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ODP - Q1 2014 Office Depot Inc. Earnings Conference Call

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OVERVIEW:

Management discussed 1Q14 results, reporting adjusted net income attributable to common stockholders of $38m or $0.07 per share on sales of $4.4b.

CORPORATE PARTICIPANTS

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Michael Lasser *UBS - Analyst*

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PRESENTATION

Operator

Good morning and welcome to Office Depot's first-quarter 2014 earnings conference call. (Operator Instructions). At the request of Office Depot, today's call is being recorded.

I would like to introduce Vice President of Investor Relations, Michael Steele. Mr. Steele, you may now begin.

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

Good morning and thank you for joining us today. Here with me are Roland Smith, our Chairman and Chief Executive Officer; and Steve Hare, our Executive Vice President and Chief Financial Officer. Please keep in mind that certain statements made on this call include forward-looking statements which are subject to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements reflect the Company's current expectations concerning future events and are subject to a number of factors and uncertainties that could cause actual results to differ materially. A detailed discussion of these factors and uncertainties is contained in the Company's filings with the Securities and Exchange Commission.

This call includes non-GAAP financial measures. The SEC filings as well as the earnings press release, presentation slides that accompany today's comments, reconciliations of the non-GAAP financial measures to the most directly comparable GAAP financial measures, as well as 2013 pro forma results for combined Office Depot and OfficeMax which were furnished to the SEC on Form 8-K on March 21, are all available on our website at investor.officedepot.com.

Today's call will begin with Roland summarizing the quarter and providing an update on select critical priorities for 2014 and our progress on merger integration. Steve will then review the Company's quarterly results and outlook for 2014. Following Steve's discussion, Roland will share closing comments and then we will open up the line for questions. Now I will turn the call over to Roland.

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

Thanks, Mike. And good morning, everyone. It is good to be here today to discuss the first quarter of 2014, our first full quarter as a merged Company.

I'm very pleased this guy performance for the quarter. In the past five months, we have made significant progress with our merger integration. We selected our headquarters, named our leadership team, restructured the organization, validated and began executing our plan to realize merger cost synergies, completed a preliminary analysis of our retail store portfolio, and have made good progress with our other critical priorities. I am very proud of our team's ability to accomplish so much so quickly.

Turning to slide 4, in the first quarter of 2014 we saw improved sales trends as the quarter progressed, and I am especially encouraged by our ability to reduce overall expenses. Adjusted operating income improved by 33% to $72 million in the first quarter of 2014 versus pro forma Q1 2013.

While weather was a challenge to our business early in the quarter, we saw improvement in sales trends as the quarter progressed. Additionally, we captured merger integration benefits earlier than planned.

Our positive first-quarter results have increased our confidence and our ability to improve profitability and achieve merger synergies. Accordingly, we are raising our 2014 adjusted operating income outlook to be not less than $160 million for the full year.

On our last call, I noted that one of our critical priorities was to construct a plan to optimize our retail store portfolio, and I mentioned that we expected to complete our analysis in the second quarter. We remain on track with that timing. But I'm very pleased to be able to share details of our preliminary analysis with you today.

Based on this preliminary work, we expect to close at least 400 stores by the end of 2016, 150 of which would close by the end of 2014. We anticipate that by the end of 2016 the optimization of our retail store portfolio will generate additional annual run rate synergies of at least $75 million in addition to our previously announced $600 million of cost synergies and will be accretive to earnings beginning in 2015. I will provide more details on store closures later on this call.

As you know, in February we introduced our 2014 critical priorities. Shown on slide 5, these are priorities that will enable us to deliver our annual operating plan and transform Office Depot.

On today's call and future calls, I will provide a progress update on selected priorities. Today I'd like to update you on our culture and organization, our plan to optimize our retail store portfolio, our progress on synergies and efficiencies, and the development of our unique selling proposition. Later on the call Steve Hare will update you on our initiatives to improve profit margins.

