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April 4, 2005

Office DEPOT

Share Price: \$22.00
Target Price: \$28.02
Shares: 312.78M
Market Cap: \$6.88B
Sales Growth: 9.76%
Earnings Growth: 21.40%
Operating Margin: 3.91%

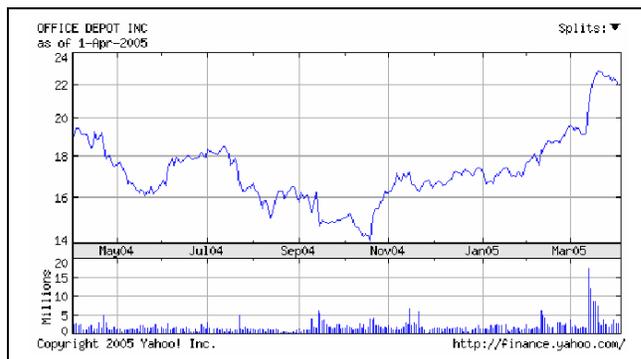
Office Depot: *Taking care of business*

We are initiating coverage on Office Depot (ODP) with an initial Buy recommendation and price target of \$28.02. We believe that the company is poised for a turnaround, and is already showing positive results from several initiatives designed to narrow the execution gap between it and Staples. Market analysts, on the other hand, continue to discount the stock due to years of poor execution and disappointing results.

Note that even with very little performance improvement we believe the company is undervalued by 13%. Given the encouraging results from several turnaround initiatives, Office Depot could well be undervalued by 27%.

Several turnaround drivers are in place and should continue to provide upside over the next 3-5 years including:

- Hiring of operationally focused and proven CEO, Steve Odland, from AutoZone. During his four years at AZO, Odland led the company to new heights in operation margin, ROIC, and stock price
- Aggressive investment and rollout of Millennium2 retail store format designed to increase operational efficiency and improve comps
- Turnaround in store comps driven by remerchandising, store redesign, and backend Magellan IT initiative
- Success in international expansion, with operating margins almost twice that of Staples – even at almost two times the scale.



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I. Office Products Industry

Office Products Superstores Are Relatively Underpenetrated



The North American office products and supplies industry is estimated at \$170 billion, of which roughly 60% is retail and 40% is delivery.¹ Currently the top three office products superstores (Staples, Office Depot, and OfficeMax) account for only 20% of the total North American retail market.² The remaining 80% is captured by other consumer electronic, mass merchandising, and food & drug retailers. For example, traditional office products superstores compete with mass merchandisers like Wal-Mart during the back-to-school season, or Best Buy for sales of portable electronic devices such as PDAs, laptops, and cell phones. On the delivery side office products superstores also hold a minority share of the market, with catalog, online, and direct marketers holding a full 60% of the North American market, and local dealers and contract suppliers accounting for roughly 20%.³ Buhrmann and United Stationers are major players in the delivery market.

There Is Generous Room For Growth

Currently Office Depot holds the second largest market share in the North American retail and delivery market, which is still less than 10%.⁴ Office products superstores have increasingly shifted their focus from building retail outlets (Exhibit 1)⁵ to aggressively pursuing alternative ways to increase their addressable market. For example, Office Depot and Staples have started expanding into high margin copy and print services, as well as providing office supplies to supermarkets chains and drug stores. Industry leaders are also beefing up their highly profitable

Business delivery and international expansion are industry growth drivers

¹ Amy Ryan, *SPLS: Thinking Outside The "Box" – Initiating Coverage With Buy* (ThinkEquity partners, 21 Feb. 2005) 7.

² Mike Troy, *Staples is latest office superstore to pursue promising int'l markets* (DSN Retailing Today, 6 Sep. 2004) Volume 43; Issue 17.

³ Ryan, 7.

⁴ Ryan, 7.

⁵ Kevin Flaherty, Jack Murphy, Teresa Ging, *Office Products Retailing* (Credit Suisse First Boston Equity Research, 9 Jun. 2004) 20.

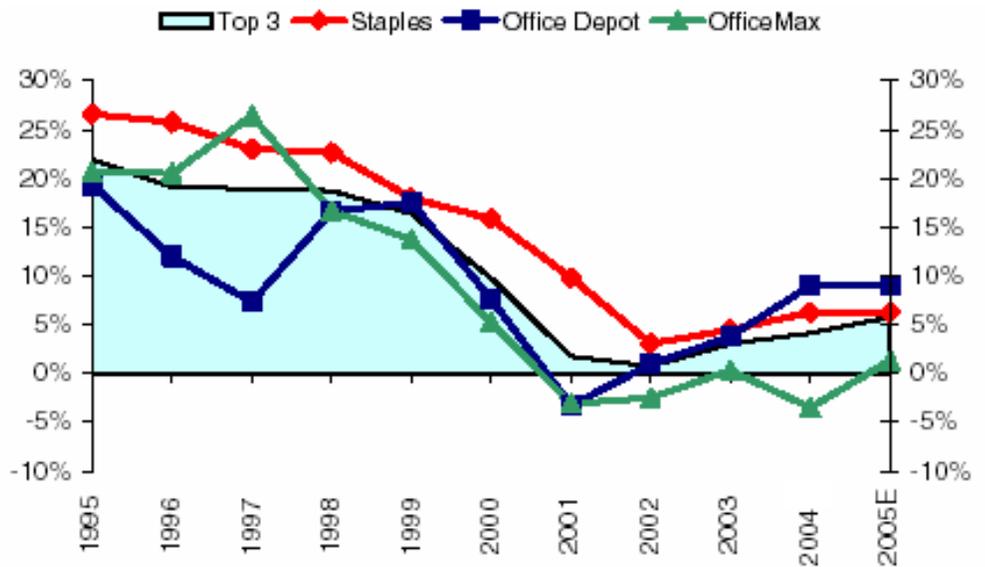


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delivery businesses through acquisitions, allowing them to compete more effectively business customers. In addition they are increasingly looking to international markets to expand their growth opportunities. For example, both Office Depot and Staples have been successful in acquiring and integrating retail and delivery businesses throughout Europe. Staples acquired Quill and Pressel International to improve its domestic and international contracts and delivery business, while Office Depot achieved a similar result with its Viking and Guilbert acquisitions. Europe is the world's second largest retail and delivery market at almost \$65 billion.⁶

Exhibit 1: Office Products Industry Y/Y Store Growth

ODP store growth was stagnant from 2000-2003



Focus On Small Business Customers



Office Products Superstores rely on small business spending to drive revenues. Currently the majority of sales, about 61%, are generated by small business and home office customers. Consumers, large businesses, and the government make up the remainder at 22%, 12%, and 6% respectively (Exhibit 2).⁷ The focus on small business customers has

⁶ Ryan, 39.

⁷ Flaherty, Murphy, Ging, 17.

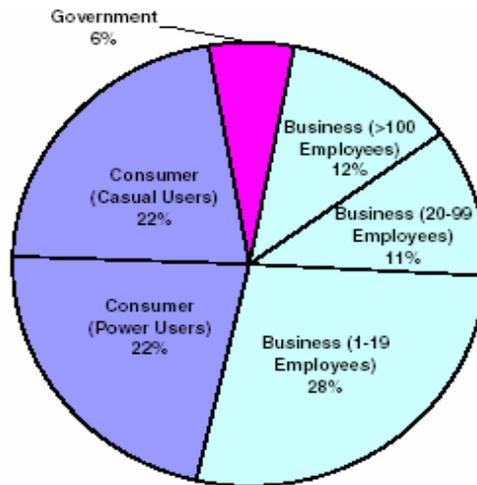


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had the advantage of insulating prices from aggressive mass merchandisers such as Wal-Mart, which compete on the basis of price for traditional consumers. Low exposure to the consumer also makes the sector attractive for investors looking to diversify their portfolio and hedge against consumer risk in the retail sector.

