative, new ways to leverage our assets in the future.

While we are building these capabilities, it is key that we move quickly and have the focus necessary to address some of our structural issues. For this reason, I have recently reorganized the company's operations under 2 business unit presidents, focused on servicing B2B and B2C customers. This structure provides improved focus and a clear line of sight to the needs of our customer base as we execute against our strategic initiatives. I now want to share with you some of the details of the initiatives that are underway across the business.

As noted on Slide 6, we're focused on strengthening the Retail channel by reaching out to our customer base with new marketing, value propositions and product offerings. We recently changed advertisement agencies and rolled out our Taking Care of Business advertising campaign. Customers' feedback has been very positive, and advertising spots will run across all marketing vehicles, including TV, radio, insert, direct mail, e-mail, online and social media, and are designed to drive awareness and traffic, especially during the important back-to-school season.

Second, we introduced a new customer loyalty program at the end of the second quarter. The new rewards program was tested in several markets and successfully resulted in increased customer enrollments, higher sales and overall better satisfaction scores.

Under the new program, rewards are simple to earn and simple to redeem. All members will receive 2% back on everything in the store and online as well as member-only promotions and opportunities for additional savings, such as bringing ink or toner products for recycling or writing an online product review. Members of the VIP Tier receive 5% back on paper, ink, toner and copy and print services in addition to receiving free delivery with no minimum order size. All members can redeem their rewards instantly at any checkout with no minimum thresholds. We believe our customers will appreciate the added value and ease of use that this new program provides.

Lastly, we believe we are well-positioned for this year's back-to-school season with a number of attractive promotions on supplies as well as a green tag sales event that's currently underway to provide additional value across a variety of categories. Customers will also see a number of new products in the store this quarter with a goal of driving attachment and increased basket. This includes expanding our very successful private brand line of TUL pens and note-taking products into a broader assortment of colors that are perfect for school and rolling out a selection of high-performance gaming PCs that I'm sure will appeal to many of the students in our stores.

We're also moving into new categories, such as LED lighting, that will appeal to both consumers and business customers. Lastly, we are building on our leadership position in the seating category, which we're #1, by rolling out a new line of Serta iComfort chairs under our WorkPro private brand that utilizes the same foam technology used in the Serta premium mattress lines. In fact, a recent research report conducted by an independent third party named Office Depot Americas #1 retailer for home office chairs based on market share, and I'm sure these new iComfort chairs will help strengthen our position even further.

Turning to Slide 7. I recently promoted Steve Calkins as President of the Business Solutions Division. He has significant amount of experience and has successfully led this division in the past and improved profitability. Steve has recently reorganized the business with a greater focus on the customer and routes to market, a structure that I have successfully used in the past. We also have a number of initiatives underway to strengthen the core of our BSD division. I am pleased to report that our sales teams continue to win new business at an aggressive pace, and our sales pipeline today is probably as healthy as it was before the Staples acquisition attempt.

Unfortunately, we continue to be impacted by challenging market conditions and prior-period customer losses. Based on the strengthening sales pipeline we have experienced in the first half of the year, we expect implementation of new customer wins to ramp up in the second half of the year.

I'm also pleased with the growth we are experiencing in our adjacent category expansion strategy. As I mentioned on last quarter's call, we hired a new executive with deep industry experience in cleaning and breakroom at the end of April and have added approximately 10,000 new SKUs into our product assortment. During the second quarter and year-to-date, we experienced growth in the facilities category as a result of our initiatives this year.

We are continuing to build our capabilities in these adjacent categories in order to strengthen our core business as well as looking at organic and inorganic transformational ideas to become a more important provider of solutions to our business customers as they look to consolidate their vendor relationships.

We will reach another milestone for the company later this year as we're nearing the completion of the OfficeMax integration. The project remains on track to be substantially complete by the end of 2017, and we continue to realize the synergy benefits. As I mentioned last quarter, the supply chain consolidation is nearly complete and I now want to take our supply chain to the next level.

We recently held my first vendor partnership meeting here in Boca with our top suppliers and executive teams. The message was very clear. Our goal is to grow our business and deliver a superior customer experience, and with their partnership, we can win together. We committed with them to a continuous improvement process with quarterly business reviews and an improved vendor scorecard to track KPIs. As they say, feedback is a gift, and we'll also invite our vendors to provide feedback going forward so we can continue to get better as an organization.

In addition, we now have John Gannfors leading our supply chain and with his experience and background in Lean Six Sigma, we believe we can drive additional process improvements and cost reduction opportunities. We plan to make additional investments in our supply chain and last mile capabilities in the future as we look to take the supply chain from good to great.

Much of the remaining integration activity is focused on the migration of the legacy OfficeMax contract customers onto the Office Depot platform. Over 75% of accounts have either started or completed the migration process, and customer feedback remains positive based on the platform's enhanced functionality and assortment. We are on track to be substantially complete with the customer migration by the end of 2017, and then can begin the final process of decommissioning many of the legacy IT systems.

