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ODP - Q1 2018 Office Depot Inc Earnings Call

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PRESENTATION

Operator

Good morning, and welcome to the Office Depot's First Quarter 2018 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 Joe Lower, our Executive Vice President and CFO. On today's call, Gerry will provide an update on the business, including highlights of some noteworthy achievements during the quarter and progress towards our transformation. Joe will then review the company's quarterly financial results, including divisional performance as well as an update on our outlook for 2018. Following Joe's discussion, Gerry will have some closing comments, and then we'll open 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 the Office Depot's CEO, Gerry Smith.

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

Thank you, Rich, and good morning to everyone on the phone with us today. I'm very pleased to be here with you this morning and report on the positive momentum that we are seeing in the business and a tangible evidence of the progress we are starting to deliver on our journey to transform Office Depot. As you know, one of the key pillars of our strategy is to strengthen our core operations, and we're making great progress as our first quarter results demonstrate. Our mindset is on winning every day by focusing on demand generation, reaching new customers and growing the



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customer base across the organization. As these initiatives continue to gain traction, we expect to build additional momentum throughout the year as we continue to fundamentally reposition Office Depot for the future. Beginning on Slide 4, I'd like to share with you some of our strong first quarter financial highlights. Total sales in the first quarter were \$2.8 billion and up 6% versus the prior year. Let me say that again. Up 6% versus last year. This is a very major milestone for us as a company, and one that we haven't seen since the combination of Office Depot and OfficeMax back in 2013. The acquisition of CompuCom played a major role in this accomplishment, and the customer base we acquired is part of that transaction. However, the demand generation efforts that I referenced earlier also had a significant impact, as the BSD division reported positive sales this quarter, which is the first time this has occurred since 2012. Let me say that again. It's the first time BSD has grown since 2012. We also increased the customer base across the organization and saw positive trends in retail, where the declines are less than we've experienced in the past. I'm extremely proud and encouraged that we are now growing again as a company. Myself and the team are committed to continue this trend in the future. In addition to strengthening the core operations, our growth strategy is also focused on creating a powerful omni-channel business services company. The first step in our transformation was the strategic acquisition of CompuCom, and we have further enhanced our services and subscription offerings in both retail and BSD throughout the year. As a result, we have enhanced our financial reporting this quarter and started to provide a breakout of product and service revenue across the business. I'm very pleased to report that total service revenue now exceeds 14% of total company revenue. This is nearly double what it was in the first quarter of 2017, and highlights the transformation that is underway. I will share some additional details in our service offerings in just a few minutes.

GAAP operating income in the first quarter was \$77 million, with a diluted earnings per share from continuing operations of \$0.06 per share. Our adjusted operating income was \$93 million with adjusted diluted earnings per share from continuing operations of \$0.08 per share. While adjusted operating income was down year-over-year due to our transformation investments and other headwinds, I'm very pleased that we're able to exceed our expectations for the first quarter.

Lastly, and very importantly, we were able to generate \$170 million of free cash flow in the first quarter, also well ahead of our expectations. As Joe will discuss in a few minutes, this was largely driven by our intense focus on working capital management, which more than offset the investments we are making to strengthen and grow the business. Last year, and every quarter, Rich and I have discussed the importance of working capital management, and we're starting to see the fruits of these investments and the hard work our teams have put in to increase our free cash flow. I'm very proud of the team for these efforts.

As a result of the strong performance in Q1 and continued confidence in our forecast, we are increasing our full year outlook of sales, our adjusted operating income and our free cash flow to reflect this momentum. I will now elaborate on a few additional highlights in the quarter that support key elements of our strategy and the strategic pivot we are making as a company.

