Equity Research

STAPLES

Share Price: $30.51
Target Price: $30.94
 # Shares: 495,260,000
Market Cap: $15,110M
Sales Growth: 9.61%
Earnings Growth: 44.51%
Operating Margin: 7.79%

March 21, 2005

Staples: *The company is great, and everyone knows it*

We are initiating coverage on Staples (SPLS) with an initial recommendation of Hold with a price target of $30.94. While we believe that the company will continue to produce strong sales and earnings growth, we also believe that the stock price already reflects this.

We believe the market has already priced in several of the upsides to Staples including:

- Expanded growth potential due to increased focus on business delivery, retail business customers, and international expansion
- Favorable operating margin vis-à-vis the competition
- Success in introducing higher margin products and services such as Staples branded products and copy/print services

However several downsides are currently underweighted such as:

- Increased competition and margin pressure in North American retail business
- Increased competition from its top competitor, Office Depot. It recently signed a strong turnaround CEO and announced Q4'04 results far exceeding expectations
- Uncertainty regarding ability to adapt to and execute well in international markets

Please see the disclaimer at back of this report for important information

I. Office Products Industry

Office Products Superstores Are Still 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] On the retail side the top three office products superstores (Staples, Office Depot, and OfficeMax) account for only 20% of the total 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 market, and local dealers and contract suppliers accounting for roughly 20%.[3] Buhrmann and United Stationers are major players in this market.

Top Office Products Retailers Are Historically Undervalued

Office retailer P/Es have not recovered like those of other specialty retailers

Shares of office products retailers such as Staples and Office Depot have historically traded at higher average P/E multiples until 2000, when investors gave traditional retailers lower multiples and focused their investments elsewhere. For example, over the seven years preceding 2000, Staples traded at an average P/E multiple of 31 to 40 while Office Depot traded at an average 21 to 45 multiple. However, after the economy tanked in 2000 these multiples declined to an average of 20 to 23 for Staples and 9 to 16 for Office Depot.

We believe this reflects changes in economics associated with decreased consumer and small business spending during an economic downturn. However, as the economy improved traditional retailer P/Es, such as Pier 1 Imports and Bed Bath & Beyond, have recovered while office products superstores have not. This could reflect investor uncertainty as

[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.

to the viability of pure play office products superstores given increased competition from mass merchandisers and big box retailers such as Wal-Mart and Best Buy, and the increased viability of low cost online direct models.

There Is Generous Room For Growth

Business delivery, int'l expansion, and value added services are industry growth drivers

Currently Staples holds the largest market share in the North American retail and delivery market, which is still less than 10%.[4] Office products superstores are aggressively pursuing ways to increase their market share. For example, in 2003 Staples started experimenting with smaller retail formats, carrying far fewer SKUs, making the penetration of smaller markets more viable.[5] Moreover, many have started expanding into high margin copy and print services, as well as providing office supplies to supermarkets and drug stores as a wholesaler. On another front, the top players are beefing up their highly profitable delivery businesses through acquisitions, allowing them to compete more effectively in the contracts and delivery space. Staples, for example, acquired Quill, a leading direct mail office supplies catalog company targeting small and medium sized businesses. It has also established a contract stationer business to compete with Buhrmann's Corporate Express for large national contracts.

Europe and Asia Pacific are the two hot int'l markets

International expansion also represents a major growth area. Both Office Depot and Staples have been successful in acquiring and integrating numerous retail and delivery office products businesses in Europe and Asia Pacific. Europe is the world's second largest retail and delivery office products market at $65 billion[6]. While China is one of the fastest growing at office products markets at $25 billion, it remains to be seen how quickly Staples can penetrate the market. Staples recently entered into a joint venture with OA365, a Chinese Internet and catalog delivery business, which gives it "an attractive platform to address the fastest growing market in the world, and the opportunity to increase its investment over time."[7] If Staples can establish its office products superstore concept in China, the company could continue to grow rapidly over the next decade and beyond.

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[4] Amy Ryan, *SPLS: Thinking Outside The "Box" – Initiating Coverage With Buy* (ThinkEquity partners, 21 Feb. 2005) 7.
[5] Staples 10-K (29 Jan. 2005) 3.
[6] Ryan, 39.
[7] Staples News Release (17 Aug. 2004).

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II. Staples Overview

Reuters' Business Description:
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. Staples' product offering includes Staples, Quill and other branded products, which represented more than 15% of its total sales (fiscal 2004). The Company is also introducing new products under the Staples brand. It also offers an array of services, including high speed, color and self-service copying, other printing services, faxing, and pack and ship services. Staples is an office supplies retailer with 1,559 office supply stores (as of 1/04) in the U.S., Canada, the UK, Germany, the Netherlands and Portugal. SPLS also operates catalog operations, a contract stationery business and e-commerce sites.

A Deeper Look at Business Unit Profitability

While the Company competes in North American Retail and North American Delivery businesses, they are not equal in terms of growth and profitability (Exhibits 1 & 2).

