Second Quarter 2011 Investor Webcast

4 August 2011

Prepared Remarks

Elizabeth Corse, Investor Relations: Welcome, everyone. Tom Adams, Rosetta Stone's CEO, and Steve Swad, our CFO, are looking forward to discussing our operations and financial results for the second quarter 2011, and the outlook for the rest of this year. Our press release, supplemental financial information and a slide deck supporting this webcast are available on our IR website, investors.rosettastone.com. Please review them to find important additional information.

There are or will be forward-looking statements in our press release, slides and conversation today. We offer these statements under the Safe Harbor provided by U.S. law. Of course, risks and uncertainties attach to any forward-looking statement. We've outlined some of those risks in our Form 10-K filed with the SEC in March 2011, which is available through our website. We ask that you review those risk factors before making any investment decision.

We also use non-GAAP numbers in our presentation. The definition of those numbers, and their reconciliation to GAAP numbers, is available in today's press release on our website and as filed with the SEC today on Form 8-K.

Now here's Tom.

Tom Adams, Chief Executive Officer: Good afternoon, everyone. Thanks for joining today's call. It's really exciting to share the progress we have made in the past quarter. Financially, performance in Q2 was better than expected. We're seeing our US consumer business stabilizing, and we're continuing to enjoy strong growth internationally. On a very positive note, we've just launched a new product – called Rosetta Stone® ReFLEX™ – that over the long run should help us drive profitability and growth materially. It specifically addresses the needs of the very large number of Asian consumers who have studied English for years and still can't speak conversationally. We expect this to be a disruptive product that addresses a market that could be bigger than the one our current prime learning product – TOTALe – serves.

Before I get into the details of this fabulous new product and how our US consumer performance has improved in the last quarter, I want to take a step back to talk about how we're approaching our market to better frame what is going on in the business.

As we've said before, our industry has a very diverse set of consumers. Some spend thousands of dollars a year on private tutorials to improve their English, while others buy inexpensive audio CDs to learn a few phrases of Japanese on their daily commute. Others get a cheap phrasebook for a trip abroad. All are looking to communicate in a language other than their own– but they differ greatly in terms of how much time and money they are ready to commit towards reaching their goal.

And yet, in total, on a global basis, it adds up - as hundreds of millions of learners spend over $80 billion annually. Of course, over 95% of the spend is outside the US, with most of it targeted at English and much of that spend focusing on intermediate and advanced levels, although beginner level English language education spend on children is also significant.

Over time, we expect all learners to move to technology driven solutions of varying scope. And we're positioning Rosetta Stone to be the prime beneficiary of the shift away from traditional media and teachers on a worldwide basis – by providing comprehensive, targeted solutions that combine software learning with live online conversational training – not just on your PC but also on your tablet, smart phone or other device. And we'll do it by having a broad range of solutions that meet the needs of the most important segments – so we're going beyond TOTALe.

To give you some historical perspective that puts Q2 in context, the past several years saw us first focus on making the US business highly profitable and our beginner solution effective with the launch of TOTALe; second, we worked on expanding into new markets around the world on the back of this beginner solution while establishing operations and marketing capabilities that help build a strong global brand. And now as a third step we are setting out to launch new products that are more targeted at a broader range of English language learners to capture more of the potential of our international efforts.

The reasoning behind this sequence was that while one of our biggest opportunities was always to solve the world's most pressing language learning issue – namely, the lack of affordable conversational English proficiency training in Japan, Korea and China – we would need to have a steady source of cash from our US consumer business (to fund the effort) and a tried and tested marketing organization in the key Asian markets (to promote it). Also, we knew that since competition in these markets is fierce, and as piracy is a challenge, we should create a disruptive solution that had a unique set of technologies that enabled conversation practice with native speakers and where access was online only. Internally, we called it our plan for winning the English war.

Q2 demonstrates meaningful progress against our game-plan.