As you may remember, we have two foundational priorities for 2014: a lean and effective organization and a high-performance culture. And we're making excellent progress on both. Our restructured organization is significantly smaller and more efficient. The new structure facilitates better decision-making, enhanced accountability, and better communication. These are all key attributes of a high-performance culture.

During the first quarter, we continued to enhance our management team with the addition of several strategic hires which are highlighted on slide 6. In March, we announced that Juliet Johansson joined Office Depot as the Executive Vice President and Chief Strategy Officer. Juliet's background includes a decade of strategic consulting experience including eight years with McKinsey & Company where she advised senior executives and recommended strategies in a variety of industries including retail, consumer products, fast food, and high technology. She also held senior executive roles in strategy, national sales and marketing with global transportation provider, Ryder System. Juliet possesses the ideal mix of advisory talent and practical experience needed to develop the strategies and initiatives that will drive future growth.

In early April, Petter Knutrud joined the team as a Senior Vice President for Merchandising. Petter has more than 25 years of experience in all aspects of merchandising, spending the past 19 years with Staples and most recently serving as SVP, Merchandising Supplies. He created new and exclusive product lines in multiple categories to improve differentiation and drive sales growth across channels. As a member of our merchandising leadership team, Petter will be instrumental in helping to set and refine merchandising strategy and direction for Office Depot.

In mid-April, we also welcomed Troy Rice as Executive Vice President of Retail. Troy has extensive multi-unit retail experience having served 24 years growing revenue, improving operations and increasing profits for two leading retail chains. He most recently served for eight years as executive vice president, stores and services, at Toys "R" Us. Previously Troy spent 16 years at the Home Depot in retail leadership roles of increasing responsibility. I'm confident that Troy's depth and breadth of retail experience will bring great value to Office Depot at a time where we're making significant structural improvements to our retail store network.

Now, I'd like to update you on a retail store portfolio. As I mentioned last quarter, we engaged Bain consulting to help us conduct a comprehensive analysis of our retail store portfolio. Our store-specific decisions are being made through a holistic market evaluation process. This process includes a three-stage approach focused on optimizing productivity and profitability, which we lay out on slide 8.

The initial stage is to identify the optimal portfolio to improve retail profitability. We're currently working on this analysis with a market-by-market and store-by-store evaluation looking at six key factors that include store performance; sales transfer rate; the impact of fixed costs on the remaining stores; store closing costs, including lease obligations; expected impacts to other sales channels; and our overall go-to-market strategy.

As we identify stores to be closed, we will sequence our closures to maximize the economics. As I mentioned earlier, our goal is to finalize our store optimization strategy in the second quarter, and we will update you on our progress on future calls.

The second stage of our approach is to maximize the profitability of the ongoing retail store portfolio. We will leverage our larger combined market presence to negotiate more favorable lease terms and continuously monitor performance of store locations, particularly approaching lease expirations.

The final stage is to define and implement our Store of the Future. This will require experimentation and testing in order to achieve the right product and service mix, but it is critical to our long-term success, particularly given the evolution in our industry and the changes in how customers shop. Our Store of the Future will closely align with our unique selling proposition, and I will update you on this in a few minutes.

We believe a staged approach to store closures allows us to minimize risk and adapt our learnings to future groups of store closings. Our continuous assessment of transfer rates, lease costs, stranded costs, et cetera, is informing our decisions to close and our closure cadence.

An important focus will be maintaining relationships with our valued customers who shop in the stores that are slated to close. We will provide continuity and direction to encourage these customers to continue to purchase from us at a nearby store or online.

As highlighted on slide 9, based on our preliminary analysis, we expect to close at least 400 stores by the end of 2016 with 150 of those stores expected to close in 2014. Most of these 150 stores will remain open through the important back-to-school selling season this fall. We expect to close at least 250 stores over the 2015 to 2016 timeframe. As we continue our review, we will determine working capital savings and closing costs.

Additionally, we have made the decision to close all 19 Grand & Toy stores in Canada. These stores represent only 3% of our Canadian sales, and we believe we can serve our customers in Canada much more efficiently through our eCommerce website, field and telephone sales representatives, and customer service centers.