Exhibit 2: Office Products Market Segmentation

Businesses and power users make up the majority of customers (73%)



Product Portfolios Shift To Reflect Business Emphasis

Many are choosing to eliminate low margin consumer oriented SKUs

Over the past few years office products retailers have shifted towards eliminating low margin, consumer oriented SKUs in favor of business oriented products and services. For example Staples recently implemented a Back-to-Brighton retail strategy which eliminated 800 consumer oriented SKUs in favor of business oriented products and services.⁸ This follows a study in which Staples found that small business and home office customers generated 93% of profits, whereas consumers generated only 7% of profits on 23% of sales (Exhibit 3).⁹ While this study was only done on Staples' sales, it is safe to assume that the customer mix at Office Depot and OfficeMax are similar to that of Staples. Office products superstores compete in major product categories such as office supplies, technology, office furniture, and

⁸ Staples 2004 Annual Report.

⁹ Ryan, 34.



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business services – though not equally. Technology products make up the bulk of their sales at 59%, followed by office supplies at 31%. Furniture and business services only account for roughly 10% of product sales (Exhibit 4).¹⁰

Exhibit 3: Staples Retail Sales & Profitability by Segment

Consumers only generate 7 % of profits on 23% sales

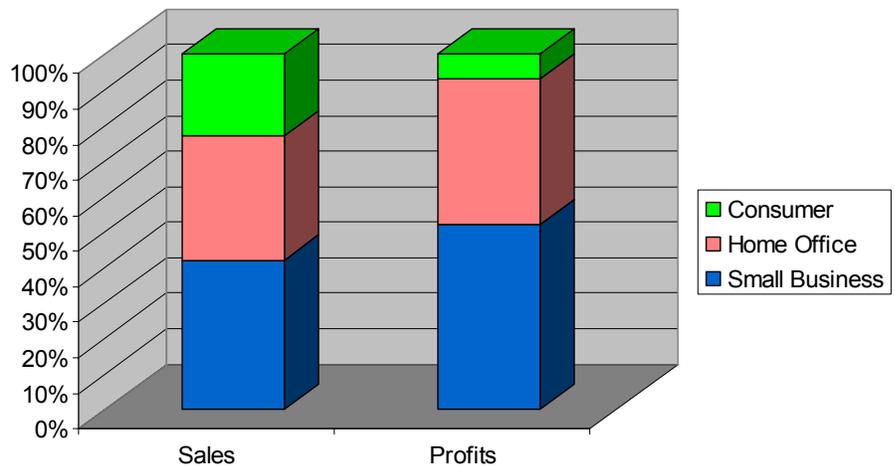
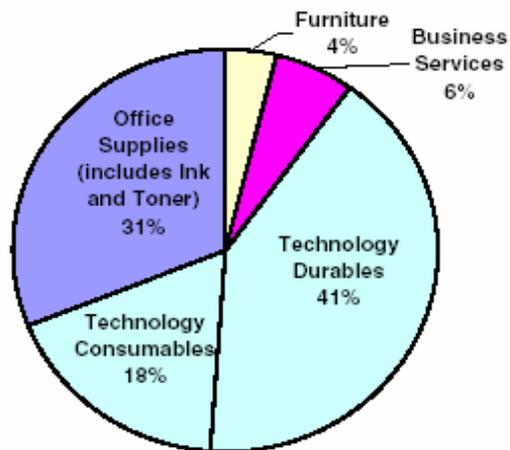


Exhibit 4: Office Products Sales by Category

Big-ticket technology products drive sales



¹⁰ Flaherty, Murphy, Ging, 16.



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II. Office Depot Overview

Reuters' Business Description:

Office Depot ("ODP") is a global supplier of office products and services under various labels, including Office Depot, Viking Office Products, Guilbert and NiceDay. The Company is organized into three business segments: North American Retail Division, Business Services Group (BSG) and International Group. The Company's North American Retail Division sells a selection of merchandise, including brand name and private-label office supplies, business machines and computers, computer software, office furniture, and other business-related products and services. BSG provides office-supply products and services to businesses through its catalog and contract-sales operations. The Company's International Group sells office products and services in 21 countries outside the United States and Canada, through direct-mail catalogs, a contract-sales force, Internet sites, retail stores (in France, Japan, Spain and Hungary), and international joint venture and licensing agreements. ODP operates a chain of retail office products stores, provides delivery of its products in the U.S. and Canada to store and catalog customers, and is a full-service contract stationer serving businesses throughout the U.S.

NA Retail store growth was essentially flat 2000-2003, and is now back on track at 100 stores per year

Office Depot competes in three distinct segments: North American Retail, Business Services Group, and International. The three segments are very different in terms of profitability and growth (Exhibits 5 & 6). North American Retail generates the majority of revenues while International is the most profitable and fastest growing division.

North American Retail accounts for an estimated 44% of total sales and 37% of operating profits. It includes 969 retail superstores throughout the U.S. and Canada. Superstores average 26,000 square feet and carry approximately 8,500 SKUs.¹¹

Business Services Group accounts for 30% of sales and 31% of operating profits.¹² It includes the company's catalog and contracts businesses, which target medium and large businesses through a direct

¹¹ Office Depot 2005 10-K.

¹² Office Depot 2005 10-K.



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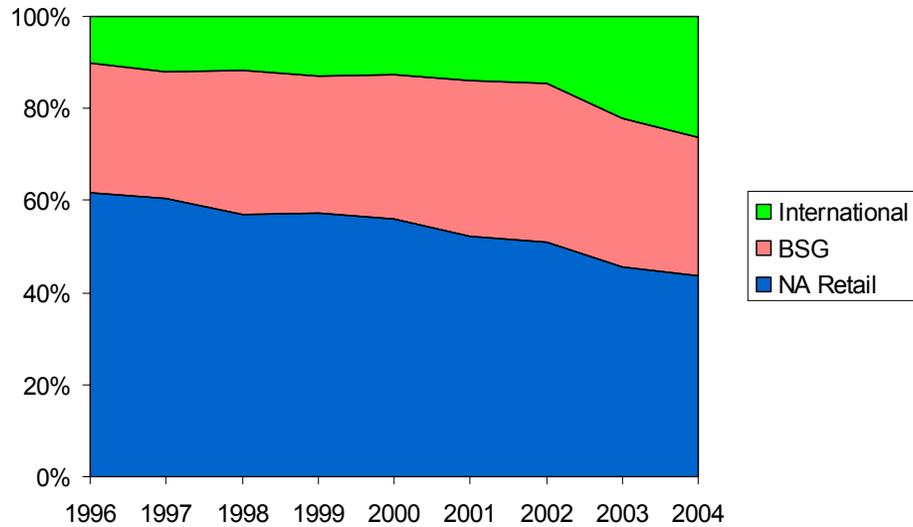


sales force, Office Depot and Viking brand catalogs, and 4Sure.com and techdepot.com websites.

International Operations accounts for 26% of sales and 33% of operating profits. International is the catalyst for Office Depot's most recent growth, with sales growing 30% in 2004 and 67% in 2003.¹³ The acquisition of Guilbert, a large contracts distributor in Europe, was the primary catalyst for sales growth in 2003. Mail order and contract business make up more than 90% of international sales¹⁴, though the company operates about 78 retail stores in France, Japan, Spain, and Hungary.¹⁵

Exhibit 5: Segments as % of Total Sales

NA Retail: 44%
BSG: 30%
International: 26%



¹³ Office Depot 2005 10-K.