North American Retail accounts for an estimated 57% of total sales and 59% of operating profits. Currently 89% of Staple's retail store base is in North America.[8]

Business Delivery is the most profitable division; int'l has strong growth potential

North American Delivery accounts for 29% of sales and 33% of operating profits. Businesses include Staples National Advantage, Staples Business Delivery, Quill, StaplesLink, Staples.com, and Quill.com. [9]

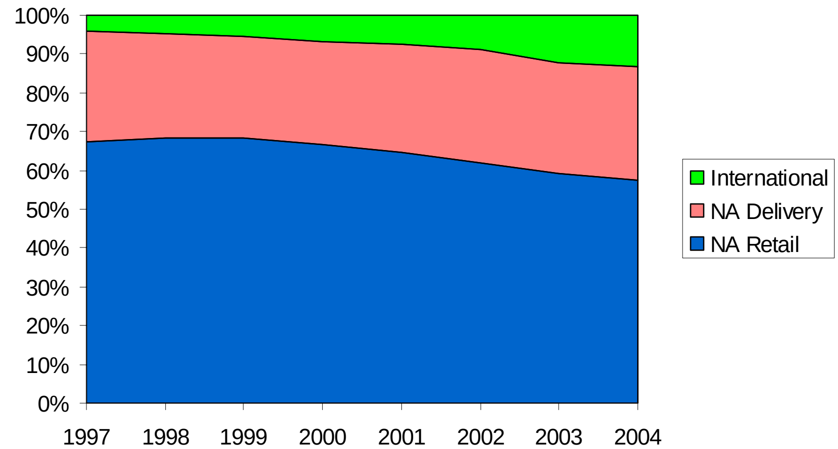
International Operations accounts for 14% of sales and 8% of operating profits.[10] Staples has operations in the U.K., Germany, the Netherlands, Portugal, Belgium, Denmark, France, Luxembourg, Spain,

[8] Staples 10-K (29 Jan. 2005) 73.
[9] Staples 10-K (29 Jan. 2005) 73.
[10] Staples 10-K (29 Jan. 2005) 73.

Italy, Sweden, Austria, Switzerland, Poland, Hungary, and the Czech Republic. The company has also acquired a minority stake in OA365 to enter the Chinese market.

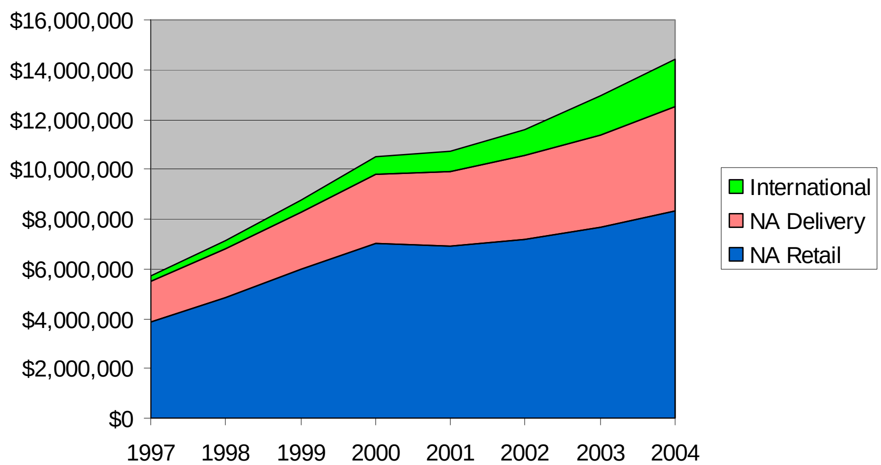
NA Retail: 57%
NA Delivery: 29%
International: 13%

Exhibit 1: Segments as % of Total Sales



Delivery and International drive Staples' growth

Exhibit 2: Sales by Segment



Staples Continues To Show Industry Leadership

The company has industry leading market share, sales growth, and profits. While its competitors have been distracted – Office Depot with the ousting of its CEO for performance reasons and OfficeMax with its probe into accounting fraud and resignation of its CFO and CEO – Staples has continued to take advantage of its competitors' weakness and execute well on all fronts.

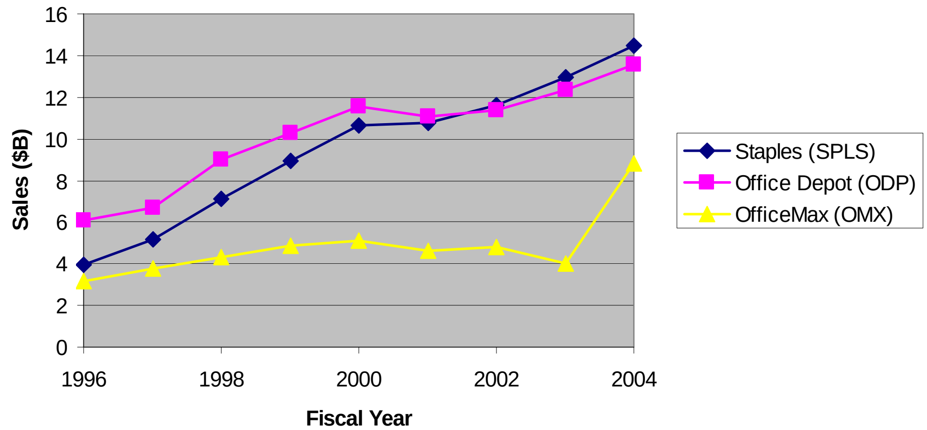
Staples currently holds the number one position in the North American delivery market, and serves half of all Fortune 100 companies. It also holds number one or number two positions in every North American retail market in which it competes.[11] While current competitors struggle, Staples plans to aggressively invest in new markets this year, such as Chicago, which is the third largest market for office supplies in the U.S. at $5 billion dollars.[12] It will build 20 stores in Chicago by year end, with a goal of eventually displacing Office Depot or OfficeMax.

In the North American retail market Staples continues to generate industry leading sales, and improve its top line, while OfficeMax struggles (Exhibit 3). Performance in the delivery segment was just as strong, with Staples increasing Q4'04 revenues 19% compared to Office Depot's gain of only 3%.[13]

[11] Ryan, 1.
[12] Marilyn Much, *Staples' Grocery Strategy Is Already Paying Off* (Investor's Business Daily, 10 Mar. 2005).
[13] Michael Baker, Jason West, *Balancing growth and investments* (Deutsche Bank, 24 Feb. 2005) 1.