Lastly, I remain very pleased with the growth we are experiencing in our omni-channel programs. Consumers continue to see the benefits of our convenient buy online-pick up in store functionality, with this business growing approximately 30% over the prior year. We also now have our ship from store capability operational across all stores to serve both B2C and B2B customers. We see this program ramping up quickly as customers can benefit from inventory that may not be available in our distribution centers.

And finally, beginning in the fourth quarter, we'll be rolling out ship to store for our contract customers who would prefer to pick up at one of our retail locations. For even more customer convenience, we just announced on Monday, same-day delivery service from our stores in select markets, and we've received positive early feedback. We expect to roll the service out to additional markets by the end of the year. All of these capabilities are key enhancements to our core operations as we leverage our integrated channels for the benefit of customers.

As I mentioned earlier, beyond strengthening our core operations, we are continuing to evaluate opportunities to transform our business for the future. Turning to Slide 8, I'd like to give you an update on the Store of the Future test that we have underway. At the end of the second quarter, we had 46 stores converted into the new format, spread across 22 states to provide some geographic diversity in the tests.

The test results remain positive, with the stores experiencing both higher customer satisfaction scores and improved overall sales trend versus a peer group of control stores. The new format also places a greater emphasis on services, and I'm very pleased that we are continuing to see an attractive sales lift in our copy and print and tech service businesses in these stores.

For the next phase of the test, we plan to expand to a full market and have all 14 of our stores in Austin, Texas converted to a version of the new format, leveraging specific services and product offerings depending on the hyper-local location of the market. By bringing all stores under one banner and a common platform, we can then implement a coordinated marketing strategy to drive awareness and communicate the benefits of the new formats to customers.

We plan to leverage our e-commerce and BSD sales channels for cross-promotion opportunities to further drive awareness, traffic and new customer acquisition. The official market launch is expected to be in the fourth quarter of this year, and we're very excited to see how this format can perform and potentially enhance future growth across our channels in the Austin marketplace. In total, we expect to have approximately 75 stores across the country converted into the Store of the Future format by the end of 2017.

Turning to Slide 9. I believe that services will play an important role in delivering on our Taking Care of Business promise to customers, and we're building on a strong foundation. In our copy and print business, we're in the middle of rolling out wide-format printing and scanning functionality across the entire chain, and expect to have these enhanced capabilities implemented in all of our stores by the end of the year.

We also recently began a process to provide copy and print production associates with an in-depth, multi-day training program to make sure they are experts in using the new technology. The teams also developed targeted selling strategies with similar high-value customer segment to drive sales growth in this area.

Beyond copy and print, we are also expanding the selling resources in our managed print services business in addition to building the selling strategies with our tech services business to focus on some attractive vertical market opportunities. We have an attractive pilot currently underway, offering enhanced tech services in our stores to small and medium businesses. Each of these businesses show great potential, and we continue to explore partnership opportunities as a way to expand our current capabilities and accelerate revenue growth and services.

To lead these efforts, we recently hired Janet Schijns to oversee the copy, print and tech services business as well as manage our regional print facilities across all of our customer channels. Janet is a seasoned executive coming to us from Verizon, where she was successful in driving customer growth and revenue in their enterprise, commercial and government channels. We see a large growth opportunity in our portfolio of service offerings, and I'm extremely happy with her leadership so far in driving our transformation efforts within our services business.

As I mentioned earlier, we're also looking at opportunities to find disruptive innovations that can create longer-term value for our shareholders. As shown on Slide 10, our recent partnership with Centriq Technologies is an example of what we think could be a disruptive technology. For those of you who aren't familiar with the application, Centriq currently provides homeowners with an award-winning asset management platform that also connects to product manufacturers for support and easy one-click ordering for replacement parts and accessories.

It is very quickly being adapted by homeowners and real estate agents as a way to provide buyers with the inventory of all existing household assets, like the brand and model of the refrigerator, air conditioner, water heater, et cetera. We believe this platform has other potential applications for providing unique service solutions, so we entered into an exclusive license agreement with Centriq to capitalize on these solutions as well as take a small equity investment position within their company.

Our focus in working with Centriq is to develop a B2B version of their current app that will enable businesses to better track and manage their assets on a single platform and from any device. We think this could also open up additional opportunities to service or replace assets during their life cycle.

Whether the business needs to manage their printers, PCs or other assets, providing additional services and solutions to our customers will further enhance the value Office Depot brings to customers and differentiate us from our competitors. I'm a strong believer in the value of partnerships like the one we have with Centriq Technologies, and we continue to explore additional opportunities to build out our platform of service offerings and bring enhanced value to our customers. We are committed to executing against the right strategic initiatives to transform our business.