¹⁴ Flaherty, Murphy, Ging, 49.

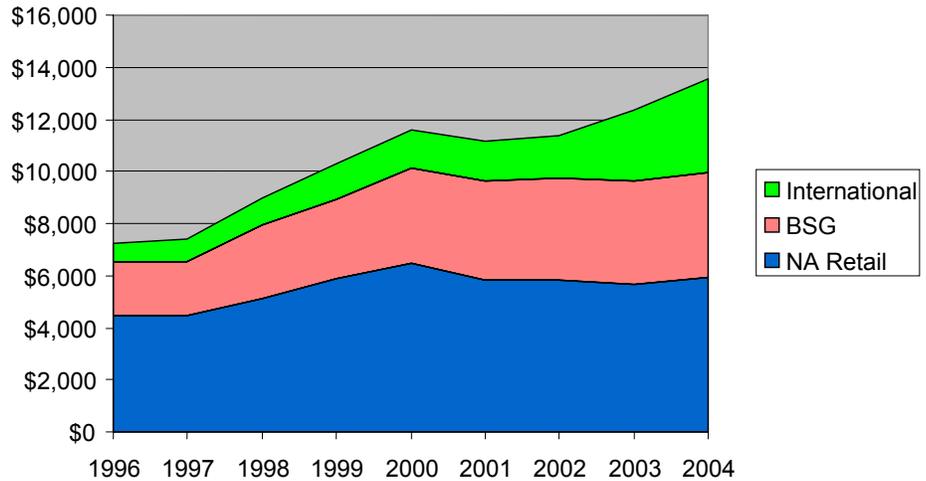
¹⁵ Office Depot 2005 10-K.



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Exhibit 6: Sales by Segment

International is the fastest growing and most profitable division



Office Depot trades at a deep discount relative to Staples

Office Depot Has Had Its Share of Problems

Office Depot has seen its share of problems over the past few years. Bruce Nelson, the company’s Chairman and CEO, was asked to resign in October due to performance issues. The company struggled with 15 consecutive quarters of declining comps, an operating margin roughly half its closest competitor, Staples, and a decline in its North American Retail store base. In general the market recognized these issues and deeply discounted Office Depot’s stock. Around the time of Nelson’s departure, the stock traded at a 35% discount relative to Staples.¹⁶ Its 13x multiple was a 43% discount to its historical ten-year average of 23x.¹⁷ Although performance measures improved late 2004 – due to several growth and performance initiatives – the market continued to remain cautiously pessimistic given Office Depot’s execution uncertainty.

A Company Poised For Turnaround

We believe the hiring of Steve Odland, former AutoZone CEO and proven turnaround leader, removes much of Office Depot’s execution uncertainty. During his four years of tenure as AutoZone’s CEO, Odland turned around AutoZone’s performance and improved operating

¹⁶ Michael E. Cox, *Office Depot, Inc.* (PiperJaffray, 7 Oct. 2004) 3.

¹⁷ Flaherty, Murphy, Ging, 61.



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Steve Odland
Chairman & CEO

margins from 10.7% in 2001 to 17.7% in 2004.¹⁸ He also improved ROIC by 500bps to 25.4%.¹⁹ When Odland joined AutoZone in January 2001 the stock traded at \$28.56 a share. After only 11 months on the job AutoZone stock soared to over \$79 a share. His success earned him recognition as the Top New CEO by Bloomberg Markets Magazine in 2002. Prior to AutoZone Odland was the COO of Ahold USA (supermarket retailer on East Coast with 1600 stores), a position he was promoted to from President and CEO of Tops Markets (an Ahold company). Odland's success in the grocery business, where razor thin margins are the norm, provided a foundation for his subsequent success at AutoZone. In addition to Ahold, Odland brings a wealth of operational and marketing experience from senior positions held at Sara Lee and The Quaker Oats Company.

We believe Odland's success in improving business fundamentals in razor thin operating margin environments will prove beneficial to Office Depot. His strict financial discipline and leadership will help narrow the gap between it and Staples. While it may take six months to a year for Odland to show results, we believe there are several positive initiatives underway that will benefit from his leadership.

Millennium2 Rollout

After underinvesting in its retail store base over the last five years (75% of the stores are 5+ years old), Office Depot is starting an aggressive remodel and rollout of its Millennium2 (M2) retail format. We believe the new format will greatly reduce operating costs and increase retail store performance. The new format takes up about 17,500 square feet, a 12.5% reduction from its traditional format. IT setup and annual maintenance costs are reduced by 40% and 45% respectively. Lighting costs are improved about 15%, and a reduction in hooks for shelving reduces the labor time required to restock the store. The modular format also makes it easier to shop without the assistance of store employees, reducing operating costs. The new format is warm, colorful, and open, and improves line of sight to related items – increasing cross-selling opportunities. The M2 redesign represents one of Office Depot's most ambitious expansion plans in recent history. Office Depot remodeled or opened 101 stores with the M2 design in 2004. In addition, 50 stores

¹⁸ AutoZone 2001 – 2004 10-K documents.

¹⁹ Joseph Feldman, Jonathan Cramer, *Office Depot, Inc.* (SG Cowen & Co., 14 Mar. 2005) 2.



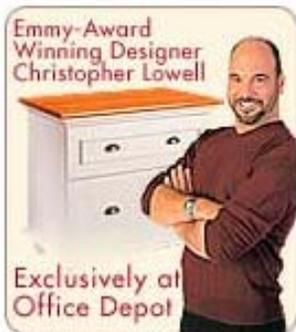
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will be remodeled with the M2 format in 2005, as will the 100 new stores projected to open.²⁰

Aggressive Expansion of Retail Store Base

Office Depot plan is to improve performance in North American Retail which accounts for 44% of revenue and 37% of profits. Following three years of stagnant growth in its retail store base, Office Depot leveraged its new M2 retail format by aggressively increasing their net store base in 2004 by 83 stores (69 in the U.S. & Canada, 14 International).²¹ To regain market share Office Depot plans to continue to rollout out 100 stores per year over the next three years. Its recent acquisition of Kids R' Us also presents Office Depot with an attractive entrance into the Northeast, a predominant stronghold of Staples. According to Office Depot, the Northeast is the country's least saturated market for office supply superstores. It also contains roughly one-third the nation's GDP and offers high concentration of small & medium businesses.²² With the new M2 format, Office Depot feels that it can enter the market with a differentiated product and service. Office Depot plans to convert 50-55 Kids R' Us stores into Office Depot locations, of which roughly half are located in the Northeast (36 were opened in 2004 with 15 planned in 2005).²³ Since 49% of Office Depot's North American Retail store base is located in CA, TX, FL, GA, and IL, the expansion into the Northeast is also attractive in that it diversifies their geographic risk.²⁴

½ of Office Depot's NA store base is located in only five states



Re-merchandising

Office Depot has completed a full-scale remerchandising of its technology and furniture products. The technology category is about one-fifth of sales for leading office products retailers, which is consistent with Office Depot's product portfolio (Exhibit 7).²⁵ The technology remerchandising efforts include a wider variety of laptops, printers, and cell phones – big-ticket items that help drive comps. After 15 consecutive quarters of declining comps, the North American Retail Division reported positive comparable sales in 2004 – primarily due to

²⁰ Office Depot 2005 10-K.

²¹ Office Depot 2005 10-K.

²² Office Depot Press Release, 21 Oct. 2004.

²³ Office Depot 2005 10-K.

²⁴ Cox, 15.

