

Office Depot

No Reason to Be a Hero; Remain Neutral; Little Earnings Visibility

- EPS Plummet.** ODP reported EPS significantly below our expectations and the Street's. Total sales fell 15.4% vs. 12.1%E, as International and BSD sales trends deteriorated, declining 14% and 15%, respectively. Additionally, retail comps fell 18% vs. (15%)E. Adjusted operating margins plummeted to (6.6%) vs. 0.2%E. Finally, we believe that it is important to note that the quarter (again) included a number of nonoperating charges related to ODP's ongoing restructuring that were difficult to reconcile.
- Near-Term Liquidity a Positive; Little Visibility on Earnings.** ODP's near-term liquidity appears sufficient to weather the storm so long as we see some economic recovery toward the end of 2009. ODP noted that it does not expect to draw down its \$712MM available asset-backed line during 2009. For the year, we forecast the company to generate ~\$6MM of free cash flow (FCF) driven by net D&A of ~\$90MM (as capex is projected at about \$150MM vs. \$330MM in 2008) and ~\$65MM in WC improvements. Furthermore, ODP is pursuing other sources of liquidity that should add a baseline of ~\$400MM of cash in 2009. These include ~\$200MM from sale-leasebacks (US and Europe), \$100MM from accounts receivable sales, cash benefits from asset monetization (\$105MM), and dividends from a JV and tax refund (\$50MM).
- Vendors on Board.** ODP has reached out to its top 50 vendors and relayed its current financial condition and projected liquidity. The company believes its key vendors are encouraged by its liquidity position. The company noted discussions with its largest and most important vendors have gone particularly well.
- No Reason to Be a Hero; Remain Neutral.** Concerns regarding ODP's long-term strategic plans, the macro backdrop, and the potential for high returns when the environment rebounds, encourage much patience (e.g., "I can miss the first 50% move and still capture the next 100%"). Effective with this note, we withdraw our price target for ODP.

Neutral

ODP, ODP US

Price: \$1.26

Hardlines Retail

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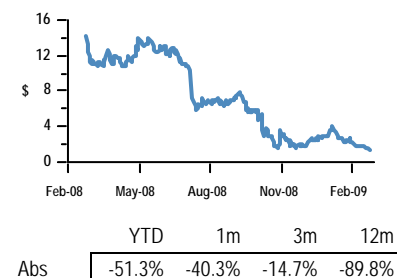
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Price Performance



Office Depot (ODP;ODP US)

	2008A	2009E (Old)	2009E (New)	2010E (Old)	2010E (New)
EPS (Operating) (\$)					
Q1 (Mar)	0.29	(0.01)	(0.17)		
Q2 (Jun)	0.04	(0.18)	(0.16)		
Q3 (Sep)	(0.01)	(0.03)	(0.15)		
Q4 (Dec)	(0.73)	0.01	(0.18)		
FY	(0.41)	(0.22)	(0.65)	0.25	(0.25)
P/E (Operating) FY	NM	NM	NM	4.9	NM

Source: Company data, Reuters, J.P. Morgan estimates.

Company Data

Price (\$)	1.26
Date Of Price	24 Feb 09
52-week Range (\$)	14.39 - 1.45
Mkt Cap (\$ bn)	0.34
Fiscal Year End	Dec
Shares O/S (mn)	273

See page 6 for analyst certification and important disclosures.

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EPS Plummet. ODP reported EPS significantly below our expectations and the Street's. Total sales fell 15.4% vs. 12.1%E, as International and BSD sales trends deteriorated, declining 14% and 15%, respectively. Additionally, retail comps fell 18% vs. (15%)E. Adjusted operating margins plummeted to (6.6%) vs. 0.2%E. Finally, we believe that it is important to note that the quarter (again) included a number of nonoperating charges, related to ODP's ongoing restructuring, that were difficult to reconcile.

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Lowering Estimates. We are lowering our FY10E EPS to negative \$0.65 and FY11E EPS to negative \$0.25 to better reflect the current macro backdrop and company-specific problems. *Please refer to the chart on page 1 for a breakdown by quarter.*

Investment Thesis

Maintain Neutral Rating. While we acknowledge that ODP "looks cheap" at its current price, we don't believe the stock will recover until financial trends progress and the macro backdrop marginally improves. Office superstores are highly macro sensitive, with top-line correlations in the 70-80% range to YOY GDP and industrial production growth. With Europe now following down the path of the U.S., the stock is likely to remain tied to trends in the overall market. Moreover, this sector is later cyclical vs. the rest of retail (which is early cyclical), and ODP has one of the highest debt-to-EBITDAR ratios in our coverage. Finally, concerns regarding management's long-term strategic plans and their execution, combined with high potential returns when the macro environment rebounds, encourage patience (e.g., "I can miss the first 50% move and still capture the next 100%").