Turning to Slide 5. While we're excited by the transformational changes underway across the company, strengthening the core is paramount as it establishes the base of customers, earnings and cash flow, which we can build upon. It starts with an increased focus on the customer and how we're redefining the experience and our offerings that attract and retain high-value business customers. We find that our customer base in the BSD and CompuCom divisions are very similar. And together, these 2 B2B-focused businesses now represent nearly 60% of total sales. I want to say that again. B2B represents 60% of our total sales. This is a large shift from just a few years back when retail was the largest percentage of the company. Most importantly, these 2 businesses are now stable. The CompuCom business was essentially flat in the first quarter, while the BSD division grew sales in the period. As I said earlier, this is the first time since 2012. This is clearly a major milestone for us, as we have moved beyond the disruptions of the past, including the OfficeMax customer migration process, which was finally completed this quarter. We're seeing success in our adjacency strategy within BSD as well, especially in cleaning and breakroom, and we've made successful acquisitions of small regional office products and janitorial supply companies along the way that brought additional selling resources and customers in geographies where we had minimal presence. The business has been making steady improvements over the past several quarters, and I'm very pleased that we are now back to growth in this important piece of our business.

Looking forward, we see continued momentum in these growth initiatives as well as a growing number of cross-selling opportunities with CompuCom. The 2 sales teams have now been fully trained, and are tracking hundreds of opportunities across the combined SalesForce.com customer database. The customer referrals go both ways, and we're seeing tech services opportunities in the Office Depot customer base as well as new office product opportunities in the CompuCom customer base. As I mentioned on our last call, we also have an incentive structure in place that is specifically focused on driving services revenue and cross-selling opportunities across our business. After only a few months of ownership,



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we've already captured several new wins and expect us to continue ramping over the balance of the year. And within the CompuCom business, we're seeing positive trends with many accounts in their existing customer base. Q1 represents the third consecutive quarter of year-over-year growth in service orders despite the first quarter being a traditionally seasonally slow quarter. Several other customers are initiating large IT projects, as they're investing back in their businesses. CompuCom is very well positioned to continue benefiting from this additional spend. We expect additional benefits this year from the continued rollout of tech services into the retail stores, and I'm very pleased to report that we're on track to deliver the cost synergies we estimated when we announced the transaction. Beyond that, we're seeing additional opportunities as we align the selling efforts across both groups. Overall, I'm very pleased that the trends in these 2 divisions have stabilized, and I'm optimistic about their prospects for the remainder of the year and beyond. This stability, combined with the demand generation initiatives that we'll talk about next, have us well positioned for growth across the enterprise.

Turning to Slide 6. I want to highlight the importance of demand generation and the shift we are making towards digital marketing to more efficiently and effectively engage with customers, especially online, where they're first beginning their shopping journey. The focus on customer is key. It is a customer-first mentality that we're driving throughout the organization, and we're starting to see some very favorable trends appear. We began the shift in Q4 of 2017 towards digital and broadcast media specifically targeting small- and medium-sized businesses. With a more focused strategy, we delivered a higher ROI and improved traffic trends as well as realized growth in the new business customer acquisition. Let me say that again. Realized growth in new business customer acquisition. These efforts are continuing to gain traction. And during the first quarter, online traffic grew 9%, loyalty enrollments were up 27% and we are capturing new customers as the rate of new business acquisition doubled in Q1 versus Q4 of 2017. We've also recently established an analytics center of excellence to streamline the tools, capabilities and people across the company for this critical function and in driving improvements in customer acquisition efficiency. As a result, we are not only driving more customers through our website, but there are more relevant customers, as online conversion was up double digits in the first quarter. By being more targeted in our efforts and moving from low ROI to higher ROI vehicles, we were able to generate a higher response rate with lower overall costs. We will continue optimizing our media mix to reach high-value businesses and expand our focus to include customer retention, while also including a services and subscription message in all of our marketing. If you remember, during our earnings call at the end of February, I indicated that we have started to activate a subscription-based customer focus across our business. This included the launch of a new ink and toner subscription offering in our stores. We are continuing to make strong progress in this area. And total subscriptions now exceed 245,000, an incredible accomplishment considering we just began operating this functionality at the beginning of the year. We are adding additional categories and functionality to make this an even more convenient service offering for our customers. And to create a sticky, reoccurring revenue streams are a key part of our strategy. Finally, we recently announced WPP as our new marketing agency. They are well regarded and proven firm in the industry that we believe can help accelerate our demand generation efforts by providing more relevant, cohesive and compelling marketing campaigns across our channels.