Our international consumer business was up 58% year over year, with especially strong momentum in Asia. Of course, we are spending to ramp up our presence internationally and the contribution margins are lower than we ultimately expect them to be when we achieve scale. We now anticipate international sales to be more than 40% of our business by 2013 – mostly based on continued and deeper penetration of markets we are already in.

Our institutional business continued to make progress regarding both the average deal size and the range of customers. We do expect that budget cutbacks will affect sales to US federal government agencies – including Army and Marines giving notice that they will not renew or extend their contracts in Q3 – but overall we are seeing growth in this channel, especially in education, where budgets are also under pressure.

And finally we are seeing the US consumer business begin to stabilize and we feel like our actions over the past six months are beginning to bear fruit with regard to bookings. But as I stated previously, all our initiatives have involved costs that have affected profitability so far year to date.

Steve will describe Q2 financial performance in more detail, but at a high level, overall, our revenues were up, a better-than-expected 10% year on year. Operating EBITDA came in close to break-even though we had higher year on year costs in key investment areas such as re-setting the US consumer business and establishing a more scalable international operation. There remains lots to do to put the company on the strong growth trajectory we should be following – but we are encouraged by improvements in our execution across the board.

I'd now like to go into more detail about ReFLEX, which we launched in Korea last week. ReFLEX is a completely new product for a completely new segment. Our goal is to make it possible for intermediate English language learners in Asia to convert their academic knowledge of English into conversational fluency.

We've been building this solution over the past several years and have had a full market trial underway over the past several weeks. While it is early days in the life of this new platform, we're very encouraged by the trial – with great usage – and we believe that ReFLEX has the potential to work magic for millions of learners. We're building additional versions that will address the specific requirements of Japanese and Chinese learners, and we'll keep you posted on our launch plans for those.

ReFLEX is unlike any other language learning solution in the world, so I'll take some time to describe it in detail. Its power comes from three new approaches that we deliver in daily, 25-minute sessions.

Each session begins with sound-based casual games that train your ear and your pronunciation to help you distinguish between and produce sounds like "light" and "right" – which sound the same to many Asian learners. ReFLEX then works on making speaking faster and more automatic, with dialogue drills using our speech-recognition technology. Finally, you end with a five-minute live conversation with a native English speaker that uses language familiar to you from the drills you've just completed.

Those of you who have worked or traveled in Asia are probably familiar with the depth of need for this solution. Millions of Asian learners are achieving proficiency in written English through their schoolwork – they can pass the tests with high scores, and so on paper they're advanced. However, when it's time to have a conversation with an English speaking client or co-worker, they're stymied. The ability to understand and use spoken English, with confidence, is truly life-changing for these individuals.

The commercial potential for this new offering is considerable in Asia, where the only real alternative is expensive, time-consuming tutoring by expatriate native speakers of English – so we think that the value proposition will be very compelling.

ReFLEX is a great example of how we have increasingly shifted our attention to more serious learners over the past several years. Serious learners offer the potential for longer relationships and more revenue over time as they are more prone to embrace regular language learning activity. Also, more serious learners care deeply about outcomes, and they're therefore more discriminating in terms of the solutions that they select. For them, quality matters – so while price is always a consideration, it is really about getting a return on effort, with time being a bigger investment than initial outlay.

While there are many learners of other languages – whether that's Spanish, Chinese, German or something else – that are serious about getting results, learners of English tend to be the most serious and focused. So it's gratifying that on a year-over-year basis, our English sales have more than doubled in each of the first two quarters of 2011, both domestically and internationally, as Hispanics, Koreans and Japanese learners become a bigger part of our customer base. English is already one of our top two languages – and based on our strategy and new product releases we expect to see continued strong momentum.

While success with ReFLEX and developing our international markets is likely to be a big long term driver of growth, putting our US consumer business on a better footing represents our biggest short term priority. In the US we're executing changes in tactical elements such as pricing and media buying, and also we are positioning the business for long-term stability by focusing our distribution on more digital points of sale, enabling delivery of the product on tablets, and moving towards a more subscription oriented value proposition. We also continue to address voids or weaknesses in our organization with new hires and are improving our capabilities to manage a global business even as we slow the rate of overall growth in corporate costs.

