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Another day at the Office Depot

By **Paula Schaap** Updated 05:16 PM, Nov-30-2012 ET

In mid-2009, when the recession was hitting Office Depot Inc. hard, the office product retailer cut what seemed, at the time, to be a good deal with **BC Partners Ltd.** In return for $350 million that the retailer needed badly, it gave the U.K. **private equity** firm three seats on its expanded board and a 10% stake in perpetual preferred stock.

But Boca Raton, Fla.-based Office Depot didn't give away the entire store — the investor rights agreement it signed with BC required the firm to cast its shareholder votes with management, except in the case of a takeover or bankruptcy.

That unusual grant of stock now has activist hedge fund **Starboard Value LP** at odds with Office Depot's management.

The problem for **Starboard** founder Jeff Smith is that, with the BC Partners voting agreement, his chances of getting his way with the company — i.e., board seats — are significantly reduced.

Which is why Smith sent a letter to the independent members of Office Depot's board on Nov. 16, detailing its "serious concerns" about how Office Depot would use its ability to grant BC Partners voting rights through in-kind quarterly preferred share dividends to ward off investors with an agenda.

Smith contends that, with the shareholder agreement, the board and BC have better than a 20% voting authority already, diluting the impact of all shareholders. In addition, Starboard's and every other shareholder's ability to control the fate of their investment will only go down as quarterly dividends are paid out to BC over time.

Starboard is especially exercised over the dilution of its voting rights as its 14.8% stake is at a standstill because of a 15% poison pill that the board hastily enacted after Smith showed his hand in September and called for the company to improve its operating margins. Starboard also said it wants the company to do something with its Mexican joint venture, which could include a sale.

Smith has called for BC to be released from its voting requirement and for the revocation of the poison pill.

Travis Dirks, whose firm Rotary Gallop provides analyses of shareholder control and odds of winning to both sides of proxy battle contests, said the removal of the voting agreement is more important even than doing away with the poison pill.

"They [Starboard] are taking the right steps," he said. "Allowing BC Partners' freedom to vote their shares is by far their biggest opportunity to increase Starboard's chances."

Dirk calculates that the likely probability of Starboard winning a proxy contest with the BC Partners' voting agreement in place is less than 15%. But the activist's chance of winning goes up to almost 60% if the voting agreement is gone. And that's even if the poison pill remains.

While 60% is a vast improvement, it's still not a slam-dunk.

Which means, according to another source, that a special meeting might be in the cards.

Office Depot's bylaws require a 25% vote of shareholders to call a special meeting. If that happens, the meeting must take place within 90 days.

And matters to be voted on at that meeting — such as those delineated in Starboard's letter — must be approved by a majority of the shareholders present.

Once quorum, rather than proxies, becomes the way votes are added up, Starboard's path to victory — at least the removal of the voting provisions for the BC shareholders rights agreement, and perhaps the poison pill as well — looks less farfetched.

Consent solicitations might also be in the cards, a strategy that activist investor Clinton Group recently pulled off successfully at clothing retailer Wet Seal Inc.

Office Depot has so far responded to Starboard's substantive recommendations by committing to spending $60 million per year to downsize or relocate 500 of its big box stores over the next five years, as well as closing 10 to 20 stores as leases expire. It also said it was putting significant effort into its business services end of operations, something Starboard has also said it should do.

For the activist, however, Office Depot's efforts are too few and too slow and simply represent a plea for investors to be patient in the face of year-over-year sales declines: Sales in the third quarter of 2012 were $2.7 billion, down 5% compared to the prior year period.

Starboard has brought in two well-known retail CEOs — Bob Nardelli of **Home Depot Inc.** fame and Joseph Vassalluzzo, whose last executive job was vice chairman of **Staples Inc.** For now, both are paid advisers.

If Starboard goes for a proxy fight of one sort or another, those two men, along with Smith himself, are likely to be on his director nominee slate, one industry observer said. (None of the three would make themselves available for comment.)

Yet, Nardelli, at least, comes with certain baggage. He was ousted from his Home Depot job in 2006, when Home Depot's board wanted to cut his pay package after a crumbling housing market resulted in declining sales and a stagnant stock price.

Telsey Advisory Group senior analyst Joseph Feldman said that while Nardelli was a "strong operator," who got Home Depot's share price up 20% during his first four years — Nardelli served for six years — he also had difficulty driving the top line.

Still, as someone with knowledge of the sector said, investors have to compare Starboard's prospective choices with the board as it is comprised now.

And with the company's Ebitda margin at 2.5%, behind its nearest competitors **OfficeMax Inc.** at 3.1% and Staples at 8.4%, as well as the share price stubbornly stuck — its 60-day moving average is currently at

$2.49 — investors may sit up and take notice if and when Starboard serves its demand for that special meeting.

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