Turning to Slide 7. By increasing our engagement with customers, we are looking to build broader relationships that are underpinned by an array of reoccurring, sticky and higher-margin services, and ultimately position Office Depot to be the preferred business services platform for a company of all sizes. I mentioned earlier that services revenue in the quarter was over \$400 million, and now represents greater than 14% of our total sales. On an annualized basis, that would translate into nearly \$1.6 billion in annual revenue. Approximately half of this revenue is related to the award-winning tech services that are performed in the CompuCom division. What most people don't realize is the other half of the services revenue is generated from the variety of offerings in our retail and BSD divisions. The store footprint will become even more important to us in the future as we continue the rollout of technology and other services across the network in 2018. While we have categorized these services into technology, print and marketing, administrative and workplace for simplicity, they are all part of a comprehensive suite of services that we offer customers to enable them to run and grow their business. Over time, we expect to add additional offerings to our business services platform and see this expanding to be even a larger percentage of our total revenue. Our strategy is to take a holistic approach to meeting customer needs by providing a comprehensive range of products and services under a common platform and delivering them when and where our customers need them. We realize that our businesses need to mirror the behavior of our customers and, first, engage with them wherever they are, including online, in our stores or at their office; second, provide the information they are searching for during the shopping process when they want it; third, and enable them to conveniently make the purchase either one-time or ongoing with a subscription offering. I firmly believe that this is the power of a true omni-channel platform that leverages our capabilities and delivers a consistent experience, regardless of how or where customers choose to interact with us. This includes using our websites, retail stores, dedicated sales force and supply chain to meet these customer needs. We've also recently introduced a new channel partnership with MicroCorp to provide additional feet on the street to engage with an even larger number of small- and medium-sized businesses that we could do on our own. Our management team and associates are energized by this new strategy and the power



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of the omni-channel business services platform. We see benefits for both our customers and shareholders as a way for Office Depot to create tremendous long-term value.

I will now turn the call over to our CFO, Joe Lower, who can provide more details on our financial results. Joe?

Joseph T. Lower - Office Depot, Inc. - Executive VP & CFO

Thank you, Gerry, and good morning, everyone. I'm happy to be here today to discuss with you our first quarter results. Similar to last quarter, we have provided our results on both a GAAP basis and adjusted basis from continuing operations. My comments will primarily address the performance from our continuing operations on an adjusted basis. Also, keep in mind that the total company financials include the results for the CompuCom division for the first quarter of 2018 only, as this business was not part of Office Depot in the prior year period. As Gerry mentioned earlier, we have enhanced our financial disclosure to report the breakdown between products and services for both sales and cost of goods sold. We hope this visibility provides greater insight into our business and the progress going forward as we continue to expand and grow our business services platform.

Let us turn to Slide 9. Here we have highlighted some key performance measures for the first quarter of 2018. Total company sales for the first quarter totaled \$2.83 billion compared to \$2.68 billion in the same period last year. The increase of 6% was driven by the addition of CompuCom's results for the first quarter in 2018 as well as positive sales growth experienced in our Business Solutions Division. With the addition of CompuCom, total service-related revenue now contributes to over 14% of the company's total net sales. We are very focused on seeing this portion of our business grow and become a larger and larger percentage of our total sales mix going forward. First quarter GAAP operating income decreased to \$77 million compared to \$124 million in the prior year. During the quarter, the company incurred \$17 million of operating expenses related to the merger integration, acquisition-related costs and other restructuring activities. Excluding these items, our adjusted operating income in the first quarter of 2018 was \$93 million compared to \$148 million in the prior year period. The decline in adjusted operating income was primarily due to the negative flow-through impact from lower sales in the Retail Division and higher marketing, advertising and other growth-related investments across the enterprise as we improve demand generation and develop more sustainable revenue streams. As you can appreciate, these investments often precede the associated revenue generation and have a short-term negative impact on margins. I also want to point out that both years include a negative impact due to the change in accounting standards starting in 2018 related to the presentation of expense related to the defined benefit pension plans. This resulted in the recognition of \$2 million of expense in the first quarter of 2018 and \$3 million in the first quarter of 2017. We expect similar impacts to be realized throughout this year as well.