Finally, we are in negotiations with our Mexican joint venture partners to sell our 51% interest in Grupo OfficeMax, which consists of 92 OfficeMax branded retail stores. We expect this transaction to close in the second quarter.

Now, I would like to provide you an update on the status of achieving our planned synergies. As I have already stated, during the first quarter we accelerated the realization of cost synergies, thereby giving us greater confidence in our ability to meet our longer-term targets.

Turning to slide 11, after the preliminary analysis of our US retail store portfolio optimization, we're increasing our expected annual run rate synergies to more than $675 million by the end of 2016. This is an increase from the Company's previous estimate of more than $600 million prior to the preliminary review of our US retail store network.

In addition to the at least $75 million of synergies from store optimization, we continue to expect purchasing synergies of approximately $130 million and more than $470 million of additional annualized savings, primarily in SG&A.

In our 2014 P&L, we expect to realize approximately $180 million of synergies, up from the $170 million we communicated on our last call. Of the estimated $180 million this year, we realized approximately $14 million of synergies in the first quarter. We expect synergies to accelerate throughout the year and end the year at an annual run rate of approximately $360 million, which is an increase from the $340 million we communicated last quarter.

This excludes any benefits from the retail store portfolio optimization.

Now, I would like to discuss progress on our unique selling proposition. As I shared with you on our last call, the foundation of our successful long-term growth strategy is a meaningful, unique selling proposition, or USP. A clear and meaningful USP will enable us to truly differentiate ourselves from our competitors and drive our branding, product assortments, new product and service selection, and how we go to market.

As you can see on slide 13, our USP development and implementation is a three-part process. First, defining the who: that is who we're going to serve in the marketplace, who we see as profitable customer segments, and who we need to target for growth.

Second, defining the what: what unique and differentiated proposition across price, product offerings, and customer experience will motivate the segments increase their total spend with Office Depot.

And finally, defining the how: how we will redefine our business channels, products, and services to fully deliver this unique proposition. This stage includes in-market testing to validate the concept and optimize USP execution before rolling out more broadly. We are making excellent progress and are on track to define and began testing our USP in the third quarter, and I will provide you more detailed update on our next call.

Now, I will turn the call over to our CFO, Steve Hare, to discuss our results for the quarter and outlook for 2014. Steve.

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

Thanks, Roland. I would like to highlight our results for the first quarter, which demonstrated significant expense improvement in each of our business divisions as well as at the corporate level. The prior-year comparisons that I will focus on today will be versus combined pro forma results, which we believe provide a more relevant measurement of our ongoing operations. The pro formas for Q1 2013 assume the merger occurred at the beginning of 2013 and include adjustments for purchase accounting, charges, and reclassifications.

Now looking at consolidated results on slide 15, first-quarter 2014 sales were $4.4 billion, down 3% from the prior-year quarter on a pro forma basis. We believe weather had a significant negative impact on sales early in the quarter.

Gross profit decreased $61 million from the prior-year pro forma and gross margin was down 68 basis points. We experienced gross margin declines in each division with the more significant decline in Business Solutions.

SG&A expenses in first quarter 2014 were $79 million lower than prior-year pro forma, representing a 114 basis point reduction as a percentage of sales.

The first-quarter reported, or GAAP operating loss, included pre-tax special charges totaling $151 million. The charges were comprised of $96 million in merger-related expenses, which included employee severance, retention, transaction, and integration expenses; $41 million in noncash impairment charges related to IT system write-offs; $9 million in noncash US store impairment charges; and $5 million in international restructuring and other operating expenses. The tax benefit of these pre-tax charges was $4 million.

Excluding these special items, first-quarter adjusted operating income was $72 million, and the adjusted net income attributable to common stockholders was $38 million or $0.07 per share.