I will now turn the call over to our CFO, Steve Hare, who can provide more details on our second quarter financial results. Steve?

Stephen E. Hare - *Office Depot, Inc. - Executive VP & CFO*

So thank you, Gerry, and good morning, everyone. I'm happy to be here today to discuss our second quarter results.

As noted on Slide 12, we have highlighted some key performance measures for the second quarter and first half of 2017. Similar to previous calls, I will primarily focus my comments on the performance from our continuing operations as we are nearing completion of the planned divestitures of our international businesses.

Total company sales declined 9% in the quarter compared to the same period last year. Excluding the impact from planned U.S. retail store closures in the prior 12-month period and foreign currency translation, adjusted sales declined 6% compared to the prior year. The decline was primarily due to continuing overall competitive pressures and prior-year customer losses in our Business Solutions Division, as well as lower traffic in our retail stores.

Second quarter operating income decreased to $46 million compared to $271 million in the prior year. As a reminder, the prior year's operating income included the Staples termination fee of $250 million. During the quarter, the company incurred $22 million of operating expenses related to the OfficeMax merger integration, restructuring activities, executive transition and an asset impairment cost. Excluding these and other special items from 2017 and 2016 results, our adjusted operating income in the second quarter of 2017 was $68 million, a decrease of $10 million compared to the prior-year period.

Adjusted operating income for the first half of 2017 was $220 million, an increase of $18 million or 9% compared to the first half of 2016. The decrease in the second quarter was driven primarily by the sales decline and a lower gross margin rate. The gross margin rate in the quarter was negatively impacted by sales deleveraging that exceeded the rate of reductions in our store and supply chain expenses, which are more fixed in nature. These negative impacts were partially offset by lower selling, general and administrative expenses realized as driven by our comprehensive business review initiatives.

Excluding the $13 million after-tax effect from charges and credits, second quarter adjusted net income from continuing operations was $34 million or $0.06 per share compared to $35 million or $0.06 per share in the prior year. Year-to-date, adjusted net income from continuing operations was $122 million or $0.23 per share compared to $104 million or $0.19 per share in the first half of 2016. This is a year-over-year improvement of 21% in adjusted earnings per share.

Our earnings performance through the first half of the year is in line with our internal expectations, and we continue to move toward our full year $500 million adjusted operating income target.

Turning to Slide 13. Comparable sales in the Retail Division declined 6% in the quarter compared to the prior year. The comp sales decline was mainly driven by lower store traffic and a slightly lower average order value during the period. Total retail sales in the quarter decreased 11% versus the prior year, including the impact from the planned store closures in the prior 12-month period.

Looking at our performance by product category, Retail sales decreased across most of our product categories, primarily in ink, toner and other technology items. However, sales in our cleaning and breakroom category increased mid-single digits compared to the prior-year period as we benefited from repositioning the location of these products towards the front of the store, making them more readily accessible to our customers.

The Retail Division reported operating income of $20 million in the second quarter of 2017 compared to $30 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 which more than offset lower selling, general and administrative expenses realized from the company's store closure program and comprehensive business review initiatives.

Looking at the performance for the first half of 2017. Comparable sales declined 5% compared to the first half of 2016. However, year-to-date Retail Division operating income was flat compared to the same period in the prior year of $132 million. Despite the lower sales, operating margins increased 55 basis points to 5.3% in the first half of the year compared to the same period in the prior year. During the quarter, we closed 31 stores and ended the second quarter with a total count of 1,408 stores in the Retail Division.

Slide 14 shows the performance of our Business Solutions Division, or BSD. Sales in the second quarter of 2017 were $1.2 billion, a decrease of 6% from the prior-year period as reported and in constant currency. The sales decline was primarily driven by continued competitive pressures, the impact from prior-year customer losses, the ongoing reduction in catalog sales through our call centers, as well as the increased sales from our omni-channel programs which are recorded in the Retail Division, where these orders are fulfilled. We are pleased that our pipeline and new customer wins continue to improve and look forward to realizing the sales potential of these new customers once fully implemented.

Looking at our performance by product category, BSD sales decreased versus the prior year in supplies, technology and furniture. However, we continue to achieve positive sales growth in cleaning and breakroom and in copy and print. The BSD division reported operating income of $64 million in the second quarter of 2017 compared to $63 million in the prior-year period.

Although operating income was slightly higher than the prior year, operating margin increased almost 40 basis points compared to the prior year. This improvement was primarily driven by lower selling, general and administrative expenses from cost savings and efficiencies which more than offset the negative flow-through impact from lower sales and a lower gross margin rate.

On a year-to-date basis, BSD sales in the first half of 2017 declined 5% compared to the same prior-year period, while operating income increased $13 million to $122 million compared to the first half of 2016. BSD operating margins increased 73 basis points year-to-date to 4.8% as cost savings and efficiencies outpaced the rate of deleverage from lower sales.