Excluding the after-tax impact from the items mentioned earlier, first quarter adjusted net income from continuing operations was \$45 million or \$0.08 per share compared to \$88 million or \$0.16 per share in the prior year. Finally, for the first quarter of 2018, cash provided by operating activities of continuing operations was \$207 million. This was very strong cash flow performance during the quarter, and was a significant increase over the \$88 million reported in the prior year period. The year-over-year increase of \$119 million was primarily due to continued working capital improvements, largely from improved vendor payment terms and inventory reductions as well as lower incentive compensation payouts. Operating cash flow for the quarter included outflows of approximately \$12 million in OfficeMax merger costs, \$10 million in acquisition and integrated-related costs and \$5 million in restructuring expenses.

Let's now turn to Slide 10, which highlights the performance of our Business Solutions Division, or BSD. Reported sales in the quarter for BSD were \$1.3 billion, an increase of 1% compared to the prior year. This is a quarterly sequential improvement of approximately 400 basis points and, as Gerry mentioned earlier, returns the division to positive sales growth. The BSD sales improvement over the prior year was primarily driven by growth initiatives in our adjacency categories, e-commerce sales and from the acquisition of new customers, both organically and inorganically, in our contract channel.

Looking at our performance by product category, BSD sales increased double digits in our furniture business and mid-single-digit in our cleaning and breakroom category versus the prior year, as our focused efforts on expanding these adjacencies continues to gain traction. These sales gains were against lower volumes in the more traditional supplies and technology categories. The BSD division reported operating income of \$55 million in the first quarter of 2018 compared to \$58 million in the prior year period. The slight year-over-year decline was primarily due to conversion costs associated with the customer migrations from the legacy OfficeMax platform to the new Office Depot system, which was completed this quarter.



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In addition, the division realized higher marketing investments in the quarter compared to the prior year as part of the company's online demand generation strategy, which mentioned earlier favorably contributed to the increased sales performance. These higher investments overshadowed the positive year-over-year success of lowering SG&A through focused cost reduction initiatives.

Turning to Slide 11. Reported sales in the first quarter for the Retail Division were \$1.2 billion compared to \$1.4 billion in the prior year period. The decline in sales was partly due to planned store closures, which occurred within the last 12 months, and a negative impact to revenue of approximately \$30 million, resulting from the adoption of the new revenue recognition standard in 2018.

Comparable sales decreased 4% versus the prior year period, primarily driven by fewer transactions and lower average order values.

Looking at our performance by product category. Comparable retail sales increased double digits over the prior year in our cleaning and breakroom category, as our efforts to make these products more accessible continues to win with customers. Sales of our more traditional copy and print business remained flat with the prior year, and declined in the technology, supplies and furniture categories.

The Retail Division reported operating income of \$72 million in the first quarter of 2018 compared to \$112 million in the prior year period. This year-over-year decline was primarily driven by the negative flow-through impact from lower sales, including store closures and higher marketing and advertising investments, which more than offset lower payroll expenses and other cost reductions.

During the first quarter of 2018, we closed 2 stores, bringing our total store count to 1,376 stores in the Retail Division. As previously announced, we have slowed the store closure program as retaining our retail footprint remains a critical part of our omni-channel strategy.