Exhibit 3: Total Sales Comparison

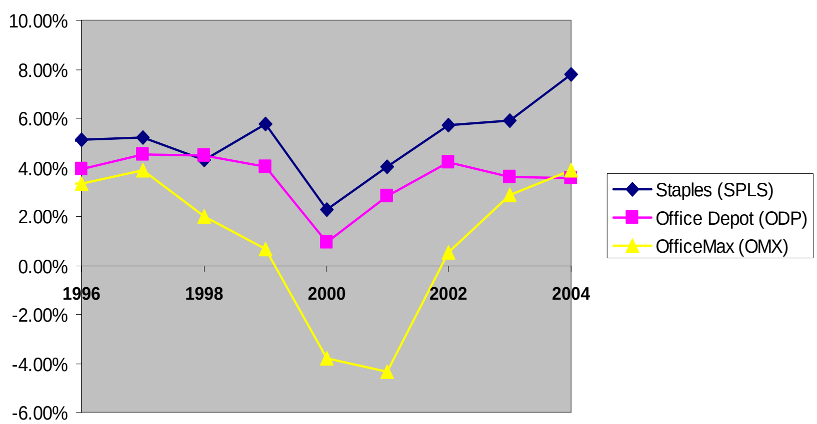
Strong spike in OMX sales due to merger with Boise Cascade



New investment is not the only area in which Staples has shown leadership. Same store comps over the past two years have improved vis-à-vis the competition, with Staples now leading the industry at 4%.[14] Q4'04 results also indicate that Staples' 7.8% margins are nearly double that of Office Depot's at 4.1% (Exhibit 4).[15] Since pricing is virtually the same across the industry, this indicates Staples has an industry cost advantage – which will favorably impact Staples as competition increases in markets such as Chicago.

Exhibit 4: Operating Margin Comparison

Staples' operating margin is almost double that of the competition



[14] Nathan Slaughter, *Staples, Black Ink, and Growth* (The Motley Fool, 24 Feb. 2005).
[15] Baker, West, 1.

One of the key drivers to Staples' operational excellence continues to be their effective utilization of personnel. In 2004, Staples operated 1,680 stores worldwide[16] with a total workforce of 33,577 employees[17]. This results in an average of 20 employees per store. In comparison, Office Depot operated 1,047 stores worldwide[18] with a total workforce of 47,000 employees[19]. 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**

By using 55.5% less human capital to run each store, Staples is able to save hundreds of thousands of dollars annually, which directly improves their bottom line.

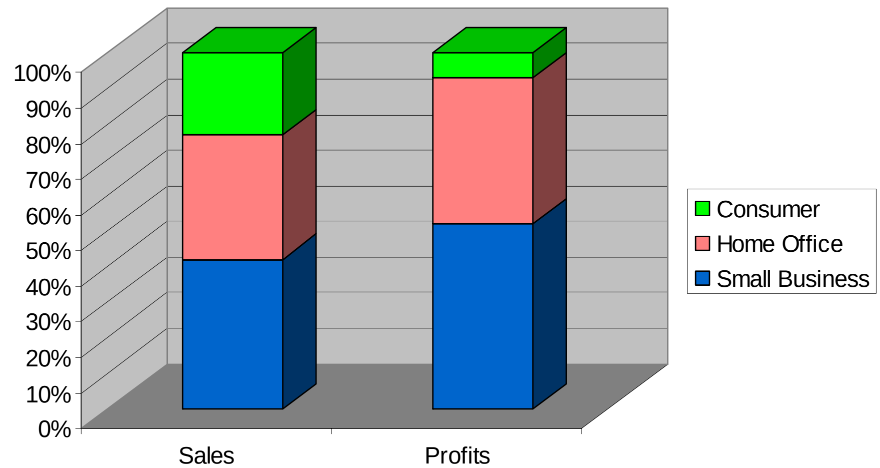
Growth Strategy Built On Key Drivers

Consumers only generate 7 % of profits on 23% sales

Product Shift Appealing To Most Profitable Customers - Negative same store sales in 2001 and a downturn in the economy forced Staples to re-evaluate its growth strategy. A review of store operations suggested that product mix was skewed towards the consumer rather than the small business and office worker. This proved problematic as small business and home office customers accounted for 93% of retail profits. Consumers, on the other hand, were much lower margin customers, generating only 7% of retail profits on 23% of sales (Exhibit 5).[20] Therefore, Staples implemented its "Back-To-Brighton" strategy to focus on business customers. It eliminated low-margin, low-turnover consumer oriented SKUs, giving more space for a wider variety of business oriented SKUs.

[16] http://investor.staples.com/ireye/ir_site.zhtml?ticker=spls&script=11936&item_id='TOOLKIT.htm'
[17] http://finance.yahoo.com/q/co?s=SPLS
[18] Office Depot 2004 10-K
[19] http://finance.yahoo.com/q/co?s=ODP
[20] Ryan, 34.

Exhibit 5: NA Retail Sales & Profitability by Segment



Focus On Higher Margin Products & Services

Beginning in 2002 Staples began to emphasize its own branded products. Surveys indicated that it had superior brand awareness relative to the competition (ranging from 11% to 18%). Staples branded products typically have a 10 to 20% higher margin than national brands and represent an incremental $1 billion opportunity.[21] In 2003, Staples' branded products were 13% of sales, a number it hopes to increase to 20% by 2007.[22]

Staples new store formats also emphasize high margin copy and print services. Services include color and self-service copying, faxing, and pack and ship services. Currently the copy center adds an incremental $300 million to staples sales, or roughly $300,000 yearly per store. In comparison, Kinko's generates $1 million per location, showing that Staples has both gained traction and has headroom for growth.[23]