Turning to Slide 15. During the second quarter, we successfully completed the sale of our business in South Korea. And on July 28, we finalized the sale of our business in Mainland China. Also during the quarter, on April 18, we announced an agreement to sell the operations in Australia and New Zealand to Platinum Equity, a leading global private equity firm. We expect the transaction to close as soon as the buyer obtains the necessary regulatory approvals in each country. We are retaining the global sourcing and trading operations in Asia which were previously included in the former International Division. These businesses contributed $4 million in sales and an operating loss of $1 million in the second quarter of 2017. The results from these operations are reported as an other segment outside of the 2 primary operating segments.

Turning to the balance sheet and cash flow highlights on Slide 16. We ended the second quarter of 2017 with total liquidity of $1.8 billion, consisting of $763 million in cash and cash equivalents associated with continuing operations and $1 billion available under our asset-based lending facility. Total debt at the end of the quarter was $375 million, excluding $787 million in nonrecourse debt related to the timber notes.

For the second quarter of 2017, cash provided by operating activities of continuing operations was $27 million. This included outflows of approximately $15 million in restructuring activities and $13 million in OfficeMax merger integration cost. Capital expenditures were $25 million in the second quarter, $3 million of which related to the OfficeMax merger integration.

As part of our shareholder return initiative, the company repurchased approximately 2 million shares of its outstanding common stock during the quarter for a total cost of $7 million. Since the share repurchase program began in May of last year, we have repurchased 41 million shares of common stock for a total cost of approximately $149 million with an average price of $3.65 per share. At the end of the second quarter, $101 million remained available for repurchase under the current $250 million buyback authorization. In addition, a quarterly cash dividend of $0.025 per share was paid on June 15 to shareholders of record for a total of approximately $13 million.

Slide 17 shows the major components of our cost savings and efficiency programs that are currently underway across the organization. We announced these initiatives about a year ago and began implementing the programs in late 2016. Since that time, our teams have made significant progress, and I'd like to update you on some of the key accomplishments. As I mentioned earlier, we closed a total of 31 retail stores in the second quarter, bringing the total closures under the second phase of our retail optimization plan to 105 stores. We are pleased that our sales transfer rates continue to exceed expectations, and we expect to close approximately 40 additional stores in the second half of the year.

Through our ongoing negotiations with landlords, we have been able to achieve incremental rent savings and square footage reductions across the retail network. Our efforts to move toward a lower-cost operating model continue to gain traction and is evidenced by the lower expense levels and G&A reductions across the business and improved year-to-date operating margins on a consolidated basis and for both the retail and BSD divisions.

We have identified additional business process improvement opportunities across the business, an example of which was a comprehensive workout session recently aimed at reducing shrink expense.

Our cash flow and procurement initiatives remain a significant opportunity for us. We have dedicated teams in place that are working hard with our vendors at reducing spend, consolidating supplier contracts, negotiating lower prices and improving terms.

Overall, we have made significant progress on our cost savings and efficiency initiatives and remain on track toward achieving our goal of more than $250 million in incremental cost savings by the end of 2018.

Slide 18 outlines the key components of our 2017 outlook. We continue to anticipate total company sales in 2017 will be lower than 2016 on a comparable 52-week basis. This decline is primarily a result of our planned retail store closures, ongoing competitive pressures in the market and the continued impact from prior-year customer losses in our contract channel. We do, however, expect an improvement in the BSD rate of sales decline for the second half of the year as we anniversary prior customer losses, new customer wins are fully implemented and turn to revenue, and growth from strategic business initiatives.

The company also continues to expect adjusted operating income of approximately $500 million in 2017, a comparable year-over-year increase of approximately 10%, excluding last year's benefit from the 53rd week. Our first half performance was in line with our internal expectations as adjusted operating income increased 9% compared to the same period in the prior year.

And our 2017 non-GAAP annual effective tax rate is estimated at approximately 41%, though the rate will depend on the mix and timing of income.

For 2017, we continue to expect to generate more than $300 million of free cash flow from continuing operations. The timing of our onetime costs associated with implementing the cost savings programs are now anticipated to be higher in 2017 than originally planned, but lower in 2018. The acceleration of 2017 cost is largely offset by reductions to our capital expenditures spend, which is now estimated to be about $150 million this year.

We anticipate depreciation and amortization expense to remain at approximately $150 million in 2017.

The free cash flow outlook includes a cash tax rate of approximately 15% as we continue to utilize available tax operating loss carryforwards and credits.

Now I'll turn the call back over to Gerry for his closing comments. Gerry?