²⁵ Flaherty, Murphy, Ging, 23 & 58.

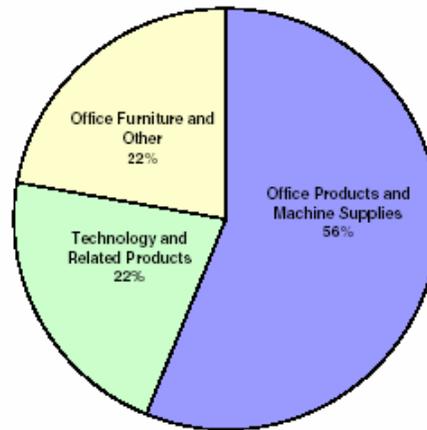


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higher sales of technology products. For example, the overall technology products category increased 13% in 2004, following an 11% decline in 2003.²⁶ On the furniture front, the company has introduced an exclusive Christopher Lowell line of office and home furniture, which contributed to positive comps in 2004.²⁷ Another initiative underway is the expansion of higher margin private label brands in the product mix. Currently about 13% of sales (3000 SKUs) are Office Depot branded products, a number Office Depot hopes to drive to 20% over the next few years.²⁸

Exhibit 7: Office Depot Product Mix

Majority of Office Depot's product line is office supplies



Magellan Rollout

Office Depot is currently 23 months into a 31-month IT upgrade dubbed “the Magellan project”. The Magellan project is designed to improve demand forecasting and store planning, and will allow stores to tailor their product mix to meet local market demands and competitive conditions. Inventory turnover has already improved by 40 basis points to 7.3x during the year – primarily due to the Magellan upgrade.²⁹ The project has so far been successful, and has the potential to significantly impact fundamental performance.

²⁶ Office Depot 2005 10-K.
²⁷ Flaherty, Murphy, Ging, 59.
²⁸ Office Depot 2005 10-K.
²⁹ Cox, 8.



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International Acquisitions



Office Depot essentially doubled its European business with the acquisition of Guilbert's contract delivery business. The integration is on track, with the integration of IT systems and warehousing facilities currently underway – leading to greater operational efficiencies. Office Depot is also currently in the process of closing warehouses, customer service centers, and decreasing the combined workforce to drive further cost reductions.³⁰ International represents a major growth catalyst for Office Depot. Over time, the company expects that international sales will account for 40% of total sales. It is currently the company's most profitable division with operating margins between 13-14% over the past three years.³¹

III. Valuation

Sales

After achieving a healthy compounded annual growth rate of 19.2% from 1995 to 1999, Office Depot – like all major office products superstores – was hit hard by the recession and subsequent slow economic growth of 2002 and 2003. During the next five years, Office Depot closed 107 stores (73 in 2001 alone) while opening 251, for a net gain of 144 stores.³² These store closures were quite expensive and limited the company's ability to grow its top line sales. Office Depot's compounded annual growth rate fell to 5.7% from 2000 to 2004.³³ This misstep allowed Staples to overtake Office Depot as the largest office supply company in the world.

³⁰ Office Depot 2005 10-K.

³¹ Office Depot 2005 10-K.

³² Office Depot 2005 10-K.

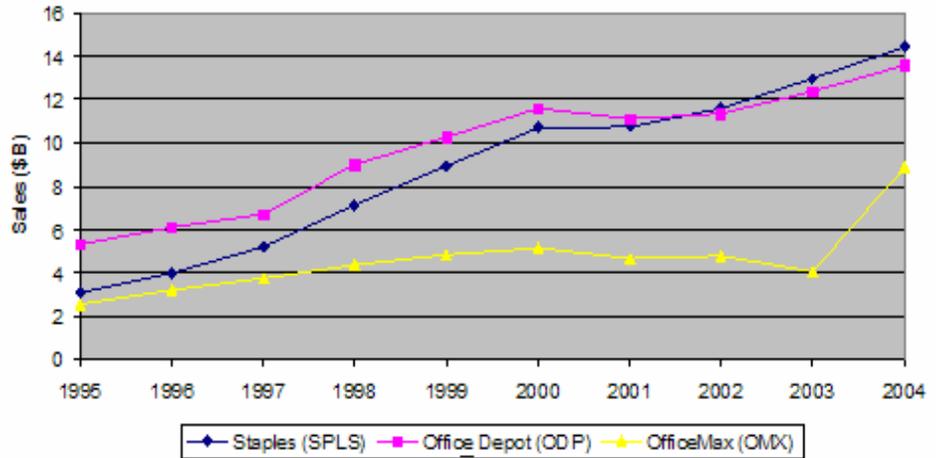
³³ Office Depot 2005 10-K.



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Exhibit 8: Office Supply Superstore Annual Sales

Strong spike in OMX sales due to merger with Boise Cascade



Though leveraging its new M2 retail format, Office Depot is aggressively investing in its retail store base in the North American market. Office Depot plans on opening 100 new stores a year (~9%) for the next three years.³⁴ Assuming that management meets this target, Office Depot should be able to achieve double-digit sales growth during that time. At the end of this three-year period, it is unclear how many domestic retail expansion possibilities the company will have available to it, as the North American retail market may, according to our estimates, be nearing saturation. To be conservative we assume that the North American retail store growth will slow from thereon out to 0.5%.



While the company’s domestic retail growth opportunities will at some point become restricted, its Business Services Group continues to have growth potential. Unfortunately, Office Depot has neglected this group over the last four years as it has only achieved a compounded annual growth rate of ~2.8%.³⁵ Looking forward, the company has not indicated plans to strategically invest in this division in the near future, which leads us to be conservative and assume that the BSG will grow at only 3% going forward.

Office Depot’s international segment offers both the largest potential for growth and the largest uncertainty. On the retail side, Office Depot has a strong foothold in France and Japan with 44 stores and 25 stores

³⁴ Office Depot 2005 10-K.

³⁵ Office Depot 2005 10-K.



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International retail business makes up less than 10% of total international sales

respectively. Outside of France and Japan, Office Depots only has nine international retail locations (five in Spain and four in Hungary).³⁶ While the company’s retail footholds in France and Japan are impressive, Office Depot’s international retail business makes up less than 10% of its total international sales.³⁷

Just as Office Depot has fallen behind Staples in terms of North American retail, Office Depot trails Staples in international retail (not delivery). Unfortunately, the company has not indicated that it will attempt to bridge this gap any time soon. Based on this, we expect Office Depot’s growth in its international retail business to be in the low single digits in the near term.

While Office Depot’s international retail business is small, the company’s international delivery business of \$3.2B is almost twice that of Staples. Office Depot has achieved growth in this area through acquisition of international office products delivery companies such as Guilbert. Going forward, we expect Office Depot to continue to grow in this manner. While neglecting to grow the international retail market is a potentially a mistake, the company may be able to generate a competitive advantage by quickly growing the international delivery business. In contrast to the big box office products retail model, which has yet to be proven in many countries, the office products delivery model already exists in most industrialized countries.

The net result of this sales growth is for Office Depot to achieve high single digit growth for the next three years (9.2% - 8.3%) before falling off to 4.1% in 2008 and gradually declining to 3.0% in perpetuity.

Margins

Through its Millennium2 and Magellan store improvements, Office Depot has been able to reverse the trend of three consecutive years of operating loses to an operating gain of 3% in 2004.³⁸ The big questions going forward are (a) “Can they build on these gains in?” and (b) “Will they ever be able to match Staples operating margins?” Office Depot’s new CEO Steve Odland was quite successful in increasing AutoZone’s



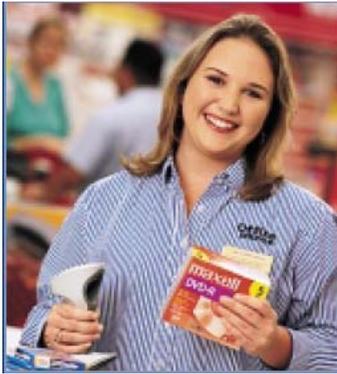
³⁶ Office Depot 2005 10-K.