Valuation

ODP is trading at 6.5x our 2010 estimate on an EV/EBITDA basis compared to 5.4x for our coverage universe, and the stock is in line with its historical 2-yr average.

Earnings summary

- ODP reported adjusted 4Q08 EPS of (\$0.73) vs. (\$0.01) last year and consensus of (\$0.06).
- Total revenues decreased 15.4% to \$3.27B vs. \$3.87B last year and below our estimate of \$3.40B.
- The gross margin rate declined 60 bps to 25.8% of sales vs. 26.4% LY and below our estimate of 28.6%.
- The total operating expense ratio was 32.5% of sales vs. 26.4% a year ago and above our estimate of 28.4%.
- The gross margin decline and operating expense deleverage yielded a (6.6%) total company operating margin vs. 0.1% LY and below our estimate of 0.2%.
- Please see the segment-specific sections below for more details.

NA Retail (42.4% of 4Q08 total sales)

- In the NA Retail division, sales decreased 16.8% to \$1.39B, with comps (18.0%) vs. (7.0%) in the year-ago period and slightly below our estimate of (15%).
- Two-thirds through the first quarter, comps are currently tracking better than in the fourth quarter.
- The comp decline was driven by lower transactions and lower average order value. Transactions were down YOY but fairly stable the past couple of quarters.
- NA Retail experienced sales declines in three major product categories – furniture, supplies, and technology – as computers, printers, and televisions were particularly weak. The best-performing products were ink and toner, paper and design print and ship services.
- The rate of decline in California was more challenging in 4Q compared to the first nine months of the year, while Florida (the largest and most profitable market) continues to decline, albeit at a slower rate.
- The NA retail operating margin declined 350 bps to (2.1%) vs. 4.5% LY. Operating profit improved \$25MM YOY due to product mix and the lapping of a negative vendor adjustment last year. However, volume sales declines and increased property costs negatively impacted operating profit by ~\$66MM and \$11MM, respectively.

N.A. Business solutions division (BSD) (28.1% of 4Q08 total sales)

- In the BSD division, sales decreased 13.6% to \$919.8MM vs. \$1.08B LY.
- In 4Q, sales declines sequentially accelerated to small to medium-size and SMB and large national customers.
- The division operating margin decreased 320 bps to (3.1%) vs. 0.1% LY. Approximately \$20MM of the YOY decline in profit related to lower sales levels, while ~\$6MM is due to increased allowances for bad debt. Also, a \$3MM decline was due to an unfavorable customer and product mix shift and increased promotions.

International (29.5% of 4Q08 total sales)

- In the International division, sales decreased 15.1% to \$963MM vs. \$1,135MM last year and our estimate for a 5.0% decline (local currency sales declined 4%).
- Sales in the direct channel were down 7% in local currency.
- The contract channel continued to outperform direct, decreasing sales by 2% in local currency.

- The divisional operating margin decreased 310 bps to 2.2% vs. 5.3% LY. The decline in operating profit was driven by lower sales levels (\$23MM), higher costs and increased competition (\$10MM), and a change in foreign currency (\$6MM).

Balance sheet and related items

- Total inventory decreased 22.5% during 4Q08 to \$1.33B vs. \$1.72B on a year-over-year basis. LTM inventory turns were 6.9x vs. 6.6x last year.
- Capital expenditures totaled approximately \$52.3MM in 4Q08 vs. \$126.6MM last year.
- For FY09, ODP expects capex and D&A of roughly \$150MM and \$240MM, respectively.
- In 4Q, ODP did not repurchase any shares of common stock.
- For 2009, ODP plans to open 15 new stores, while closing 118 stores by the end of the first quarter.
- During 4Q08, the company opened two new stores, closed ten and relocated one store, to end the period with 1,267 stores in North America vs. 1,222 last year.

Risks to Our Rating

Key upside risks:

- **An unexpected near-term recovery in GDP growth.** Office Depot's top line is highly correlated to macro factors. In the near term, we expect weak office supply sales concurrent with GDP growth. If macro trends were to make an unexpected rapid recovery, it would likely drive an earlier-than-expected rebound in top-line results.
- **Increase in middle market account acquisitions.** Office Depot has been making a strong push into the middle-market delivery business. The middle market is highly fragmented and increased traction could lead to unforeseen sales and margin expansion.

Key downside risks:

- **Dependence on continuation of rational pricing.** Will a relatively rational pricing environment hold? An irrational pricing environment may pressure margins beyond expectations.
- **Weaker-than-expected business spending.** Office Depot's results are highly correlated to the macro environment, and the outlook for business spending is weak.
- **Poor visibility.** Office Depot has not demonstrated a strong ability to anticipate what to expect in a slowdown and how change might impact financial results. In other words, it doesn't seem to have a "handle on the numbers." The company needs to anticipate the impact of the slowdown, in our view, as well as bake in the effect of new initiatives, which it has not demonstrated a strong ability to do. This makes earnings visibility very low.