Looking at the Slide 12. We highlight the performance of the CompuCom division. As I mentioned earlier, reported financials include the results for CompuCom in the first quarter of 2018 only, as this business was not part of Office Depot in the prior year period. However, to provide greater perspective into the year-over-year performance of this business, we have presented unaudited, adjusted historical results for the first quarter of 2017 for reference purposes only. The adjustments made to the 2017 results take into account the treatment of historical restructuring acquisition costs to more closely align with Office Depot's reporting format. Reported sales in the first quarter for the CompuCom division were \$257 million, roughly flat to historical sales in the prior year period. The business experienced sales growth within the small- and medium-sized business, or SMB market, and continued the strong momentum from Q4 into the new year with high order volumes realized again. As Gerry mentioned earlier, this was the third consecutive quarter of year-over-year growth in service orders. The CompuCom division reported operating income of \$5 million in the first quarter of 2018, down slightly to the adjusted historical results from the first quarter of 2017. Q1 performance included investments to support growth initiatives, including an increase in technicians for the SMB market as well as incremental depreciation and amortization expense related to the acquisition and alignment of accounting policies. This was largely offset by lower selling, general and administrative expenses as a result of targeted cost-reduction initiatives and administrative efficiencies.

Turning to the balance sheet and cash flow highlights on Slide 13. We ended the first quarter of 2018 with total liquidity of approximately \$1.6 billion, consisting of \$737 million of cash in continuing operations and about \$900 million of availability under our asset-based lending facility. Total debt at the end of the quarter was approximately \$1 billion, excluding the \$770 million in nonrecourse debt related to the timber notes.

For the first quarter of 2018, cash provided by operating activities of continuing operations was \$207 million. As I highlighted earlier, the year-over-year increase was primarily due to continued working capital improvements. Operating cash flow for the quarter included outflows of approximately \$12 million in OfficeMax merger costs, \$10 million in acquisition and integration-related costs and \$5 million in restructuring costs. Capital expenditures were \$37 million in the first quarter of 2018. The investments reflected our commitment to continue to strengthen our core as well as invest in future growth. In corporate and capital expenditures, we generated robust free cash flow from continuing operations of \$170 million during the quarter. In addition, during the first quarter of 2018, the company paid a quarterly cash dividend of \$0.025 per share to shareholders on March 15 for approximately \$14 million in total. We also repaid \$19 million of our outstanding term loan consistent with the repayment schedule. Furthermore, as previously announced on our call last quarter, we successfully completed the sale of our business in Australia in February, and late last week closed on the sale of our business in New Zealand. The sale of both businesses will provide the company with approximately \$102 million of incremental cash to continuing operations. With these 2 transactions now finalized, the company has fully completed the international divestiture plan, and can now sharpen our focus on the transformational growth opportunities in front of us.



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Looking at Slide 14, we provide the company's updated outlook on key financial measures for the full year 2018. As we have discussed throughout this morning, results for the first quarter of 2018 exceeded our expectations. Due to the favorable results achieved, the company is now increasing its full year outlook as follows. The sales outlook is increasing by \$200 million to be approximately \$10.8 billion. Adjusted operating income for the year is increasing by \$10 million to be approximately \$360 million. And free cash flow is increasing by \$25 million to be approximately \$350 million.

With the strong Q1 performance and the momentum we are seeing with our key growth initiatives, we feel it's appropriate to raise our full year outlook at this time. Our teams are focused on this transformational journey, and we believe we are taking the necessary actions to position the company for long-term sustainable growth.

Finally, I want to remind you, we will be hosting our 2018 Investor Day next week on May 16 at the Mandarin Oriental Hotel in New York City. A live webcast will also be available on the Office Depot Investor Relations website at investor.officedepot.com. We are very excited about this event, and having the opportunity for Gerry's leadership team to meet with many of you. We look forward to providing a more in-depth look into our strategy, the ways we are generating higher demand, improving our operations and deploying the significant cash we are generating. I hope to see you there.