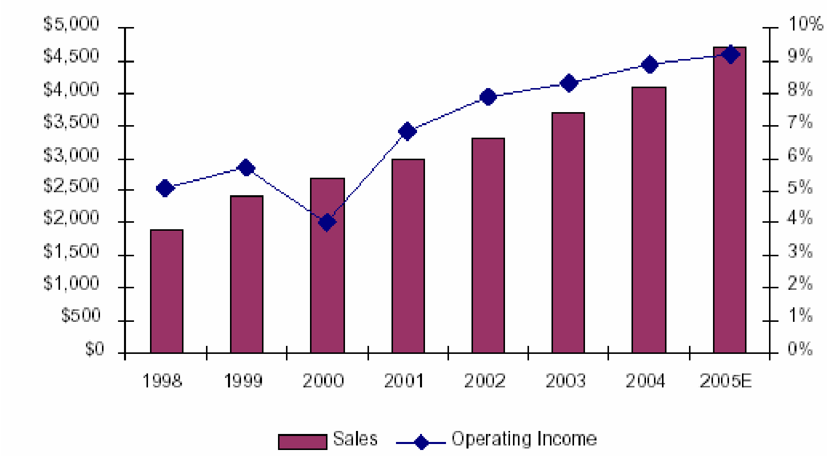
Expand Highly Profitable Delivery Business – Staples is rapidly expanding its reach into the delivery business, their most profitable and fastest growing business. It has grown at a CAGR of 12% over the past five years. The operating margin has also increased 75% from 5.1% in 1988 to 8.9% in 2004 (Exhibit 6).[24] There is plenty of room for growth

[21] Ryan, 7.
[22] Marilyn.
[23] Baker, West, 3.
[24] Ryan, 1.

as Staples' share in the $64 billion North American delivery market is estimated at only 6.5%.[25]

Exhibit 6: Delivery Business Sales & Operating Income

Operating margins have increased 75% since 1988



Note: Excludes all previously recorded non-recurring charges or credits
Source: Staples and ThinkEquity Partners Estimates. [26]

Staples continues to aggressively segment the delivery market and target potential customers through multiple channels.

Staples Business Delivery

Business delivery targets small companies with fewer than 20 employees. It reaches potential customers through several channels including direct mail and the Staples.com web site. It currently has more than 1.5 million active customers and offers 700,000 office products and services. Staples offers free next day delivery on orders over $50.

Quill Corporation

Quill targets company with up to 100 employees. Quill is an established direct mail catalog business acquired by Staples in 1998. The company serves more than one million small and medium sized businesses. Quill generates an estimated 80% of Staples' delivery sales even though there are approximately 50% fewer customers than Staples Business

[25] Ryan, 38.
[26] Ryan, 9

Delivery.[27] Channels include a direct sales force, catalog operations, and the Quill.com web site.

Staples National Advantage & Staples Business Advantage

Staples National and Business Advantage target medium and large businesses requiring specialized contracts, services, and pricing. Staples National Advantage is a nationwide contract stationer business selling to large national accounts and Fortune 500 companies. Staples Business Advantage sells to medium sized companies and has more flexibility in handling smaller accounts. The company is currently expanding into offering print and copy service for its contract customers, an attractive business at roughly 60% gross margin.[28]

Staples the Wholesaler

Staples is also experimenting with a wholesaler concept, which has completed testing in 40 Stop & Shop locations and is set to be rolled out nationally to 550 stores in July.[29] Grocery store comps have shown that such arrangements have boosted office product sales 60 to 80%.[30] We expect that this will give Staples leverage to aggressively expand their wholesaler concept.

Expand International Operations

Particulares

STAPLES OFFICE CENTRE

International sales have increased from a about 7% of total sales in 2000 to roughly 13% in 2004, and operating profits during this same time have increased from a loss of $24 million to a profit of over $80 million (Exhibit 7).[31] Staples has a very strong cash flow from operations, including its current $1 billion dollar war chest, which it can use to aggressively invest into international acquisitions and joint ventures – increasing their addressable market. For example, Staples just recently acquired Pressel International to expand its delivery business in Europe. It also recently entered the $25 billion Chinese market though a joint venture with OA365, the largest office products company in China.

[27] Ryan, 39.
[28] Ryan, 39.
[29] George Anderson, *Ahold Stocks Up On Staples* (retailwire, 10 Mar. 2005).
[30] Ryan, 39.
[31] Ryan, 10.

III. Valuation

Sales

Despite the recession and subsequent slow overall economic growth in 2002 and 2003, Staples has been able to grow at a CAGR of 10% over the last five years. Based on management's goal of opening about 100 new domestic stores (~6%) a year for the next 3 years (starting with 20 in Chicago), we believe that Staples will be able to achieve double-digit sales growth during that time.[32] 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 be reaching saturation. At that point, we assume that the North American retail store growth will slow to 1%. This 1% will be split between new store openings and further expansion of Staples branded products into other retail distributors (grocery stores, pharmacy's, etc.).

Office Products Superstores – Chicago

Office Products Superstores - Chicago PMSA

County	Number of Stores ODP	SPLS	OMX	Total
Cook	16	0	20	36
Dekalb	0	0	1	1
DuPage	7	0	10	17
Grundy	0	0	0	0
Kane	3	0	4	7
Kendall	1	0	3	4
Lake	2	0	3	5
McHenry	1	0	3	4
Will	0	0	0	0
Total	30	0	44	74

Source: Company reports, Bernstein Hexagonal Trading Radius Analysis.

While the company's domestic retail growth opportunities at some point will become restricted by market saturation, its North American delivery segment has significant growth potential. The North American delivery segment has averaged 11% sales growth over the last five years.[33] As the company shifts more of its domestic focus from the retail segment to the delivery segment, we expect this business to continue to average double-digit sales growth over the next five years before gradually declining to a rate equal to GDP growth. Staples will be able to achieve this growth by (a) offering customers lower prices, (b) providing customers with "Easy" service, and (c) leveraging the Staples brand.