³⁷ Office Depot 2005 10-K.

³⁸ Staples 2005 10-K.



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operating margins from 10.7% in 2001 to 17.7% in 2004.³⁹ We believe that with his new leadership Office Depot can sustain an increase in operating margins. We do not, however, expect Office Depot eliminate the operating gap between it and Staples.

A major obstacle facing Office Depot is its staffing level relative to Staples. One of the key drivers to Staples' operational excellence continues to be its effective utilization of personnel. In 2004, Staples operated 1,680 stores worldwide⁴⁰ with a total workforce of 33,577 employees⁴¹. This results in an average of 20 employees per store. In comparison, Office Depot operated 1,047 stores worldwide⁴² with a total workforce of 47,000 employees⁴³. This results in an average of 45 employees per store.

	Staples	Office Depot
Sales	\$14.45B	\$13.56B
Employees	33,577	47,000
Stores	1680	1047
Employees per Store	19.99	44.89

In order to match Staples' employee per store ratio of 20, Office Depot would have to cut 26,060 employees and still provide the same level of service to its customers. We view such downsizing to be logistically difficult and extremely complicated. However, we do realize that this comparison is not entirely fair as Staples' international business is predominately retail whereas Office Depot's is delivery. Staples would, therefore, have a lower employee to store ratio. Taking this into consideration, we believe that Office Depot is not currently capable of eliminating the entire operating margin gap between it and Staples. To be conservative we model margins peaking at 6% (compared to Staples current margins of 7.79%) and remaining there indefinitely.

³⁹ Feldman, Cramer, 2.

⁴⁰ http://investor.staples.com/ireye/ir_site.zhtml?ticker=spls&script=11936&item_id='TOOLKIT.htm'

⁴¹ <http://finance.yahoo.com/q/co?s=SPLS>

⁴² Office Depot 2005 10-K.

⁴³ <http://finance.yahoo.com/q/co?s=ODP>



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Inventory Management

As part of Office Depot's drive to reduce its operating expenses, the company has been upgrading its IT infrastructure and inventory management capabilities. These efforts have already reduced its inventory to sales ratio from 12.4% in 2000 to 10.4% in 2004.⁴⁴ We expect Office Depot to continue to utilize its inventories more efficiently and ultimately achieve an inventory to sales ratio of 9.2%.



Weighted Average Cost of Capital

Our discounted cash flow model utilizes a WACC of 11.6%. This estimate incorporates the following:

DATA	Amount of equity	6,755		
	Amount of debt	599		
	% Debt	8%		
	% Equity	92%		
	Tax rate	30%		
	Equity beta	1.46		
RESULT	$1 + (1-T)D/E$	1.06		
	Unlevered equity beta	1.37		
DATA	Risk-free rate	4.97%		
	Market risk premium	5.00%		
RESULT	Equity beta	1.46		
	Market risk premium	<u>5.00%</u>		
	Equity risk premium	7.28%		
	Plus risk-free rate	<u>4.97%</u>		
	Cost of equity	12.25%		
DATA	Cost of debt	6.3%		
RESULT			Weighted	
			Weights	Cost
	After-tax cost of debt	4.4%	8.1%	0.4%
	Cost of equity	12.2%	91.9%	<u>11.2%</u>
	Weighted average cost of capital			11.6%

⁴⁴ Office Depot 2005 10-K.



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Income Statement (\$M)	2004A	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Sales	13,565	14,816	16,135	17,475	18,185	18,879	19,551	20,192	20,798	21,422	22,065	22,727	23,409
COGS and occupancy costs	(9,309)	(10,164)	(11,068)	(11,988)	(12,475)	(12,951)	(13,412)	(13,852)	(14,268)	(14,696)	(15,136)	(15,591)	(16,058)
Gross profit	4,256	4,652	5,066	5,487	5,710	5,928	6,139	6,340	6,531	6,727	6,928	7,136	7,350
Operating and selling expenses	(3,037)	(3,304)	(3,517)	(3,722)	(3,773)	(3,823)	(3,959)	(4,089)	(4,212)	(4,338)	(4,468)	(4,602)	(4,740)
Other operating expenses	(23)	(22)	(24)	(26)	(27)	(28)	(29)	(30)	(31)	(32)	(33)	(34)	(35)
SG&A	(666)	(741)	(807)	(874)	(909)	(944)	(978)	(1,010)	(1,040)	(1,071)	(1,103)	(1,136)	(1,170)
Depreciation expense addback	269	275	291	315	328	341	353	364	375	387	398	410	422
EBITDA	799	860	1,009	1,180	1,328	1,473	1,526	1,576	1,623	1,672	1,722	1,774	1,827
Amortization of intangibles	0	0	0	0	0	0	0	0	0	0	0	0	0
Depreciation expense	(269)	(275)	(291)	(315)	(328)	(341)	(353)	(364)	(375)	(387)	(398)	(410)	(422)
EBIT	530	585	718	865	1,000	1,133	1,173	1,212	1,248	1,285	1,324	1,364	1,405
Interest income	20	52	56	61	64	66	68	71	73	75	77	80	82
Interest expense	(61)	(27)	(50)	(52)	(53)	(55)	(56)	(57)	(59)	(60)	(61)	(62)	(64)
Miscellaneous income	18	9	10	10	11	11	12	12	12	13	13	14	14
Loss on extinguishment of debt	(45)												
Income before income taxes	461	619	668	813	947	1,078	1,117	1,154	1,189	1,226	1,263	1,301	1,341
Income tax expense	(126)	(186)	(200)	(244)	(284)	(323)	(335)	(346)	(357)	(368)	(379)	(390)	(402)
Accounting Change													
Net income	336	433	468	569	663	755	782	808	833	858	884	911	939
Outstanding Shares	313	313	313	313	313	313	313	313	313	313	313	313	313
EPS	\$1.06	\$1.38	\$1.50	\$1.82	\$2.12	\$2.41	\$2.50	\$2.58	\$2.66	\$2.74	\$2.83	\$2.91	\$3.00
Sales growth	9.8%	9.2%	8.9%	8.3%	4.1%	3.8%	3.6%	3.3%	3.0%	3.0%	3.0%	3.0%	3.0%
Gross margin	31.4%	31.4%	31.4%	31.4%	31.4%	31.4%	31.4%	31.4%	31.4%	31.4%	31.4%	31.4%	31.4%
EBITDA margin	5.9%	5.8%	6.3%	6.8%	7.3%	7.8%	7.8%	7.8%	7.8%	7.8%	7.8%	7.8%	7.8%
EBIT margin	3.9%	4.0%	4.5%	5.0%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%
Net margin	2.5%	2.9%	2.9%	3.3%	3.6%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Tax rate	27.3%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%
Net income growth	22.7%	29.1%	8.0%	21.7%	16.5%	13.8%	3.6%	3.3%	3.0%	3.0%	3.0%	3.0%	3.0%
COGS/Sales	68.6%	68.6%	68.6%	68.6%	68.6%	68.6%	68.6%	68.6%	68.6%	68.6%	68.6%	68.6%	68.6%
Operating expenses/sales	22.4%	22.3%	16.5%	16.5%	16.5%	16.5%	16.5%	16.5%	16.5%	16.5%	16.5%	16.5%	16.5%
Pre-opening costs/sales	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
SG&A/sales	4.9%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Amortization/sales	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Miscellaneous income/sales	0.13%	0.06%	0.06%	0.06%	0.06%	0.06%	0.06%	0.06%	0.06%	0.06%	0.06%	0.06%	0.06%