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

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

Thanks, Joe. Overall, I'm extremely pleased with the performance in the first quarter, and continue to believe that we have the right long-term strategy in place. We recognize that 2018 is an important year of transition for Office Depot, and I'm encouraged by the positive trends we are realizing across the enterprise, including the stability we are seeing in our BSD and CompuCom divisions and expectations of future growth; the aggressive demand generation strategy we are employing that is benefiting all of our channels, driving significant improvements in online traffic and increasing the number of active business customers; the continued growth of our service and subscription offerings; and the strong progress we are making at driving working capital improvements and free cash flow generation. I look forward to spending much more time on our strategy, initiatives and long-term outlook when we get together next week with the rest of my leadership team at our upcoming Investor Day in New York City. I will now turn the call back over to the operator, and we can take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question will come from the line of Matt Fassler.

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

My questions relate primarily to BSD. First of all, can you talk about -- you mentioned some acquisitions driving the core BSD numbers. How significant were the acquired revenues to BSD this quarter?

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

Well, it's a combination of things, Matt. Obviously, we're very, very happy with the 1% BSD growth. It's a combination of a lot of progress in the core contract business. I'll say our online e-commerce business is doing extremely well. It's some of the highest levels we've seen before, and the acquisitions make up a small contribution to the overall business. Important, and I want to touch on that for a second, we do believe there's a buy versus build approach here. and we've done a lot of work that says the customer relationships of some of these acquisitions, we can actually speed the customer and speed to market that it's a very effective strategy for us to -- from a cash perspective just to roll up some of these acquisitions because we like the spaces they're in. They're in some geographies that we don't have a lot of density in. And I also think that having that retentive



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sticky relationship on a day-to-day basis is important, especially as we start pivoting to not just selling core products, but in selling services and other services as well. So it does make a contribution, but it's really a combination of great performance across the whole BSD team that have led to this piece. And we've seen substantial -- sequential improvement for the last 3 to 4 quarters. And we've said that we're going to do this, and I'm very pleased that we've done it now. And I'm very confident that we'll continue to do it going forward as well.

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

To follow up on the numbers, can you talk about how much of the growth came from the acquired businesses in BSD?

Joseph T. Lower - Office Depot, Inc. - Executive VP & CFO

Matt, we're not breaking out specifically the acquisitions. As Gerry mentioned, it's -- they are a modest contributor. The strongest contributor really is coming from of the e-commerce initiatives we have.

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

Can you talk about what the core organic growth rate did in 1Q versus what it did in 4Q?

Joseph T. Lower - Office Depot, Inc. - Executive VP & CFO

I'm not sure we've -- I mean, it was down slightly. We're not providing kind of the core -- we're not breaking it down to the pieces, but it was down slightly. The acquisitions contributed slightly, and the e-commerce contributed slightly for a net of a 1% positive year-over-year.

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

I'll add some color. We've seen improvement. It's not -- obviously, we want everything to be growing, but it's down slightly. But the e-commerce team is doing a tremendous job. And then you couple in the acquisitions of our smaller -- some of our smaller marketplaces, it's made for a very successful strategy. And we think we can continue to replicate this. And it's -- then you have the CompuCom piece, and it's 60% of our overall business. So we think we're onto something, and our strategy of strengthening the core is going to be very valuable for us long term.

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

I understand. And then kind of related to that, I realized that BSD is now obviously a smaller piece of what you've got, given CompuCom. A number of competitive changes obviously. Staples now is a private enterprise, Amazon perhaps doing a bit more in this space, obviously some changes pending on the wholesale front, but really focusing -- or as you go out for bids, for example, and think about new business wins, are you finding a narrower field that you're up against, given that perhaps some of your competitions has -- needs to be a bit more restrained?

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

Well, I think, obviously, we compete every day. We have -- I don't like to comment on competitors, but what we try to do here is make sure we do our job well. So obviously, it's making sure we have the right cost position, the right product breadth, the right supply chain. Our supply chain is a top 20 supply chain. We'll see you next week in New York. We'd love to expand on that more, but we're -- I'm very pleased with our win rate as well as the execution of Steve and the BSD team as well as, again, we're seeing tremendous success in the e-commerce business. And I love the fact that we found some of these key markets that we didn't have the density in before. But it's a combination of the strategy, and we think that we're going to continue the momentum. So we're very, very positive of where we're at.