Strong foothold in Europe, the world's 2nd largest market, with 254 Stores

Staples international segment offers both the largest potential for growth and the largest uncertainty. On the retail side, Staples has a strong foothold in Europe with 254 stores located throughout the United Kingdom, Germany, the Netherlands, Portugal, and Belgium. The company plans to open 15 new stores in Europe in 2005, which is consistent with the North American store growth rate of 6%.[34] We expect the growth of international retail stores to continue to grow at 6%

[32] Staples 10-K (2001-2005)
[33] Staples 10-K (2001-2005)
[34] Staples 10-K (2005)

over the next three years. Although Office Depot has larger international sales ($3.58B vs. $1.93B), most of these sales are from delivery as Office Depot has less than a third as many international retail stores as Staples (78 vs. 254).[35] While either company can continue to grow their international delivery business by acquiring existing international office supply delivery companies, the more difficult task is to prove the office supply superstore concept in each new country. Staples' head start in the international retail market should provide the company an advantage over the competition in achieving the same operating performance abroad as it enjoys domestically.

Once North American retail opportunities diminish, we believe that Staples will attempt to significantly increase its international retail presence. While this strategy has the potential to allow Staples to continue to achieve double-digit sales growth, its feasibility is unknown. A more likely opportunity for sustained international growth exists in the international delivery business. While the big box office products retail model has yet to be proven in many countries, the office product delivery model already exists in most industrialized countries. To date, acquisition has been the growth engine of choice in this segment and we expect it to remain so in the short-run. In the long run, we expect Staples to achieve the same operational effectiveness that it has domestically.

The net result of this sales growth is for Staples to grow at a blended low double digit rate for the next three years (11.8% - 10.5%) before falling off to 7.1% in 2008 and gradually declining to 3.5% in perpetuity.

Margins

Through its "Back to Brighton" business improvement plan, which focused on internal process improvement and cost cutting, Staples has been able to increase it operating margins from 4.01% in 2001 to 7.79% in 2004.[36] This almost doubling of its operational margins in 3 years is nothing short remarkable. This margin growth is the result of Staples "Summit Supply Chain" initiative, which has been ongoing for the last three years.[37] In the near term, we expect Staples to modestly build on these gains as the company continues to improve its processes and the

[35] Office Depot 10-K (2005) 6.
[36] Staples 10-K (2005)
[37] Colin McGranahan, *SPLS 4QF04| A Strong Quarter, but Margin Gains Begin to Taper; Fairly Valued; Market Perform* (Bernstein Research Call, 25 Feb. 2005) 1.

competition continues to stumble. These margins will decrease in the long run as the competition improves its own processes and margins across the industry fall.

Cash

In 2003, Staples greatly increased its cash position from 5% of sales to over 10% of sales. This doubling of Staples cash position continued into 2004 as Staples prepares to finance its rapid domestic store expansion over the next three years. In our model, we maintain this 10% cash position before slowly decreasing it back to 5% as Staples sales growth slows.

Income Statement ($M)	2004A	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Sales	14,448	16,151	17,955	19,844	21,247	22,614	23,915	25,143	26,270	27,273	28,232	29,225	30,253
COGS and occupancy costs	(10,344)	(11,467)	(12,658)	(14,089)	(15,149)	(16,192)	(17,195)	(18,153)	(19,046)	(19,855)	(20,553)	(21,276)	(22,024)
Gross profit	4,105	4,684	5,297	5,755	6,098	6,422	6,720	6,990	7,224	7,418	7,679	7,949	8,229
Operating and selling expenses	(2,349)	(2,584)	(2,873)	(3,135)	(3,357)	(3,573)	(3,779)	(3,973)	(4,151)	(4,309)	(4,461)	(4,617)	(4,780)
Pre-opening costs	(11)	(12)	(13)	(15)	(16)	(17)	(18)	(19)	(19)	(20)	(21)	(22)	(22)
SG&A	(611)	(662)	(736)	(814)	(871)	(927)	(981)	(1,031)	(1,077)	(1,118)	(1,158)	(1,198)	(1,240)
Depreciation expense addback	279	272	305	337	361	384	407	427	447	464	480	497	514
EBITDA	1,413	1,698	1,980	2,129	2,215	2,290	2,350	2,395	2,424	2,434	2,520	2,609	2,700
Amortization of intangibles	(9)	(10)	(11)	(12)	(13)	(14)	(14)	(15)	(16)	(16)	(17)	(18)	(18)
Depreciation expense	(279)	(272)	(305)	(337)	(361)	(384)	(407)	(427)	(447)	(464)	(480)	(497)	(514)
EBIT	1,126	1,416	1,664	1,779	1,841	1,892	1,929	1,953	1,961	1,954	2,023	2,094	2,168
Interest income	31	73	81	89	86	81	75	68	59	61	64	66	68
Interest expense	(40)	(49)	(52)	(55)	(57)	(59)	(61)	(62)	(64)	(65)	(68)	(70)	(73)
Miscellaneous income	(1)	1	1	1	1	1	1	2	2	2	2	2	2
Income before income taxes	1,116	1,440	1,611	1,724	1,784	1,833	1,868	1,890	1,897	1,889	1,955	2,024	2,095
Income tax expense	(407)	(526)	(588)	(629)	(651)	(669)	(682)	(690)	(693)	(690)	(714)	(739)	(765)
Net income	708	915	1,023	1,095	1,133	1,164	1,186	1,200	1,205	1,200	1,242	1,285	1,331
Outstanding Shares	495	495	495	495	495	495	495	495	495	495	495	495	495
EPS	$1.43	$1.85	$2.07	$2.21	$2.29	$2.35	$2.39	$2.42	$2.43	$2.42	$2.51	$2.59	$2.69