Equity Research

Balance Sheet (\$M)	2004A	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Assets													
Cash, cash equivalents, & ST Investments	955	1,037	1,129	1,223	1,273	1,322	1,369	1,413	1,456	1,500	1,545	1,591	1,639
Receivables, net	1,304	1,482	1,613	1,748	1,818	1,888	1,955	2,019	2,080	2,142	2,206	2,273	2,341
Merchandise inventories, net	1,409	1,482	1,549	1,608	1,673	1,737	1,799	1,858	1,913	1,971	2,030	2,091	2,154
Other Current Assets	249	224	224	224	224	224	224	224	224	224	224	224	224
Total Non-Cash Current Assets	2,961	3,188	3,387	3,580	3,716	3,849	3,978	4,101	4,218	4,337	4,461	4,588	4,719
Total Current Assets	3,916	4,225	4,516	4,803	4,989	5,171	5,347	5,515	5,674	5,837	6,005	6,179	6,357
Net property and equipment	1,463	1,549	1,678	1,746	1,812	1,877	1,938	1,997	2,057	2,118	2,182	2,247	2,315
Net Goodwill and Intangibles	1,050	1,544	1,544	1,544	1,544	1,544	1,544	1,544	1,544	1,544	1,544	1,544	1,544
Other assets	338	370	403	437	455	472	489	505	520	536	552	568	585
Total assets	6,767	7,688	8,141	8,530	8,800	9,064	9,318	9,560	9,794	10,035	10,283	10,538	10,801
Liabilities and Shareholder's Equity													
Accounts payable	1,650	1,867	2,033	2,202	2,291	2,379	2,463	2,544	2,621	2,699	2,780	2,864	2,949
Accrued expenses & other current liabilities	820	859	936	1,014	1,055	1,095	1,134	1,171	1,206	1,242	1,280	1,318	1,358
Income taxes payable	133												
Operating Current Liabilities	2,603	2,726	2,969	3,215	3,346	3,474	3,597	3,715	3,827	3,942	4,060	4,182	4,307
Short-term debt	15	20	21	22	23	23	24	25	25	26	26	27	28
Total current liabilities	2,618	2,746	2,990	3,237	3,369	3,497	3,621	3,740	3,852	3,967	4,086	4,209	4,335
Long-term debt	584	776	808	829	853	872	893	913	931	949	968	989	1,011
Other long-term liabilities	342	384	407	426	440	453	466	478	490	502	514	527	540
Total stockholders' equity	3,223	3,781	3,937	4,037	4,138	4,241	4,338	4,430	4,521	4,616	4,714	4,813	4,915
Total liabilities and stockholders' equity	6,767	7,688	8,141	8,530	8,800	9,064	9,318	9,560	9,794	10,035	10,283	10,538	10,801
Return on Assets	5.2%	6.0%	5.9%	6.8%	7.7%	8.4%	8.5%	8.6%	8.6%	8.7%	8.7%	8.8%	8.8%
Return on Equity	11.2%	12.4%	12.1%	14.3%	16.2%	18.0%	18.2%	18.4%	18.6%	18.8%	19.0%	19.1%	19.3%
Return on Capital	9.1%	10.3%	10.0%	11.8%	13.4%	14.9%	15.1%	15.2%	15.4%	15.5%	15.6%	15.8%	15.9%
Days Sales Outstanding	32.5	34.3	35.0	35.1	35.8	35.8	35.9	35.9	36.0	36.0	36.0	36.0	36.0
Days Inventory	36.9	35.6	34.3	33.0	32.9	33.0	33.0	33.0	33.1	33.1	33.1	33.1	33.1
Debt to Equity	18.6%	21.1%	21.1%	21.1%	21.2%	21.1%	21.1%	21.2%	21.1%	21.1%	21.1%	21.1%	21.1%



Equity Research

Cash Flow Statement	2004A	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Net Income	336	433	468	569	663	755	782	808	833	858	884	911	939
+ After-tax net interest expense	44	19	35	36	37	38	39	40	41	42	43	44	44
+ Depreciation	269	275	291	315	328	341	353	364	375	387	398	410	422
+ Amortization	0	0	0	0	0	0	0	0	0	0	0	0	0
CFO before WC adjustments	649	727	794	921	1,028	1,134	1,174	1,213	1,249	1,286	1,325	1,365	1,406
-D cash	(64)	(82)	(92)	(94)	(50)	(49)	(47)	(45)	(42)	(44)	(45)	(46)	(48)
-D non-cash curr. assets	(276)	(226)	(199)	(193)	(136)	(133)	(129)	(123)	(116)	(120)	(123)	(127)	(131)
+D curr. liab	337	123	243	247	131	128	124	118	111	115	118	122	125
CFO before investments	647	542	1,036	1,196	1,301	1,420	1,474	1,527	1,577	1,624	1,673	1,723	1,775
-capex	(438)	(361)	(420)	(384)	(395)	(405)	(414)	(423)	(435)	(448)	(462)	(476)	(490)
-D other assets	(18)	(32)	(33)	(34)	(18)	(17)	(17)	(16)	(15)	(16)	(16)	(17)	(17)
FCF to D+E	190	149	583	779	889	998	1,043	1,088	1,127	1,160	1,195	1,231	1,268
- After-tax net interest expense	(44)	(19)	(35)	(36)	(37)	(38)	(39)	(40)	(41)	(42)	(43)	(44)	(44)
+ Net debt issuance	(243)	197	33	22	25	20	21	21	19	19	19	22	22
FCF to E	(98)	327	581	765	876	979	1,025	1,069	1,104	1,138	1,172	1,209	1,246
- Dividend payments	0	0	0	0	0	0	0	0	0	0	0	0	0
- Net stock repurchase	(66)	0	0	0	0	0	0	0	0	0	0	0	0
Net Increase in Cash Balance	(163)	327	581	765	876	979	1,025	1,069	1,104	1,138	1,172	1,209	1,246
growth in fcf to D+E	-	-	292.2%	33.6%	14.0%	12.3%	4.6%	4.3%	3.5%	3.0%	3.0%	3.0%	3.0%
PV of fcf to D+E		133	468	561	573	576	540	505	468	432	399	368	340
Cumulative PV of fcf		133	602	1,162	1,735	2,311	2,851	3,356	3,824	4,256	4,654	5,022	5,362

next year's FCF	1,306
TV	15,179
PV of TV	4,065
PV of firm	9,427
+excess cash	(64)
MV of D+E	9,364
-MV of D	(599)
=MV of E	8,765
# of shares	313
share price	\$28.02