The first-quarter 2014 adjusted operating income was a 33% improvement over the prior-year pro forma, and adjusted net income this quarter was over 100% higher than the prior-year pro forma. These improvements were largely attributable to SG&A reductions, including $14 million in merger cost synergies and improving execution on day-to-day operations in each division. The expense reduction efforts more than offset the sales deleverage impact of the lower sales versus the prior-year pro forma.

Turning to slide 16, first-quarter 2014 sales in North American Retail decreased 5% versus the prior-year pro forma. Same-stores sales for the combined Office Depot and OfficeMax stores declined 3%. The comp sales decline was driven by lower transaction counts partially offset by higher average order values. We experienced sales declines in supplies, furniture, and technology-related products while sales increased in copy and print. Adverse weather in the first part of the quarter had a negative impact on comps for the combined Company.

The Retail Division generated $37 million in operating income in the first quarter, which was a 19% improvement over the prior-year pro forma. The division operating margin improved by 44 basis points. Deleveraging due to lower sales was more than offset by lower operating expenses including payroll, advertising, and other in-store expenses in both Office Depot and OfficeMax retail stores.

On to slide 17. Earlier Roland mentioned our focus on 12 critical priorities in 2014. I would like to provide you a little bit of color on some of the key initiatives that each division is focused on to improved profit margins. In North American Retail, the realignment of the field leadership team, which was completed in the first quarter of 2014, was a significant step toward realizing ongoing merger synergies and creating a foundation for future profit-building initiatives. In addition to reducing the number of combined Company regions and districts and increasing span of control throughout the division, the process allowed senior management to select the best talent from both organizations. This leadership team will be focused in 2014 on creating a consistent operating model for retail operations in both Office Depot and OfficeMax retail stores.

Components include an optimized staffing and labor model, an enhanced selling model, a streamlined logistics process, division-wide key performance indicators, and standardized reporting as well as developing consistent bonus and incentive plans -- all to drive results.

Another significant initiative for the North American Retail Division this year will be to support and execute the retail store portfolio optimization effort that Roland spoke about. The retail teams will be focused on maximizing sales transfer, selecting the best talent going forward, and ensuring that customers of both brands continue to have a great shopping experience.

Turning now to slide 18 and the first-quarter results in our Business Solutions Division, or BSD, first-quarter 2014 sales in BSD were $1.5 billion, a decrease of 2% from the prior-year quarter pro forma sales. Sales in the contract channel within BSD were down low single digits and direct channel sales were up slightly. Adverse weather in the early part of the quarter had a negative impact on contract sales. Many workplaces, including schools and government offices, were closed during the periods of extreme weather and customers therefore did not order products or consume office supplies.

Sales in the contract channel were also negatively impacted by the currency exchange rate in our Canadian business and the new year's calendar shift partially offset by the positive impact of an Easter calendar shift.

Excluding these factors, sales for the quarter in the contract channel would have been flat for the quarter. In the direct channel, online sales increased and call center sales decreased, continuing the trend that we have been seeing for some time. We continue to enhance the online shopping product offering and customer experience.

On a product category basis within BSD, sales of supplies and technology items in the first quarter were lower than the prior-year pro forma, while sales of furniture, copy and print, and cleaning and break room increased.

BSD gross margin declined in the first quarter of 2014 compared to combined pro forma results in the prior-year quarter, driven in large part by a greater mix of lower margin enterprise customers in the consolidated portfolio. The leadership team in contract is focused on harmonizing the sales strategies between the legacy brands to improve our overall customer mix and to retain and win business that meets our margin objectives.

The BSD division operating income for the first quarter of 2014 was $40 million, an increase of 5% versus pro forma in the prior-year quarter. Division operating margin improved by 17 basis points. Lower payroll, which included sales force synergies, lower advertising expense, and other SG&A efficiencies, more than offset the flow through impact on lower sales.

On slide 19, we outline a few of the key initiatives that our BSD contract and direct channel teams are working on this year to improve profit margins. To optimize margin potential, we are harmonizing contract sales strategies between the Office Depot and OfficeMax brands through the alignment of pricing, assortment, and incentive strategies. The contract teams are focused on expanding sales into more profitable customer segments and also increasing sales in adjacencies such as cleaning and break room.