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Operator

Our next question comes from the line of Michael Lasser.

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

This is Atul Maheswari filling in for Michael Lasser, Company name is UBS. So I also have a question on your BSD division. So you highlighted furniture growing double digits; cleaning and breakroom, up low single digits. So were there any other categories outside of these 2 that grew this quarter?

Joseph T. Lower - *Office Depot, Inc. - Executive VP & CFO*

Those are the largest 2, I mean, the largest 2 that we really kind of commented on here. So you should assume that the majority of the growth coming out of the categories is from those 2.

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

And how big -- yes, please go ahead.

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

And those are very important as well because the ability to have that omni-channel approach we're taking, we're using the approach that we can -- in our flagship store in Austin, you can do virtual reality to design your office. We're putting more and more capabilities for our BSD sellers to sell furniture. We have expanded our assortment at both in the store as well as online as well as our BSD teams. We've added SKUs and capabilities within our supply chain to deliver cleaning and breakroom, and we've brought in some expertise. We've brought in a great cleaning and breakroom leader with years of experience, and brought that -- Wayne's done a fantastic job for us. And so I think it's a combination of many different levers we've pulled. And so we're going to continue -- I think Mark Perrotti and his team have done a great job in the furniture and the merchandising side. So we're going to double down on these categories. And we're seeing tremendous strength, but we're not ignoring their other categories as well. Again, the vision is to sell not just narrow pieces of products and sell products and services. And we think there's a number of that. The tech services piece is making progress. We think there's workplace and other type of areas we can also sell to our active customer base, which we'll go into a lot of detail next week at Investor Day, but we've got a large active customer base that we think is a huge asset for the company that we're going to leverage to sell furniture, cleaning and breakroom, a number of other services and products, too. And again, this is driving the BSD growth. We've said we're going to do it. We've done it. We're going to do it again.

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

And if I may ask a follow-up. How big is furniture and cleaning and breakroom as a percentage of the total BSD?

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

Knowing that our competitors are probably listening on the phone, we're obviously not going to disclose that. But it's -- I would encourage you to come to Investor Day. You'll see a lot of great information. And -- but it is a key category for us. We're a business services and product company. We sell paper. We sell ink and toner. We sell furniture. We sell cleaning and breakroom. We sell services, plus a lot of other key things to our business partners and consumers as well.



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

Okay. So the sequential improvement that you've, of course, mentioned a couple of times for the division, should we assume that, that was because some of these growing categories, like the furniture and the cleaning and breakroom, your online, did they accelerate more than the previous quarters? Or were there also improvement in some of the core categories, which declined, but declined less than the past few quarters?

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

I think the piece that we haven't touched on that I want to really amplify and emphasize, which I touched on my piece, is we've had dramatic improvements in our demand generation and our marketing activities. Jerri DeVard and her team have done a tremendous job. They'd come in, we're looking at -- we're using an analytic center of excellence, We're looking at ROI in all our mediums. We're moving from an analog, what I call analog marketing and digital marketing. And we're investing in vehicles and marketing that are driving traffic. And so it really starts at the start of the funnel. So we're driving a tremendous improvement in marketing, demand generation and traffic. That and with the merchandising improvements that Janet and her team have done, who've done a tremendous job of improving our assortment of our products. Those, coupled together with great execution by our channels, is leading to the growth you're seeing in BSD. So it's a combination of all these pieces coming together. We've been focused on it for the last year. And now we're -- all these pieces are coming together. And we're strengthening our core, which is our center of our strategy, and that drives customer generation. And you saw the fantastic cash generation we have as well. And we're positive, over the year, we'll continue -- we've brought the numbers up, that this strategy's working. Demand generation, great merchandising, great supply chain, all driving, helping our sellers and all 3 of our channels be successful. And I am confident that all the categories will see improvements from where they were historically.