Sales growth	9.6%	11.8%	11.2%	10.5%	7.1%	6.4%	5.8%	5.1%	4.5%	3.8%	3.5%	3.5%	3.5%
Gross margin	28.4%	29.0%	29.5%	29.0%	28.7%	28.4%	28.1%	27.8%	27.5%	27.2%	27.2%	27.2%	27.2%
EBITDA margin	9.8%	10.5%	11.0%	10.7%	10.4%	10.1%	9.8%	9.5%	9.2%	8.9%	8.9%	8.9%	8.9%
EBIT margin	7.8%	8.8%	9.3%	9.0%	8.7%	8.4%	8.1%	7.8%	7.5%	7.2%	7.2%	7.2%	7.2%
Net margin	4.9%	5.7%	5.7%	5.5%	5.3%	5.1%	5.0%	4.8%	4.6%	4.4%	4.4%	4.4%	4.4%
Tax rate	36.5%	36.5%	36.5%	36.5%	36.5%	36.5%	36.5%	36.5%	36.5%	36.5%	36.5%	36.5%	36.5%
Net income growth	0.6%	29.1%	11.9%	7.0%	3.5%	2.7%	1.9%	1.2%	0.4%	-0.4%	3.5%	3.5%	3.5%
COGS/Sales	71.6%	71.0%	70.5%	71.0%	71.3%	71.6%	71.9%	72.2%	72.5%	72.8%	72.8%	72.8%	72.8%
Operating expenses/sales	16.3%	16.0%	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	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
SG&A/sales	4.2%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%
Amortization/sales	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Miscellaneous income/sales	-0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%

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Balance Sheet ($M)	2004A	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Assets													
Cash,cash equivalents, & ST Investments	1,470	1,615	1,795	1,984	1,912	1,809	1,674	1,509	1,314	1,364	1,412	1,461	1,513
Receivables, net	485	520	578	639	684	729	770	810	846	879	910	941	975
Merchandise inventories, net	1,603	1,777	1,975	2,183	2,337	2,488	2,631	2,766	2,890	3,000	3,106	3,215	3,328
Other Current Assets	224	224	224	224	224	224	224	224	224	224	224	224	224
Total Non-Cash Current Assets	2,312	2,521	2,778	3,047	3,246	3,440	3,625	3,800	3,960	4,103	4,239	4,381	4,527
Total Current Assets	3,782	4,136	4,573	5,031	5,158	5,250	5,300	5,309	5,274	5,467	5,651	5,842	6,040
Net property and equipment	1,601	1,795	1,984	2,125	2,261	2,391	2,514	2,627	2,727	2,823	2,922	3,025	3,132
Net Goodwill and Intangibles	1,544	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	145	162	180	198	212	226	239	251	263	273	282	292	303
Total assets	7,071	7,637	8,281	8,898	9,176	9,411	9,597	9,731	9,808	10,107	10,400	10,703	11,018
Liabilities and Shareholder's Equity													
Accounts payable	1,241	1,389	1,544	1,707	1,827	1,945	2,057	2,162	2,259	2,346	2,428	2,513	2,602
Accrued expenses & other current liabilities	954	1,042	1,165	1,287	1,378	1,467	1,551	1,631	1,704	1,769	1,831	1,896	1,963
Operating Current Liabilities	2,196	2,431	2,709	2,994	3,206	3,412	3,608	3,793	3,963	4,115	4,259	4,409	4,564
Short-term debt	1	1	1	2	2	2	2	2	2	2	2	2	2
Total current liabilities	2,197	2,432	2,710	2,996	3,207	3,413	3,610	3,795	3,965	4,117	4,261	4,411	4,566
Long-term debt	558	792	832	869	895	920	944	967	989	1,024	1,060	1,097	1,135
Other long-term liabilities	201	200	217	233	240	247	251	255	257	265	272	280	289
Total stockholders' equity	4,115	4,213	4,522	4,800	4,833	4,831	4,792	4,714	4,597	4,702	4,807	4,915	5,028
Total liabilities and stockholders' equity	7,071	7,637	8,281	8,898	9,176	9,411	9,597	9,731	9,808	10,107	10,400	10,703	11,018
Return on Assets	10.4%	12.4%	12.9%	12.7%	12.5%	12.5%	12.5%	12.4%	12.3%	12.0%	12.1%	12.2%	12.3%
Return on Equity	18.2%	22.0%	23.4%	23.5%	23.5%	24.1%	24.7%	25.3%	25.9%	25.8%	26.1%	26.4%	26.8%
Return on Capital	15.6%	18.9%	19.7%	19.9%	19.9%	20.3%	20.6%	21.0%	21.4%	21.2%	21.4%	21.6%	21.9%
Days Sales Outstanding	11.3	11.4	11.2	11.2	11.4	11.4	11.4	11.5	11.5	11.5	11.6	11.6	11.6
Days Inventory	38.8	38.2	38.1	38.2	38.8	38.9	39.1	39.2	39.3	39.4	39.5	39.5	39.5
Debt to Equity	13.6%	18.8%	18.4%	18.1%	18.6%	19.1%	19.7%	20.5%	21.5%	21.8%	22.1%	22.4%	22.6%