Equity Research

Assumptions:	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
# of NA Stores	888	859	867	900	969	1066	1167	1266	1273	1279	1285	1292	1298	1305	1311	1318	1325
growth in NA Stores		-3.3%	0.9%	3.8%	7.7%	10.0%	9.5%	8.5%	0.5%	0.5%	0.5%	0.5%	0.5%	0.5%	0.5%	0.5%	0.5%
Same Store Sales Growth			-2.0%	-4.0%	3.0%	3.0%	3.0%	3.0%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%
NA Retail Sales	\$6,488	\$5,843	\$5,804	\$5,650	\$5,941	\$6,713	\$7,552	\$8,421	\$8,673	\$8,933	\$9,201	\$9,477	\$9,762	\$10,055	\$10,356	\$10,667	\$10,987
NA Delivery Sales	\$3,618	\$3,763	\$3,914	\$3,965	\$4,046	\$4,167	\$4,292	\$4,421	\$4,553	\$4,690	\$4,831	\$4,975	\$5,125	\$5,278	\$5,437	\$5,600	\$5,768
International Sales	\$1,393	\$1,480	\$1,641	\$2,747	\$3,581	\$3,939	\$4,293	\$4,637	\$4,961	\$5,259	\$5,522	\$5,743	\$5,915	\$6,093	\$6,275	\$6,464	\$6,658
Total Sales	\$11,499	\$11,086	\$11,360	\$12,362	\$13,567	\$14,819	\$16,137	\$17,478	\$18,188	\$18,882	\$19,554	\$20,196	\$20,802	\$21,426	\$22,069	\$22,731	\$23,413
NA Retail Growth		-9.9%	-0.7%	-2.7%	5.1%	13.0%	12.5%	11.5%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
NA Delivery Growth	19%	4%	4%	1%	2%	3%	3%	3%	3%	3%	3%	3%	3%	3%	3%	3%	3%
International Growth		6.2%	10.9%	67.3%	30.4%	10%	9%	8%	7%	6%	5%	4%	3%	3%	3%	3%	3%
Total Sales Growth		-3.6%	2.5%	8.8%	9.7%	9.2%	8.9%	8.3%	4.1%	3.8%	3.6%	3.3%	3.0%	3.0%	3.0%	3.0%	3.0%
% of Sales Retail	56%	53%	51%	46%	44%	45%	47%	48%	48%	47%	47%	47%	47%	47%	47%	47%	47%
% of Sales Delivery	31%	34%	34%	32%	30%	28%	27%	25%	25%	25%	25%	25%	25%	25%	25%	25%	25%
International	12%	13%	14%	22%	26%	27%	27%	27%	27%	28%	28%	28%	28%	28%	28%	28%	28%
COGS/Sales	73.38%	71.65%	70.63%	68.65%	68.62%	68.6%	68.6%	68.6%	68.6%	68.6%	68.6%	68.6%	68.6%	68.6%	68.6%	68.6%	68.6%
Oper. Exp./Sales	20.77%	20.96%	20.63%	22.71%	22.39%	22.30%	21.80%	21.30%	20.75%	20.25%	20.25%	20.25%	20.25%	20.25%	20.25%	20.25%	20.25%
Other Oper. Exp./Sales	1.02%	0.19%	0.09%	0.18%	0.17%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
SGA/Sales	3.89%	4.02%	4.28%	4.68%	4.91%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Amort/Sales	0%	0%	0%	0%	0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
depr/beg net PPE			18.35%	19.57%	18.40%	18.8%	18.8%	18.8%	18.8%	18.8%	18.8%	18.8%	18.8%	18.8%	18.8%	18.8%	18.8%
Misc. Income/Sales	0.04%	-0.08%	0.06%	0.12%	0.13%	0.060%	0.060%	0.060%	0.060%	0.060%	0.060%	0.060%	0.060%	0.060%	0.060%	0.060%	0.060%
tax rate	46.6%	35.8%	35.0%	32.1%	27.3%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%
Cash/sales	1.3%	5.1%	7.8%	7.2%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%
Receivables/sales	7.8%	7.0%	6.8%	9.0%	9.6%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
Inventories/sales	12.4%	11.3%	11.5%	10.8%	10.4%	10.0%	9.6%	9.2%	9.2%	9.2%	9.2%	9.2%	9.2%	9.2%	9.2%	9.2%	9.2%
net PPE/sales	10.1%	9.7%	9.0%	9.5%	9.9%	9.6%	9.6%	9.6%	9.6%	9.6%	9.6%	9.6%	9.6%	9.6%	9.6%	9.6%	9.6%
other assets/sales	1.4%	1.5%	1.6%	2.6%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%
AP/Sales	9.9%	9.6%	10.3%	10.7%	12.2%	12.6%	12.6%	12.6%	12.6%	12.6%	12.6%	12.6%	12.6%	12.6%	12.6%	12.6%	12.6%
Other cur liab/sales	5.1%	5.6%	5.8%	6.6%	6.0%	5.8%	5.8%	5.8%	5.8%	5.8%	5.8%	5.8%	5.8%	5.8%	5.8%	5.8%	5.8%
ST debt/Assets	3.7%	7.4%	0.3%	0.2%	0.2%	0.26%	0.26%	0.26%	0.26%	0.26%	0.26%	0.26%	0.26%	0.26%	0.26%	0.26%	0.26%
Other LT Liab/Assets	2.1%	1.5%	1.4%	5.5%	5.1%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
LT debt+equity						plug											



Equity Research

Cost of Capital for flows in	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
assumed after-tax D/D+E (in MV)	5.50%	5.40%	5.30%	5.25%	5.20%	5.16%	5.12%	5.07%	5.02%	4.97%	4.93%	4.89%
after-tax E/D+E (in MV)	94.50%	94.60%	94.70%	94.75%	94.80%	94.84%	94.88%	94.93%	94.98%	95.03%	95.07%	95.11%
tax rate	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%
pre-tax D/D+E (in MV)	7.68%	7.54%	7.40%	7.33%	7.27%	7.21%	7.16%	7.09%	7.02%	6.95%	6.90%	6.84%
pre-tax E/D+E (in MV)	92.32%	92.46%	92.60%	92.67%	92.73%	92.79%	92.84%	92.91%	92.98%	93.05%	93.10%	93.16%
assumed unlevered beta	1.26	1.26	1.26	1.26	1.26	1.26	1.26	1.26	1.26	1.26	1.26	1.26
assumed debt beta	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
equity beta	1.455	1.455	1.455	1.455	1.455	1.455	1.455	1.455	1.455	1.455	1.455	1.455
risk-free rate	4.97%	4.97%	4.97%	4.97%	4.97%	4.97%	4.97%	4.97%	4.97%	4.97%	4.97%	4.97%
risk premium (for beta=1)	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%
cost of debt	6.25%	6.25%	6.25%	6.25%	6.25%	6.25%	6.25%	6.25%	6.25%	6.25%	6.25%	6.25%
cost of equity	12.25%	12.25%	12.25%	12.25%	12.25%	12.25%	12.25%	12.25%	12.25%	12.25%	12.25%	12.25%
WACC	11.6%	11.6%	11.6%	11.6%	11.6%	11.6%	11.6%	11.6%	11.6%	11.6%	11.6%	11.6%
PV factor for WACC	1.12	1.25	1.39	1.55	1.73	1.93	2.16	2.41	2.69	3.00	3.35	3.73
PV factor for equity	1.12	1.26	1.41	1.59	1.78	2.00	2.24	2.52	2.83	3.17	3.56	4.00
after-tax cost of debt	4.38%	4.38%	4.38%	4.38%	4.38%	4.38%	4.38%	4.38%	4.38%	4.38%	4.38%	4.38%
PV factor for after-tax debt	1.04	1.09	1.14	1.19	1.24	1.29	1.35	1.41	1.47	1.53	1.60	1.67



Equity Research

Comparables

Office Depot is a member of the specialty retail sector. This sector contains a wide range of companies ranging from Petsmart to Tiffany's. Office Depot's largest competitors are Staples and OfficeMax. While it would be ideal to use both companies in a comparative analysis, OfficeMax was purchased by paper manufacturer Boise Cascade in December of 2003. While this in and of itself isn't a major issue, the new company is in the midst of selling off the paper business. These two radical changes in business make OfficeMax an inadequate comparable. Instead, we have chosen four other leading big box retailers with strong brands.