In the direct channel, we are leveraging our resources and investments across brands to improve our Web platform. Our teams are improving website and mobile app usability and selling features, making it easier for customers to find products, check out, and manage their account and preferences. We are also building personalized product recommendations. Additionally, we are optimizing our digital marketing and promotional programs to improve customer acquisition and retention while lowering costs by leveraging efficiencies across both Office Depot and OfficeMax banners.

On slide 20, I will cover the first-quarter results in the International Division. For international sales comparisons to combined prior-year pro forma results by channel, I will use constant currency.

First-quarter 2014 sales in the International Division decreased 1% in constant currencies versus the combined prior-year quarter pro forma results. Sales in the contract and direct channels in Europe both declined in the quarter, and sales in the retail channel increase from the prior-year quarter. The timing of the Easter holiday had a positive impact on European sales in the first quarter when comparing 2014 to pro forma 2013.

First-quarter 2014 division operating income was $20 million, an increase of 18% versus pro forma in the prior-year quarter. Division operating margin improved by 34 basis points. The division experienced gross margin pressure in the quarter largely due to higher-than-expected supply-chain costs; significant reductions in operating expenses, including reduce payroll and advertising expense, offset the negative flow through impact of lower sales and lower gross margins. The International Division continues to focus on increasing efficiencies and reducing costs.

As Roland mentioned, we're currently in negotiations with our joint venture partners to sell our interest in the Grupo OfficeMax business in Mexico. The assets and liabilities of the joint venture have been classified as held for sale on our balance sheet at the end of the first quarter. Sales and expenses of the joint venture will be included in our International Division operating results through the date of sale, which we expect to occur sometime during the second quarter.

Now, let me review a few of the key initiatives in the International Division that target improved profit margins. In Europe, we are changing the division's operating model to shift from a company-specific or regional focus to a channel focus, which is expected to reduce redundancies and provide greater opportunities for top-line growth. The operating model change will be a catalyst for moving to a lower cost-to-serve model. Plans to increase gross margin include expansion of private brands, broadening the utilization of customer profitability tools to eliminate unprofitable accounts, identify new account opportunities, improve bid decisions, and optimize the mix of outsourced versus private fleet transportation.

Salesforce effectiveness will be increased through a combination of factors including improved compensation plans, sales training, adjustments to customer coverage models, and leveraging best practices across the regions. Components of the online initiative include investing in additional online advertising funded through catalog efficiencies, personalization, and optimizing product search as well as check-out and payment functions.

Turning to the balance sheet highlights on slide 22, we ended the first quarter of 2014 with total liquidity of approximately $2 billion consisting of $870 million in cash and $1.1 billion available under our asset-based lending facility.

Total debt at the end of the quarter was $720 million, excluding $854 million of nonrecourse debt related to the legacy OfficeMax timber notes securitization transaction.

Office Depot used $74 million of operating cash in the first quarter of 2014, which included $80 million in merger-related cash payments. Capital expenditures were $39 million. We expect free cash flow to be negative this year as we continue to incur significant merger integration expenses in the short term that will lead to a more profitable and efficient organization over the long term.

In the first quarter of 2014, we received a distribution of 1.6 million shares of Boise Cascade Company common stock related to a legacy OfficeMax equity investment in Boise Cascade Holdings. We sold 785,000 shares during the quarter with proceeds totaling $22 million. The market value of the remaining shares at the end of the first quarter was $20 million. We expect to liquidate all of these securities this year.

Turning to our 2014 outlook on slide 23, we continue to expect market trends will remain challenging and anticipate total Company sales in 2014 to be lower than the prior year combined pro forma sales. As we have noted, we improved profitability during the first quarter with earlier-than-expected realization of cost synergies and improved operational execution. Accordingly, we are increasing our adjusted operating income outlook for the full year to not less than $160 million. That said, we are now in the second quarter, which historically has been our lowest sales volume quarter of the year, and, therefore, it's more difficult to drive profitability. As a reminder, we had an adjusted operating loss in Q2 of last year on a pro forma basis.