Gerry P. Smith - *Office Depot, Inc. - CEO & Director*

Thanks, Steve. I'm pleased with the progress we made in the first half of the year on our strategic initiatives and that we remain on track to deliver our 2017 operating plan. As I mentioned earlier, I have internal teams focused on -- around a number of critical priorities to strengthen our core while identifying opportunities to transform our business and disrupt traditional ways of thinking as we: First, build a foundation for profitable top line growth; continue to develop our omni-channel capabilities and leverage our retail store for a unique last-mile delivery platform for customers; third, expand even faster on the attractive growth opportunities that we have identified in adjacent products and services; continue to execute on our cost savings and efficiency programs to deliver the full financial benefits; and utilize business process improvements to drive additional margin and free cash flow opportunities across the businesses to deliver shareholder value.

My goal is to expand our customer base and make it more important to our customers in order to stabilize and eventually pivot towards profitable top line growth and position Office Depot for long-term future success. We're in the process of building out the capabilities to provide our customers with superior solutions that will truly embody our Taking Care of Business customer mission. I look forward to updating you on our progress in future quarters, and I will now turn the call back over to

(technical difficulty)

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from Matt Fassler. Please state your company.

Matthew Jeremy Fassler - *Goldman Sachs Group Inc., Research Division - MD*

It's Goldman Sachs. My question relates to BSD sales. Can you talk about the puts and takes between the sales trends, presumably declined, based on the numbers, with existing accounts, relative to the sales movement associated with account wins or losses? Just as we think about what that underlying same-store trend is, if you will, and assuming that run rate is constant, just understanding the degree to which the overall sales growth rate can improve as your new customer win dynamics have improved.

Hello?

Operator, if you're there, I'm not hearing a response.

Operator

I apologize. There will be a slight delay in today's conference. Please hold, and the conference will resume momentarily.

Pardon me, Mr. Fassler, could you please repeat your question?

Matthew Jeremy Fassler - *Goldman Sachs Group Inc., Research Division - MD*

Sure. Is everybody back on? Is the management back on the line?

I'm happy to repeat my question. The question relates to the trend to BSD, comparing the underlying trend from existing accounts, presumably declines, given the overall sales decline; to what you're seeing from new accounts, the net wins or net losses, just understand the degree to which the underlying sales run rate or the reported sales run rate should improve as that new customer dynamic changes.

Operator

(technical difficulty)

Stephen E. Hare - *Office Depot, Inc. - Executive VP & CFO*

Hey Matt. Steve here. Can you hear me now?

Matthew Jeremy Fassler - *Goldman Sachs Group Inc., Research Division - MD*

I hear you. Can you hear me?

Gerry P. Smith - *Office Depot, Inc. - CEO & Director*

Yes. We heard your questions twice, Matt, so we'll have Steve answer it. We apologize for the technical challenges.

Stephen E. Hare - *Office Depot, Inc. - Executive VP & CFO*

So Matt, to your question around BSD, what we are seeing is obviously the rebuilding of the pipelines since the Staples transaction, where the pipeline went down to basically 0 as a result of that extended transaction. And what we've been pleased with is the rate of wins in the marketplace and the ability to rebuild that pipeline, as Gerry mentioned, to actually a level higher than it was pre those merger discussions. That's the good news. However, as you saw on the second quarter, you did see the sales continue to decline and actually reduce quarter-over-quarter by about 1 point. And what we're seeing there is some of the just competitive pressures in the marketplace there and the decline in usage of a lot of our key accounts there that are offsetting the pace of wins. And as you know, the wins, so these contracts take a while to implement, so there is a timing factor. So that was part of our reason, as we look at the outlook for the second half of the year and part of our optimism about being on track for our target for the year, is that we do believe you will see improvement in the pace of BSD sales in the second half of the year.

Gerry P. Smith - *Office Depot, Inc. - CEO & Director*

The other thing. Matt, this is Gerry. I'll add one more comment as well. We've also -- Steve's organized by -- well, I talked about in my piece, but by the route to market, I think that's important. And he made a significant adjustment from the operating expense perspective from the plan. We think we're getting sellers closer to customers, and I think our conversion rate will improve as a result of that.

Matthew Jeremy Fassler - *Goldman Sachs Group Inc., Research Division - MD*

If I can ask 2 very brief follow-ups directly related to that question. The first, is how does the equivalent of the comp store number compare to that reported number? And then secondly, the margin implications of some of the new account wins, I know from time to time, they tend to come in at somewhat at lower margins until you ramp them and get deeper into the catalog and off the front list.

Stephen E. Hare - *Office Depot, Inc. - Executive VP & CFO*

And Matt, that is the nature of that contract part of our BSD business. With the pace of wins that we're seeing, it is in an environment where it is very competitive. And what generally you'll see is, as we implement these accounts, they start off at a lower level of profitability. And as we work those accounts and build a relationship and broaden out what we're selling to those accounts, the margins tend to improve over time.

Operator

(Operator Instructions) Your next question comes from the line of Dan Binder. Please state your company.