Office Depot: Summary of Financials

Income Statement - Annual	FY08A	FY09E	FY10E	Income Statement - Quarterly	1Q09E	2Q09E	3Q09E	4Q09E
Revenues	-	-	-	Revenues	-	-	-	-
COGS	-	-	-	COGS	-	-	-	-
Gross Profit	-	-	-	Gross Profit	-	-	-	-
SG&A	-	-	-	SG&A	-	-	-	-
Operating Income	-	-	-	Operating Income	-	-	-	-
EBITDA	-	-	-	EBITDA	-	-	-	-
Interest, Net	-	-	-	Interest, Net	-	-	-	-
Pretax Income	-	-	-	Pretax Income	-	-	-	-
Taxes	-	-	-	Taxes	-	-	-	-
Tax Rate	-	-	-	Tax Rate	-	-	-	-
Net income - operating	-	-	-	Net income - operating	-	-	-	-
Diluted Shares Outstanding	-	-	-	Diluted Shares Outstanding	-	-	-	-
Operating EPS	(0.41)	(0.65)	(0.25)	Operating EPS	(0.17)	(0.16)	(0.15)	(0.18)
Balance Sheet and Cash Flow Data	FY08A	FY09E	FY10E	Ratio Analysis and Valuation	FY08A	FY09E	FY10E	
Cash and Equivalents	-	-	-	Sales growth	-	-	-	
Inventories	-	-	-	Same store sales	-	-	-	
Current Assets	-	-	-	EBITDA Growth	-	-	-	
PP&E	-	-	-	EBIT Growth	-	-	-	
Total Assets	-	-	-	EPS growth - operating	-	-	-	
Short-term Debt	-	-	-	Gross Margin	-	-	-	
Current Liabilities	-	-	-	EBIT Margin	-	-	-	
Long-term Debt	-	-	-	EBITDA Margin	-	-	-	
Total Liabilities	-	-	-	Inventory growth	-	-	-	
Shareholders' Equity	-	-	-	AP/inventory	-	-	-	
Net Income (including charges)	-	-	-	Debt/EBITDA	-	-	-	
D&A	-	-	-	Debt/Capital (book)	-	-	-	
Other adjustments	-	-	-	Return on invested capital (ROIC)	-	-	-	
Changes in Working Capital	-	-	-	Enterprise value / revenues	-	-	-	
Cash flow from Operations	-	-	-	Enterprise value / EBITDA	6.3	5.5	-	
Capex	-	-	-	Free Cash Flow Yield	-	-	-	
Free Cash Flow	-	-	-	P/E	NM	NM	NM	
Free Cash Flow/Share	-	-	-					
Dividends	-	-	-					
Dividend Yield	-	-	-					

Source: Company reports and J.P. Morgan estimates.

Note: \$ in millions (except per-share data). Fiscal year ends Dec

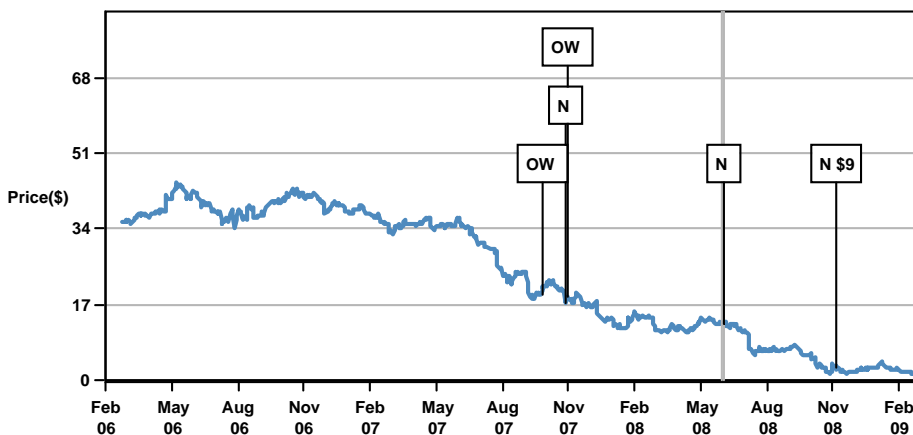
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Office Depot (ODP) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
26-Sep-07	OW	19.22	--
29-Oct-07	N	17.43	--
01-Nov-07	OW	18.76	--
02-Jun-08	N	12.71	--
04-Nov-08	N	2.88	9.00

Source: Reuters and J.P. Morgan; price data adjusted for stock splits and dividends.
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