On the cost side, to achieve the more than $675 million in expected merger run rate synergies, we continue to estimate that $400 million of cash integration costs will be required to substantially complete the integration with approximately $300 million of those expenses incurred in 2014. These expense estimates exclude costs relating to optimizing the US retail stores, which have not yet been determined.

Capital spending to complete the integration is expected to be between $200 million and $250 million over the 2014 through 2016 period with up to $50 million of that spend expected in 2014. Excluding capital spend related to the merger, we expect capital expenditures for the core business to be approximately $150 million this year.

Depreciation and amortization in 2014 is expected to be approximately $300 million.

That covers the financial results for the quarter. We are pleased with our progress and with much work ahead, continue to focus the teams on integration, cost control, and improving operating margins. Now, I will turn it back over to Roland for closing comments.

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

Thanks, Steve. As you can see on slide 24, our path to transformation began in November as we focused on restructuring into a leaner, more efficient organization.

As I noted earlier, we have made significant progress in our integration transformation over the past five months. We selected our headquarters, named our leadership team, restructured the organization, validated and began executing our plan to realize merger cost synergies, completed a preliminary analysis of our retail stores portfolio, and have made good progress with our other critical priorities.

We certainly have a lot of work ahead of us, but I am very pleased with the team's energy, morale, and optimism. I am also very proud of how quickly our associates transformed from being competitors to a unified team working in harmony towards common goals.

The increase in our 2014 adjusted operating income outlook to not less than $160 million reflects the improving sales trends we experienced as the first quarter progressed, our ongoing focus on expense control, and our improved realization of synergies and efficiencies. As we continue our integration across all areas of the Company, we're beginning to take steps toward the next phases of our transformation, sales and margin stabilization and pursuing long-term profitable growth opportunities.

Thank you for your attention this morning. Now I will turn the call over to Mike.

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

We have reserved the balance of the hour for Q&A. We ask you to limit yourself to one question so we can get to as many of you as possible. Operator, please open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Brad Thomas.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Congratulations on all the progress and the good quarter here.

I wanted to ask about the contract segment. If you could just comment a little bit more about the underlying trends that you are seeing there. We have been hearing that the government spend was a little bit better this quarter, and then how the retention of your contract customers has been.

And if I can squeeze in one housekeeping item as well here, was wondering for the first quarter if you could quantify a synergy number for that quarter.

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

So from a contract basis, as we talked about in our prepared comments, if you eliminate the issues of weather and the calendarization, our sales would have been flat on a pro forma basis this quarter versus previous quarter in 2013. So we are pretty pleased with the progress that we're making in that regard.

Also from our prepared comments you remember that we spoke about the fact that our mix had caused us some margin erosion as it relates to enterprise customers, and we are working hard to ensure that as we go forward and we sign new customers that we are using very specific margin expectations before we take on additional business.

So, we are pleased with the progress that we are making in our contract business and expect that we will continue to be able to service our customers as we have in the past and be able to retain the customers that we have and sign new contracts.

Operator

Mike Baker.

Mike Baker - *Deutsche Bank - Analyst*

I wanted to ask you about the $75 million benefit of store closing. How much of that is coming from sales transfers? What are you assuming for sales transfers? What is the incremental flow through to the bottom line? How much of that $75 million is from just taking the costs out of the closed stores? Thanks.

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

Well, certainly, sales transfer, Mike, it is a big factor in ultimately how much we will enjoy from the standpoint of synergies as we work towards closing the at least 400 stores that we spoke to you about this morning. As we spoke about on our last call, historically we have enjoyed about a 20% sales transfer. And this has flowed through somewhere in the neighborhood of 25% to 30%. And if you do that math, that is what is driving our expectation of at least $75 million of synergies based on the closing of these 400 stores.