1. Staples (SPLS): "Staples, Inc. (Staples) is an office supplies retailer that sells its products through a superstore concept. The Company conducts operations through three segments: North American Retail, North American Delivery and International Operations. The Company sells a wide variety of office supplies and services, business machines and related products, computers and related products, and office furniture."⁴⁵



2. Costco (COST): "Costco Wholesale Corporation operates membership warehouses based on the concept of offering members very low prices on a limited selection of nationally branded and selected private-label products in a wide range of merchandise categories. During the fiscal year ended August 31, 2004 (fiscal 2004), Costco operated 417 warehouse clubs, of which 327 were in the United States, 63 were in Canada, 15 were in the United Kingdom, five were in Korea, three were in Taiwan and four were in Japan."⁴⁶



3. Best Buy (BBY): "Best Buy Co., Inc. is a specialty retailer of consumer electronics, home-office products, entertainment software, appliances and related services. The Company operates retail stores and/or commercial Websites under the brand names Best Buy (BestBuy.com and BestBuyCanada.ca), Future Shop (FutureShop.ca), Magnolia Audio Video (MagnoliaAV.com) and Geek Squad (GeekSquad.com), as well as an outlet store on eBay."⁴⁷

⁴⁵ <http://finance.yahoo.com/q/pr?s=SPLS>

⁴⁶ <http://finance.yahoo.com/q/pr?s=COST>

⁴⁷ <http://finance.yahoo.com/q/pr?s=BBY>



Equity Research



4. Lowe's (LOW): "Lowe's Companies, Inc. is a home improvement retailer, with a specific emphasis on retail do-it-yourself (DIY) and commercial business customers. Lowe's specializes in offering products and services for home improvement, home decor, home maintenance, home repair and remodeling and maintenance of commercial buildings. As of the end of the fiscal year ended January 30, 2004, Lowe's operated 952 stores in 45 states, with approximately 108.8 million square feet of retail selling space."⁴⁸

Sales, Earnings, and Margins Comparison

In analyzing Office Depot and its competitors, we first looked at the sales, net income, and net margins for all five companies. We also aggregated the four comparable firms and compared Office Depot against this "comparative average".

Growth and margins not as strong as other Big Box retailers

Company	Office Depot	Comp. Average	Staples	Costco	Best Buy	Lowe's
2004						
Sales	\$13,564.7	\$30,891.6	\$14,448.4	\$48,107.0	\$24,547.0	\$36,464.0
Growth	9.76%	14.53%	9.61%	13.07%	17.19%	18.24%
Operating Margin	3.91%	6.54%	7.79%	2.88%	5.31%	10.18%
Net Income	\$335.5	\$1,118.0	\$708.4	\$882.4	\$705.0	\$2,176.0
Net Margin	2.47%	3.89%	4.90%	1.83%	2.87%	5.97%

After analyzing the sales, earnings, and margin data, it is apparent that Office Depot is not growing as fast as the comparable average (9.76% vs. 14.53%). Furthermore, its operating and net margins trail the average by 263 and 142 basis points respectively. Trailing its peers in sales growth and margins, Office Depot should trade at a discount to its peers, including Staples.

⁴⁸ <http://finance.yahoo.com/q/pr?s=LOW>



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Valuation Measures

This hypothesis can best be measured by analyzing the valuation metrics for all five firms.

ODP trades at a discount to its peers

Company	Office Depot	Comp. Average	Staples	Costco	Best Buy	Lowes
2004						
P/E 1YR	16.92	17.50	18.68	20.84	15.32	16.98
P/E	18.49	20.40	21.75	22.92	17.67	20.81
P/S	0.51	0.84	1.04	0.43	0.68	1.19
P/BV	2.14	3.75	3.66	2.71	4.86	3.77
EV/EBITDA	8.37	9.76	10.36	10.50	8.81	10.10
EV/Sales	0.49	0.82	1.01	0.40	0.61	1.28

A quick analysis of the valuation ratios reveals the Office Depot does trade at a discount to its peers, including Staples. This result is in line with the weaker growth and operating performance of Office Depot relative to its peers. However, since we expect Office Depot to improve its margins in the coming years, this suggests that a buying opportunity might exist for Office Depot.

Sensitivity Analysis of Operating Margins

Our DCF model has the company experiencing strong sales growth in the next three years before falling off to 4.2% and gradually declining to a 3% in perpetuity. The big question is “What perpetual operating margin will the company be able to achieve?”

Our model has assumed that that Office Depot will increase its operating margin from its current level of 3.9% to 6% over five years. We view this assumption to be a conservative one given (1) Steve Odland’s track record at AutoZone, (2) the fact that Staples has been able to achieve a similar basis point increase in last 2 years (5.71% to 7.79%), and (3) 6% will still be 179 basis points lower than Staples’ current operating margin.



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Varying Office Depot’s operating margin between its current level of 3.9% and Staples current level of 7.79% yields the following prices from our DCF model.

Operating Margin	DCF Price
3.9%	\$20.44
5.0%	\$24.75
6.0%	\$28.02
7.0%	\$30.90
7.79%	\$32.82

Even in a low operating margin growth scenario, the company is undervalued

Based on this analysis, Office Depot seems to be undervalued since any further increase in the company’s operating margins will only add create more free cash flows for equity holders.

IV. Risks

Investors should realize that several risks are inherent in the valuation:

Increased Operating Efficiencies

Incorporated into the DCF model are conservative assumptions that Office Depot will be able to improve its operating margins. These improvements will only result if the major turnaround initiatives they invest in are successful. Any failure in these structural changes could result in decreased profits for Office Depot.

Industry Competition

The retail office supply market is very competitive with very little differentiation between top firms in regards to product selection and pricing. Until this point, the office supply market has been very rational. However, increased saturation of office products superstores and increased competition from mass merchandise like Wal-Mart, warehouse clubs, computer and electronic superstores, and other discount retailers, could drive down prices and profitability. Increased competition could also drive up the cost to compete, with higher





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advertising and promotional spend required to maintain or increase market share.

Slave to Business Spending

A decline in small business spending, in either North America or Europe, would have a strong material impact on Office Depot's retail profitability. Small businesses are Office Depot's most profitable customers. Any major economic shift which dampens small business sector sentiment could lead to decreased office products spending and reduced profitability for Office Depot.

International and Delivery Drive Growth

Office Depot's future growth prospects are dependent on delivery and international so inability to effectively integrate related acquisitions would negatively Office Depot's long-term performance. The failure of management to understand and meet the needs of fundamentally different markets, and anticipate demographic and geographic trends as it expands its international store base would also negatively impact valuations.

Staples Buyout of OfficeMax

While it seems very unlikely to occur in the near term, if Staples was able to acquire all or most of OfficeMax's retail and delivery business, Office Depot's competitive position would be further reduced. The addition of OfficeMax's retail and delivery businesses would allow Staples to increase its margins further by spreading the company's fixed costs across a larger number of sales.



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V. Recommendation



Office Depot's recent operational turnaround combined with Steve Odland's recent arrival as CEO both point to a positive future for Office Depot. Based on conservative assumptions for sales growth and operating margins, the market has underestimated how much upside exists and just how easily it can be obtained (even with no change in operating margins, the DCF model price exceeds the current price). The comparative analysis demonstrates that Office Depot continues to trade at a discount to its peers. Our DCF model price of \$28.02 confirms this assertion as the stock currently trades at \$22.00. Given the fact that both the comparative analysis and DCF model suggest that Office Depot is undervalued, we have to place a BUY recommendation on the stock.

Important Disclaimer

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