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Cash Flow Statement	2004A	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Net Income	708	915	1,023	1,095	1,133	1,164	1,186	1,200	1,205	1,200	1,242	1,285	1,331
+ After-tax net interest expense	25	31	33	35	36	38	39	40	41	42	43	44	46
+ Depreciation	279	272	305	337	361	384	407	427	447	464	480	497	514
+ Amoritization	9	10	11	12	13	14	14	15	16	16	17	18	18
CFO before WC adjustments	1,021	1,228	1,372	1,479	1,543	1,599	1,646	1,682	1,708	1,721	1,782	1,844	1,909
-D cash	(78)	(146)	(180)	(189)	72	103	135	165	195	(50)	(48)	(50)	(51)
-D non-cash curr. assets	(225)	(209)	(257)	(269)	(199)	(194)	(185)	(175)	(160)	(143)	(136)	(141)	(146)
+D curr. liab	263	236	278	285	212	206	196	185	170	151	145	150	155
CFO before investments	981	1,108	1,518	1,644	1,989	2,099	2,199	2,286	2,359	2,143	2,222	2,300	2,381
-capex	(374)	(467)	(494)	(478)	(498)	(515)	(529)	(540)	(547)	(559)	(579)	(600)	(621)
-D other assets	(38)	(17)	(18)	(19)	(14)	(14)	(13)	(12)	(11)	(10)	(10)	(10)	(10)
FCF to D+E	569	625	1,006	1,147	1,477	1,571	1,656	1,733	1,801	1,574	1,633	1,690	1,750
- After-tax net interest expense	(25)	(31)	(33)	(35)	(36)	(38)	(39)	(40)	(41)	(42)	(43)	(44)	(46)
+ Net debt issuance	(198)	234	40	38	26	25	24	23	22	35	36	37	39
FCF to E	345	828	1,013	1,150	1,467	1,558	1,641	1,717	1,782	1,567	1,626	1,683	1,742
- Dividend payments	(100)	0	0	0	0	0	0	0	0	0	0	0	0
- Net stock repurchase	(512)	0	0	0	0	0	0	0	0	0	0	0	0
Net FCF	(266)	828	1,013	1,150	1,467	1,558	1,641	1,717	1,782	1,567	1,626	1,683	1,742
growth in fcf to D+E	2318.4%	9.9%	61.0%	14.0%	28.7%	6.4%	5.5%	4.7%	3.9%	-12.6%	3.8%	3.5%	3.5%
PV of fcf to D+E		564	818	841	976	936	890	840	786	620	580	541	505
Cumulative PV of fcf		564	1,382	2,222	3,198	4,134	5,024	5,864	6,650	7,270	7,849	8,390	8,895

next year's fcf	1,811
term. value	24,487
PV of TV	7,066
PV of firm	15,962
+excess cash	(78)
MV of D+E	15,884
-MV of D	(559)
=MV of E	15,325
# of shares	495
share price	$30.94

Equity Research

Assumptions:	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
# of NA Stores	1426	1512	1602	1698	1715	1733	1750	1767	1785	1803	1821	1839	1858	1876	1895
growth in NA Stores		6.0%	6.0%	6.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Same Store Sales Growth		4.0%	3.8%	3.6%	3.4%	3.2%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
Retail Sales	$8,324	$9,157	$10,054	$11,019	$11,504	$11,987	$12,467	$12,965	$13,484	$14,023	$14,584	$15,168	$15,774	$16,405	$17,062
NA Delivery Sales	$4,197	$4,701	$5,218	$5,739	$6,256	$6,756	$7,229	$7,663	$8,046	$8,368	$8,619	$8,878	$9,144	$9,418	$9,701
International Sales	$1,927	$2,293	$2,683	$3,086	$3,487	$3,870	$4,219	$4,514	$4,740	$4,882	$5,028	$5,179	$5,335	$5,495	$5,660
Total Sales	$14,448	$16,151	$17,955	$19,844	$21,247	$22,614	$23,915	$25,143	$26,270	$27,273	$28,232	$29,225	$30,253	$31,318	$32,422
NA Retail Growth	8.6%	10.0%	9.8%	9.6%	4.4%	4.2%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
NA Delivery Growth	13.3%	12%	11%	10%	9%	8%	7%	6%	5%	4%	3%	3%	3%	3%	3%
International Growth	20.5%	19%	17%	15%	13%	11%	9%	7%	5%	3%	3%	3%	3%	3%	3%
Total Sales Growth	11.4%	11.8%	11.2%	10.5%	7.1%	6.4%	5.8%	5.1%	4.5%	3.8%	3.5%	3.5%	3.5%	3.5%	3.5%
% of Sales Retail	58%	57%	56%	56%	54%	53%	52%	52%	51%	51%	52%	52%	52%	52%	53%
% of Sales Delivery	29%	29%	29%	29%	29%	30%	30%	30%	31%	31%	31%	30%	30%	30%	30%
% of Sales International	13%	14%	15%	16%	16%	17%	18%	18%	18%	18%	18%	18%	18%	18%	17%
COGS/Sales	71.59%	71.0%	70.5%	71.0%	71.3%	71.6%	71.9%	72.2%	72.5%	72.8%	72.8%	72.8%	72.8%	72.8%	72.8%
Oper. Exp./Sales	16.26%	16.0%	16.0%	15.8%	15.8%	15.8%	15.8%	15.8%	15.8%	15.8%	15.8%	15.8%	15.8%	15.8%	15.8%
Pre-Open/Sales		0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
SGA/Sales	4.23%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%
Amort/Sales		0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
depr/beg net PPE	17.42%	17.0%	17.0%	17.0%	17.0%	17.0%	17.0%	17.0%	17.0%	17.0%	17.0%	17.0%	17.0%	17.0%	17.0%
Misc. Income/Sales		0.006%	0.006%	0.006%	0.006%	0.006%	0.006%	0.006%	0.006%	0.006%	0.006%	0.006%	0.006%	0.006%	0.006%
tax rate	36.5%	36.5%	36.5%	36.5%	36.5%	36.5%	36.5%	36.5%	36.5%	36.5%	36.5%	36.5%	36.5%	36.5%	36.5%
Cash/sales	10.2%	10.0%	10.0%	10.0%	9.0%	8.0%	7.0%	6.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Receivables/sales	3.4%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%
Inventories/sales	11.1%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%
net PPE/next year's sales	9.9%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
other assets/sales	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
AP/Sales	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%
Other cur liab/sales	6.6%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%
ST debt/Assets	0.0%	0.02%	0.02%	0.02%	0.02%	0.02%	0.02%	0.02%	0.02%	0.02%	0.02%	0.02%	0.02%	0.02%	0.02%
Other LT Liab/Assets	2.8%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%
LT debt+equity		plug	plug	plug	plug	plug	plug	plug	plug	plug	plug	plug	plug	plug	plug