However, we are taking a very disciplined and sequential approach to closing stores. As you know, we expect we will close 150 this year. We will close them as I mentioned, later in the year because we want to have them open during the key back-to-school selling timeframe. And so the benefit for 2014 will be minimal.

But we are currently in the process of testing ways where we can actually improve our sales transfer rates. We have those tests in market. We're beginning to read the benefits of those tests. We have some outside consultants that are helping us with that, and we believe that based on this and sequentially learning and then applying that to future stores, we will hopefully be able to improve those sales transfer rates. And that will allow us to hopefully improve the $75 million to a greater number as we get more information and we improve our execution of closing these stores and maximizing our transfer rates.

Operator

Matthew Fassler.

Matthew Fassler - *Goldman Sachs - Analyst*

I also have a question on the store closings and the associated accretion. What proportion of your retail cost base is variable such that when you close a store you will see costs coming out of the business? Presumably, some of it is somewhat fixed related to distribution, advertising, et cetera.

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

Right. This is Steve. What we are looking at and this is where we need to do more work and we will come back to you with I think a more detailed quantification of that. But I think as a rule of thumb you could say that about 25% of our cost would be variable that could be eliminated as we start to downsize, depending on the store, depending on the market. And about 75% I think would fit into the category that I think you are referencing, which would be fixed. For example, the marketing spend that we might be doing in a market, assuming we would keep that marketing level the same as we reduced a store in a particular market, that would have to be absorbed by the remaining stores.

So I think a 75%/25% rule of thumb is probably a good starting point.

Operator

Greg Melich.

Greg Melich - *ISI Group - Analyst*

I wanted to get a bit into the trends on sales and gross profit dollars. You said the first half of the quarter was harder because of weather, but it finished stronger. Was it strong enough to actually be flat by the second half of the quarter? Then I have a follow-up on gross margin dollar trend.

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

Well, thanks for your question, Greg. I will reiterate that's our sales started off softly because of weather and they did improve, but we did not talk about the specific numbers month by month and we don't plan on doing that. But I am pleased with the fact that they did improve throughout the quarter. It is only the first quarter, however, and we are still forecasting that sales will continue to decline on the trend that we talked about on our last call.

As we look at what happens throughout the second quarter and get a better idea of how much our execution will help us improve sales, we will be able to come back to you and give you a better idea of what we would expect that to impact as it relates to adjusted operating income.

Operator

Michael Lasser.

Michael Lasser - *UBS - Analyst*

Two-fold: first, looking at your guidance and based on what you did, the core business, excluding synergies produced about $58 million in the first quarter. That is up from $54 million last year. So to get to a $20 million loss for the core business excluding synergies, it's going to have to lose $78 million after its produced $54 million in the final three quarters of last year. I know that's a lot of numbers. Maybe you can help illuminate what it is that aside -- is it all going to be deleverage associated with fixed costs on a tough sales environment despite trends improving over the course of the quarter?

And then a second question is on the 400 store closings. As a group, what was the operating loss or operating profit associated with those stores? Thanks a lot. I know it is a lot. I'm sorry.

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

Michael, it is Steve. Let me take a crack at those two.

As you look at the guidance for the year, the actual adjusted operating income of $72 million versus pro forma last year, you saw an increase of $18 million. Now again, we had merger synergies that we realized in the quarter of $14 million as part of that and that was a little bit ahead of schedule.

But I would also say when you look and dig into the quarter, there's some timing aspects of things that hit in the first quarter that I think were favorable that maybe pulled up from the rest of the year. If I were to characterize that overage, I would characterize maybe about half of that could be timing as you start to think about what that means for the rest of the year.

Also to your point around the ability to offset sales deleverage for the rest of the year, as Roland has said, we continue to think that our sales trends are going to be negative for the year based on historical trends that we have seen and the secular declines in some of our key products.