Daniel Thomas Binder - *Jefferies LLC, Research Division - MD and Senior Equity Research Analyst*

It's Jefferies. I was wondering if you could just tell us a little bit about how the back-to-school business is doing thus far versus last year. I realize there's a lot still in front of us, but an update there would be helpful. And also on that topic, you mentioned introducing gaming PCs. I'm just curious what kind of exposure you actually have on that. It seems like that of a risky bet since it's a category that, I think, sort of other retailers have considered it kind of the go-to-for on that.

Gerry P. Smith - *Office Depot, Inc. - CEO & Director*

I'll start with the gaming piece and I'll let Steve -- and a little bit on back-to-school and Steve jump in as well. Our vendor communities actually are the ones who we've collaboratively reached out together, and we both think it's an opportunity. Gaming's obviously one of the fastest-growing areas in the tech space. I think our last mile footprint's an advantage. And I think we're excited with the partnerships we have with 2 of the larger PC companies that want to partner with us in bringing gaming to the marketplace. I know there's other competitors out there that have this, but we're excited that it's an opportunity. And I think it's an exposure with the customers we have coming in the stores. It's an exciting tech opportunity. And we'll -- we're going to highlight that again in our Store of the Futures in Austin as well. Back-to-school, the assortments is improved. We're optimistic with our ability to have the right merchandise and the right products. At our vendor conference a couple of weeks ago, we did just an alignment with the vendors there. We've made immediate and rapid adjustments where we thought there were areas we needed to improve also. But we're optimistic on back-to-school. I'll let Steve comment as well.

Stephen E. Hare - *Office Depot, Inc. - Executive VP & CFO*

Yes. I think Dan, obviously, Q3 is a big quarter for us. And a lot of that depends on our success around back-to-school. But we're pleased with what we have seen in the marketplace. And as Gerry mentioned, we've, I think, improved our marketing campaign, which hopefully, you've seen in the marketplace over the last couple of days. And we're very optimistic that we'll do well compared to last year as we work through this season.

Daniel Thomas Binder - *Jefferies LLC, Research Division - MD and Senior Equity Research Analyst*

And as a follow-up on retail, could you discuss the value you see in potentially buying a significant number of stores in the space if they became available?

Gerry P. Smith - *Office Depot, Inc. - CEO & Director*

That's a clever way to introduce that question. I like that. Obviously, we can't comment on acquisition activities as a result of what our competitors or other people do in the marketplace. What I will say is we're always looking, both organically and inorganically, to grow our business. And we'll be continuing to pursue those opportunities. As I've stated all along, our #1 objective is to grow the top line and to also hit our $500 million plan that Steve has committed to and I've committed to today as well. And we're going to always look for opportunities to enhance those -- enhance that capabilities.

Operator

Your next question comes from Kate McShane. Please state your company.

Christopher Weng

This is Chris filling in for Kate. Just kind of curious, with Staples probably going private, do you see any change in the competitive landscape going forward?

Gerry P. Smith - *Office Depot, Inc. - CEO & Director*

I think the way I look at that is I always respect our competitors, whether they're public or private. And I think it's -- we need to focus on growing Office Depot and growing our customers and really leveraging our strategic assets, which is our 3 routes to market. Our last mile, I think, is a huge advantage. You saw our -- 2 days ago, we announced ship from store, same day. Same day delivery, we're excited about in 3 markets. We have ship from store, we have an online. Our online and pick up in store is growing rapidly. So we're focused on growing our business and I think it's -- we respect our competitors and we need to make sure Office Depot's ready to compete.

Christopher Weng

And also on the CapEx reduction, could you talk about what drove the reduction versus your prior estimate? And is that the driven by the reduction in converting stores to the Store of the Future format?

Stephen E. Hare - *Office Depot, Inc. - Executive VP & CFO*

Chris, that was a big piece of the pullback. The target we had at the beginning of the year was our budget for the year as we looked at timing and what think will actually hit this year, that was a component of it. But we did pull back on the number of Stores of the Futures that we will complete this year. Although as Gerry mentioned, we are also improving that program, we think, by taking a market focus in Austin, Texas. So you'll -- we'll continue to invest in the Store of the Future program, but in aggregate, that's part of the reduction to our target now of $150 million.

Gerry P. Smith - *Office Depot, Inc. - CEO & Director*

And I think just to add on the Store of the Future. We're -- I think the approach of approach it by markets is a good one. We're obviously testing Austin. We're going to invite many of you down to Austin once we've rolled these out. We think it's an opportunity because it's not just a common platform where -- I think is important I mention in the hyper-local type of approach. We'll have various formats depending on where that store is located in that market. They're all going to be common, but there's going to be tweaks and nuances relative to -- some will be more heavily services-orientated, some could be more print store-orientated, some could be more technology-orientated as well. And as we roll out that market, I think you guys will be excited with the approach we're taking. And we'll continue to -- as we roll out Austin, we'll continue to look at other markets we can expand that into in the future as well.