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)	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
after-tax E/D+E (in MV)	97.00%	97.00%	97.00%	97.00%	97.00%	97.00%	97.00%	97.00%	97.00%	97.00%	97.00%	97.00%
tax rate	37%	37%	37%	37%	37%	37%	37%	37%	37%	37%	37%	37%
pre-tax D/D+E (in MV)	4.64%	4.64%	4.64%	4.64%	4.64%	4.64%	4.64%	4.64%	4.64%	4.64%	4.64%	4.64%
pre-tax E/D+E (in MV)	95.36%	95.36%	95.36%	95.36%	95.36%	95.36%	95.36%	95.36%	95.36%	95.36%	95.36%	95.36%
assumed unlevered beta	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
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	1.431	1.431	1.431	1.431	1.431	1.431	1.431	1.431	1.431	1.431	1.431	1.431
risk-free rate	4.80%	4.80%	4.80%	4.80%	4.80%	4.80%	4.80%	4.80%	4.80%	4.80%	4.80%	4.80%
risk premium (for beta=1)	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%
cost of debt	6.60%	6.60%	6.60%	6.60%	6.60%	6.60%	6.60%	6.60%	6.60%	6.60%	6.60%	6.60%
cost of equity	11.24%	11.24%	11.24%	11.24%	11.24%	11.24%	11.24%	11.24%	11.24%	11.24%	11.24%	11.24%
WACC	10.91%	10.91%	10.91%	10.91%	10.91%	10.91%	10.91%	10.91%	10.91%	10.91%	10.91%	10.91%
PV factor for WACC	1.11	1.23	1.36	1.51	1.68	1.86	2.06	2.29	2.54	2.82	3.12	3.47
PV factor for equity	1.11	1.24	1.38	1.53	1.70	1.89	2.11	2.34	2.61	2.90	3.23	3.59
after-tax cost of debt	4.19%	4.19%	4.19%	4.19%	4.19%	4.19%	4.19%	4.19%	4.19%	4.19%	4.19%	4.19%
PV factor for after-tax debt	1.04	1.09	1.13	1.18	1.23	1.28	1.33	1.39	1.45	1.51	1.57	1.64

Comparables

Staples is a member of the specialty retail sector. This sector contains a wide range of companies ranging from Petsmart to Tiffany's. Staples largest competitors are Office Depot 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 three other leading big box retailers with strong brands.

1. Office Depot (ODP): "Office Depot, Inc. 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."[38]

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."[39]

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."[40]

[38] http://finance.yahoo.com/q/pr?s=ODP
[39] http://finance.yahoo.com/q/pr?s=COST
[40] http://finance.yahoo.com/q/pr?s=BBY

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."[41]

Sales, Earnings, and Margins Comparison

In analyzing Staples 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 Staples against this "comparative average".

Growth not as strong as other Big Box retailers

Company	Staples	Comp. Average	Office Depot	Costco	Best Buy	Lowes
2004						
Sales	$14,448.4	$30,670.7	$13,564.7	$48,107.0	$24,547.0	$36,464.0
Sales Growth	9.61%	14.57%	9.76%	13.07%	17.19%	18.24%
Operating Margin	7.79%	5.57%	3.91%	2.88%	5.31%	10.18%
Net Income	$708.4	$1,024.7	$335.5	$882.4	$705.0	$2,176.0
Net Margin	4.90%	3.29%	2.47%	1.83%	2.87%	5.97%

After analyzing the sales, earnings, and margin data, it is apparent that while Staples is not growing as fast as the comparable average (9.61% vs. 14.57%). However, its operating and net margins exceed the average by 222 and 139 basis points respectively. This mix of positive (higher margins) and negative (lower growth rate) would suggest that Staples should not trade at a significant discount or premium to its peers.

[41] http://finance.yahoo.com/q/pr?s=LOW

Valuation Measures

Based on comparable metrics, Staples seems to be slightly overvalued

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

Company	Staples	Comp. Average	Office Depot	Costco	Best Buy	Lowes
2004						
P/E 1YR	18.72	17.47	17.58	20.81	15.54	17.22
P/E	21.79	20.18	19.20	22.88	17.92	21.11
P/S	1.05	0.71	0.53	0.43	0.69	1.21
P/BV	3.67	3.42	2.22	2.71	4.93	3.83
EV/EBITDA	10.38	9.21	8.70	10.48	8.96	10.23
EV/Sales	1.02	0.71	0.51	0.40	0.62	1.29

A quick analysis of the valuation ratios reveals the valuation is anywhere from slightly overvalued in the case of its forward P/E ratio (7.17%) to significantly overvalued relative to its P/Sales ratio (46.59%).

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IV. Risks

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

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 (e.g. Chicago market), and increased competition from mass merchandise like Wal-Mart, warehouse clubs, computer and electronic superstores, and other discount retailers, prices could be lowered as a lever to drive market share. Increased competition could also drive up the cost to compete, with higher 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 product superstore profitability as small businesses are Staples most profitable customers. Any major change in the economic environment which dampens small business sector sentiment could lead to decreased office products spending and reduced profitability for Staples.

International and Delivery Drive Growth

Staples future growth prospects are dependent on delivery and international so inability to effectively integrate related acquisitions would negatively Staples' 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.

V. Recommendation

It appears that much of the upside of the company's potential has already been priced into the stock while some of the downside risks have not been accounted for. The comparable analysis suggests that the stock is overvalued while our DCF model price of $30.94 vs. the current price of $30.51 suggests that the stock is fairly price. These results combined with the fact that Staples has already squeezed most of the savings internal operational savings from the business, we have to place a HOLD recommendation on the stock.

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