You saw all the sales deleverage hit us pretty hard in the first quarter at the gross margin line because we did have a $61 million gross profit decline. So there is significant -- now, not all of that is what I would characterize as sales deleverage, but we had $130 million lower sales versus pro forma last year with a $61 million reduction in gross margin. And I think that is why when we look at our floor for the year and going to $160 million, we remain cautious despite the fact that first quarter was favorable because we know we're going to see significant sales deleverage for the rest of the year and that we need to continue to drive our overall cost control to offset that.

And that is really what our underlying assumptions are. So, we were comfortable going from $140 million to $160 million. And if we get to better visibility the rest of the year, we will try to continue to update our view for the year quarter by quarter.

As far as the closures, we're not in a position, because we really haven't finalized our analysis yet, to stratify and talk about stores that will be closed that actually are starting with an operating loss. But clearly when we look at the $75 million, it reflects an assumption around the elimination of a certain amount of stores that are operating at a loss today plus the improvement that we will get as we transfer sales to existing stores and get the incremental profit on that transfer process.

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

Let me just add to that, Michael, that, as I mentioned in my comments, we are completing our analysis as it relates to the store closures. We committed on our last call that we would complete that in the second quarter and we still plan to do that.

We did want to today to give you a preliminary look based on all the work that we have done because we are comfortable with the numbers that we talked about today. As we mentioned, at least 400 stores closing by the end of 2016; 150 of those will be by the end of 2014. And comfortable that we will get at least $75 million in synergies.

But to the point about profitability, I would like to remind you that we are looking at six key factors. And we will continue to look at these six. Certainly, store performance and profitability is one of them, but we are also looking at sales transfer rates. And as you know, those rates will be defined by specifics, dynamics, and competition in markets. Stranded costs, after the store closes. And that will be defined by lease terms and other factors. Store closing costs, expected impact to other channels that we will also look at, and then clearly, our overall go-to-market strategy which will be informed as we complete our work on our unique selling proposition which again, we talked about coming back to the market and talking about that in more detail at the end of the second quarter.

And while I updated you on that today, we feel very good about our progress, we are clearly at the beginning stages of our concept of defining who and then what and then finally how. And that how portion of our USP will be when we actually get into the market and have multiple tests that can validate and help us iterate where our USP will actually go.

Operator

Dan Binder.

Dan Binder - *Jefferies & Company - Analyst*

It is Dan Binder.

My question was around your buying synergies. Just curious, you have now had several months to talk with vendors. I think you settled on your wholesale relationships. Can you just give us an update on where you are in the vendor talks and how much of the synergies that you have talked about are already buttoned down at this point?

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

Yes, Dan, great question. Happy to update you on that.

We have been very pleased with the progress that we have made as we have began to talk to our vendors and talked about purchasing synergies based on the combined companies. I think I mentioned on our last call that we were able in the middle of February to actually hold a large vendor conference here in Boca where we have representation of over 450 members from our vendor community that came in. We could talk to them a little bit about our 12 priorities and what we were thinking about doing, and then we sat down and spoke with them with our senior team to talk about different areas where we could actually enjoying those synergies.

We updated you today saying that we are on track to achieve the $130 million of synergies that we have spoken about. And quite honestly, we are continuing to be comfortable with that number even in the light of the fact that we are expecting now to close at least 400 stores. And those 400 stores will obviously have a negative impact on revenue. But that negative impact on revenue is offset by better execution with our vendors to enjoy more synergies than ultimately we had initially contemplated. So, we continue to be on track for our synergies as it relates to cost of goods, and we will update you on that on a regular basis.

As that is the end of our questions, let me just close by reiterating quickly three points.

First, I want to say how pleased we are with our performance in the first quarter. We are improving our execution in all our channels. We're delivering the integration synergies more quickly than we planned, and we're managing our SG&A very effectively.

Second, we remain focused and are making great progress on our 12 critical priorities to include the ones we spoke about today -- optimizing our retail portfolio and developing a meaningful USP.

And third, we remain confident in our ability to achieve more than $675 million of synergies by the end of 2016 and not less than $160 million of adjusted operating income in 2014.

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

Operator

Again, thank you for your participation. This concludes today's call. You may now disconnect.