Operator

Your next question comes from Anthony Chukumba. Please state your company.

Anthony Chinonye Chukumba - *Loop Capital Markets LLC, Research Division - Analyst*

I'm with Loop Capital Markets. I guess -- you've sort of touched on (inaudible) at bit in an earlier question. But I guess I'm just -- I'm struggling with the Business Solutions Division and the declines that the we've seen there and the fact that it accelerated in the second quarter. I mean, I would think that, given that the fact that the Staples merger speculation is so far in the rearview mirror at this point, that we would see better trends there. And I guess -- I mean, is it just increase competition? Is it just sector declines in use of office supplies? I guess I'm just trying to figure out why we're not seeing better numbers there. And then more importantly, what gives you the confidence, given these trends, that the trend -- that the top line trend will improve significantly in the back half of this year?

Stephen E. Hare - *Office Depot, Inc. - Executive VP & CFO*

Anthony, this is Steve. I agree with you. I think from a timing standpoint, we had gone into this rebuild from the Staples transaction, thinking that we could, as we saw the pipeline build, that we would start to see the sales improve a little faster. And as you've seen, it's taken us longer. But I still think directionally, and the initiatives we have in place, are moving us in that direction. And that's why our outlook for the second half of the year is to see that change in sales improve as we continue to look at the number of wins we're bringing in and the timing of then bringing those accounts to where we're now recognizing revenue on those. So I think it's a timing issue. I think from a competitive situation, that market is always competitive. The Staples transaction doesn't really change the competitive context. We're in there. We're fighting hard to win new business. And we are being successful and we're happy with the pace of wins. But we do think it's taking longer to actually realize the sales improvement that we had hoped for.

Anthony Chinonye Chukumba - *Loop Capital Markets LLC, Research Division - Analyst*

Okay. And then just one question. I mean, so you mentioned, I mean, the marketplace is always very competitive. I mean, that's obviously hasn't changed over the last several years. But I mean, are you seeing any incremental competition in terms of new entrants, i.e. Amazon Business? Or just sort of changes in competitive dynamics, people getting more aggressive? Or anything along those lines?

Gerry P. Smith - *Office Depot, Inc. - CEO & Director*

I think it's fair to say there's a lot of companies that are seeing specific competition from online resellers. And what -- that's why it's so important we execute against our strategic initiatives. I've discussed about the strength of our -- of making sure our last mile footprint is an advantage. And I think we're taking a different approach to other competitors. And we really think our integrated omni-channel approach will be a way that customers respond and allow us to compete, longer-term, effectively over a period of time. We're making significant investments and are making sure our supply chain world-class as well. And I think that's going to be a differentiator over a period of time, also. So it's supply chain, it's our integrated channel, and it's putting Steve back in charge and getting the route to market and the segmentation correct. And we're seeing the results. He's been In place about 2.5, 3 months now, and we're going to start seeing that optimization take place.

Stephen E. Hare - *Office Depot, Inc. - Executive VP & CFO*

And Anthony, look. Anthony, I would add to that. I think that when we talk about why the new wins are not as apparent in our sales numbers, I think part of that is exactly what you're pointing out. Is that people, like an Amazon Business, are pulling away some business from our core customer base, even though they're contract customers to us or to Staples. And that's a phenomenon that we're dealing with. And that's also part of the sales change overall. But over time, our pace of wins should drive that number in a positive direction.

Gerry P. Smith - *Office Depot, Inc. - CEO & Director*

The operating income that Steve's produced for the quarter was -- is a positive as well. Even with the challenge that we have, we're seeing the operating income improvement as well. As I've said in my statement earlier, there's significant expense reduction in our go-to-market expenses in the second half that Steve already captured and executed against, which is very significant to allow us to be competitive and be aggressive and growing the business.

Operator

Your next question comes from the line of Christopher Horvers. Please state your company.

Christopher Michael Horvers - *JP Morgan Chase & Co, Research Division - Senior Analyst*

JPMorgan. So want to talk a little bit about the gross margin. The past couple years has been up and then there was a different direction this quarter. So is that a change in the pace of rent reductions versus prior periods? Is it something about the mix in the business that is changing? Or perhaps both? And any quantification or bucketing of those shifts will be great.

Stephen E. Hare - *Office Depot, Inc. - Executive VP & CFO*

Chris, I'll take the start at that question. I think, as you're aware, if you look back over the last couple of quarters, I think our overall focus around occupancy cost, the leverage that we've received from closing stores, has been beneficial to our gross margin and been a component of the overall improvement there. If I look at the business, though, remember that second quarter is always our softest quarter as we look at the margin. And I think that as we look at the trends there, sometimes, they get amplified when we've had soft sales. I tend to look at the year-to-date gross profit margin, where we're just about flat year-over-year, and think that that's a little more representative of what we expect for the year from an overall outlook standpoint.