Operator

(Operator Instructions) Our next question will come from the line of Elizabeth Suzuki.

Elizabeth Lane Suzuki - *BofA Merrill Lynch, Research Division - VP*

It's Bank of America Merrill Lynch. So in the furniture category, what kind of gross margin are you seeing in that category compared to the corporate average? And how is that margin compared to a year ago? Because you just mentioned that you're doubling down on the category. So I'm just curious what the implications would be for gross margin.

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

Again, it's -- we cannot discuss this because -- from a competitive perspective. I will just say we're comfortable with where we're at, and we're going to continue to -- we think we found an important growth category for us. We are the largest seller of business chairs in the United States. A lot of people don't know that. But we think, again, the merchandising team has done a great job of finding great products for us. We have some great partnerships with suppliers that give us some exclusives. And it's really, again, going back to the demand generation, vehicle and using our online -- our order online, pick up in store. It's using -- getting that traffic in has been the key. I mean, I want to highlight again that that's been the key driver for a lot of this demand generation. And then obviously, our channels have to go execute to it. But we're not going to disclose the margins. But we're going to continue to put a lot of focus on growing furniture, growing cleaning and breakroom and growing other adjacencies. We think -- you'll see at Investor Day, we think there's new categories. Because of the fact we have a relationship, we want to make sure that we execute that relationship across products and services to our customers.

Joseph T. Lower - *Office Depot, Inc. - Executive VP & CFO*

But I'd only add is, you should assume that the desire for us to grow these categories reflects our confidence that this can be done profitably.



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

Or we wouldn't have brought our guidance up if we didn't think we can do that.

Elizabeth Lane Suzuki - BofA Merrill Lynch, Research Division - VP

Okay, great. That answers my question. And just given the increased focus of the company on being at the forefront of technology and services, can you just talk a little bit about the smart office being what the market looks like now versus the potential growth profile, and what you think your competitive advantage is?

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

Well, I think we're excited with the smart office. And if you look at our retail stores, Kevin Moffitt, our retail team and Janet have done a good job. We're starting to roll out our smart home, smart office and offerings with some partners in a lot of our stores as well as online. But I think it's a huge growth opportunity. Dan Stone and his CompuCom team actually just were moved into a completely smart office building that we think is world-class and leading. So Dan's team did this with the CompuCom side as a pilot, really demonstrating where the technology and capability could go. They're able to build the building faster, cheaper than any and most historical builds. For example, it's all done from an Internet of Things sensor device perspective. You have no light switches, et cetera. Everything's done from a tech perspective. Now we think that is a demonstration of where people can go in the future because green is important to us, saving energy, saving costs, making it more effective in time. You can go walk into a CompuCom conference room, your presentation automatically goes up on the screen. It saves our -- a customer's time. We're going to see improved emphasis of Office Depot focus on this category. We think it's very small right now, but I think it's a huge growth market for the traditional industry as well as, as we pivot to be a broader company for us going forward. And the key is we've demonstrated it. We have a building that shows it. And so we've merchandised it. And so you're going to see our furniture and our merchant teams and our retail teams and our BSD teams all focused on not just selling furniture, but how do we use AR, VR to sell it more effectively. How do we use this technology to sell it more effectively? Because we think we're not -- just not a office supply company anymore, we're a true service product company that can sell services and products to new categories. And I'm excited by these growth categories. These are awesome. And we've demonstrated, and we have a real building that demonstrates that why.

Elizabeth Lane Suzuki - BofA Merrill Lynch, Research Division - VP

Great. All right. I'll see you next week.

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

Excellent. I look forward to it.

Operator

(Operator Instructions)

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

Any other questions?



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Operator

That will conclude 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 want to thank everyone again for joining the call this morning. I look forward to updating you with my team on the progress on our next quarterly conference call, and especially I look forward to seeing you all next week in New York on Investor Day. We've had a great quarter. I want to thank the team. And everyone, have a great day. Thank you.

Operator

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

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