Gerry P. Smith - *Office Depot, Inc. - CEO & Director*

Another thing I'll emphasize is, we've said it a few times, just year-to-date, we're ahead of our plan of where we were last year. I think it's important to emphasize that we're up year-to-date, and this is our softest quarter. Q2 is our softest quarter. And from a timing perspective, I like to look at things in bigger chunks. In the first half, I mean, Steve went through it well. But I mean, we're on track to our $500 million operating plan.

Christopher Michael Horvers - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Understood. So as you, guess, one would've expect -- has to dig in a little bit. So did sales mix to that component of gross margin change trend in the second quarter? Outside of the deleverage on occupancy, did sales mix change in trend? Because if you look at, in your description on categories, tech was down, copy and print, Jan/San are all up. So it would've suggested that mix benefited gross margin rate in the second quarter. Did that happen? And is it simply that maybe the benefits of the decline in tech are just moderating as that category just shrinks in penetration?

Stephen E. Hare - *Office Depot, Inc. - Executive VP & CFO*

Chris, I don't think mix really played into the margin, the gross profit change in the second quarter. I would say, we did make a comment in our prepared remarks that one of the things we saw, again, in a seasonally soft quarter was we did see the more fixed cost around supply chain were a part of the margin decline. And we are, as Gerry has mentioned, we've got a number of initiatives to address supply chain cost. But when you hit that in a softer second quarter from a sales standpoint, it does magnitude -- magnify the impact of that. So I would say that would be the one other issue, as you dig down a little bit, that I think hit us in the second quarter around our gross profit, that we think we can mitigate in the second half of the year.

Christopher Michael Horvers - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Understood, and just the last question on gross margin. So as you look forward, you talked about gaming PCs. You talked about the outlook for better contract growth in BSD. So is the expectation that these lower, sort of, rate categories get offset by the leverage on those fixed costs?

Stephen E. Hare - *Office Depot, Inc. - Executive VP & CFO*

Yes. I think that's a fair comment.

Gerry P. Smith - *Office Depot, Inc. - CEO & Director*

And I'll just add that scale always wins. And I know this is a journey and we have to prove to the -- to you guys that we can grow and we will grow. But as we start to grow, we're going to get scale advantages. And that's why the focus is both organic and inorganic growth.

Operator

Your next question comes from Michael Lasser. Please state your company.

Atul Maheswari - *UBS Investment Bank, Research Division - Associate*

This is UBS. This is actually Atul Maheswari filling in for Michael Lasser. So we had a question on your of $500 million target. And presumably, that would imply a reasonable amount of margin expansion in the back half of the year. So what is it, outside of the cost savings? And I know you previous spoke a little bit about fixed cost leverage from higher sales. But other than these 2 factors, what would -- or where would that margin expansion come from, essentially?

THOMSON REUTERS

Stephen E. Hare - *Office Depot, Inc. - Executive VP & CFO*

So let me take a start at that one. I think in terms of our outlook for the year, at the $500 million, what we look at is the increase. That represents about a 10% increase year-over-year, excluding the 53rd week benefit from last year, on adjusted operating income. If you look at the first half on a comparable basis, we're up about 9%. So when we say we're tracking to that number, really based on the actual for the first half of the year. I do think, when we go forward, then, the other aspects of getting to that number revolve around the improvement we've talked about in the second half for BSD, with the pace of the new wins, as we've talked about, kicking in, we do see the sales trends starting to improve in the second half of the year. Obviously, the Retail business, if we're successful in back-to-school, third quarter is a very big quarter for Retail business and we can make up ground there compared to the second quarter of the year. But then also, as you mentioned, the cost savings programs are very important to us. So if you remember, we did a comprehensive business review going into this year. And that was called for about $250 million, including the benefits from the store closure program. That program is well along. And I think you really do see the benefits of that. If you look at SG&A for the first half of the year, we are down about $125 million. So on a rate basis, even with softer sales, you're seeing about a 70 basis point improvement on SG&A as a percent. So the impact of that program is very significant to us and very important as we weather the storm of softer sales here, as we pivot toward some of these longer-term growth initiatives that Gerry has talked about.

Operator

That concludes the Q&A session for today. I will now turn the call back over to Gerry Smith for any closing remarks.

Gerry P. Smith - *Office Depot, Inc. - CEO & Director*

I just want to thank everyone for being on the call today. Just want to reemphasize the fact that we're going to grow as a company. We're going to use an omni-channel approach. We're going to be aggressive in both inorganically and organically. We think we're positioned well, as Steve said, from an expense perspective. And we believe we can -- we have a vision in place to strengthen our core, transform our business and disrupt in new areas. And most importantly, we are -- this first half of the year, we're still on track from an operating plan perspective, and we're committing to make sure we continue to execute going forward. Thank you for your time today and we'll chat again in the near future.

Operator

Thank you for your participation. This concludes the call. You may now disconnect.