Last time I spoke to you, I said that our US consumer business was showing signs of improvement. That's partly the result of our new pricing, which we began testing in February. The positive trends we saw then have continued, with sales steadily ramping upward in each month of Q2. A critical marketing shift underlying our new pricing strategy is that we are no longer focusing messaging on discounts or price promotions. Our communication strategy has shifted towards communicating our real value proposition around the benefits of learning a language with our system. We expect that this shift will be beneficial to the brand in the long term, but we are pleased to see positive short term impact, as demonstrated by web sales in June being significantly higher than a year ago, despite last year's performance having had heavy "dollar-off" promotions.

Our shift in media strategy towards more targeted audience reach, as opposed to being just direct response, also led to positive results as we saw significant year on year increases in web traffic. A metric that illustrates how well this is working is that 30% more people typed www.rosettastone.com in June 2011 than in June last year. We're also focusing on doing a better job of following up with prospects on email, and on leveraging our Facebook community, which now exceeds half a million fans. We expect to continue to nurture our CRM capabilities as our business moves increasingly online.

As I mentioned, another key part of our US consumer initiatives for the quarter included the expansion of TOTALe to allow usage on the iPad platform. We rolled this out and got very positive reviews. We're also pleased that bi-directional synching is working, so that when you use us on one device, a cloud-based instance of your profile is updated so that you are able to switch devices and keep your progress. Clearly there is a lot more to do in terms of platforms and bringing more functionality to them, but our direction is clear: we are positioning ourselves to be platform agnostic and multi-device – so that our customers can use us wherever they find it convenient, and we can leverage the latest technologies to provide even more powerful learning environments.

There is still a lot to do, but I do believe that our US consumer initiatives are working to improve results: new market segmentation and pricing programs are resulting in higher traffic and higher conversion; more brand discipline and better messaging is strengthening our positioning; more digitally-oriented distribution activity is creating lower cost points of sale; and a multi-device technology approach allows us to handle the shifting tastes of consumers over time.

With good execution on the US consumer turnaround effort, we're seeing some stabilization. And with stronger performance coming through from international, fueled by the launch of ReFLEX, we should see the business return to stronger growth in the coming quarters.

Now Steve will review our financials in detail.

Steve Swad, Chief Financial Officer: Thanks, Tom, and welcome everyone.

Overall, I'm pleased with our financial performance in Q2. Bookings from institutional and international were better than we guided, and much of that over-delivery dropped to the bottom line. Further, US consumer came in at the high end of our guidance; so, while we still have a ways to go to deliver strong numbers on a consistent basis, we're making good progress.

Looking at slide 9, you can see that bookings were up 4% to $66.7 million, just above the top-end of our guidance.

Profitability was up over last quarter as our US consumer business showed signs of stability and our Institutional business saw strength in the education sector. But we were down compared to prior year because of softer US sales, and our investments in ReFLEX, international marketing and our sales force for worldwide institutional markets.

On slide 10, you can see the strong top-line results from our international consumer business. Bookings were $12.9 million, up 58% over last year. The growth continues to come primarily from Asia where bookings from Korea remained strong and bookings from Japan recovered from the disasters of March.

From a contribution perspective, the international consumer business delivered slightly negative net contribution in the quarter, as positive net contribution margin in Asia was offset by negative contribution in Europe. As you may recall, net contribution is one of our profitability measures. It represents bookings less direct cost of goods sold and direct sales and marketing costs. In Europe, net contribution was negatively affected by lower yields on our marketing investments, particularly early in the quarter, and some extra marketing spend around the launch of TOTALe in the UK.

As we look forward, we expect the international business to grow and contribution to expand as we begin to gain some leverage in our business model. This will happen first in Korea as we deliver two products over our existing sales channels, coaching platform and support infrastructure. After Korea, we're planning for similar expansion in Japan.

Moving to institutional, you can see on slide 11 that bookings were $17.0 million, down 1% from a year ago. The decline was driven by weakness in the government sector, where we experienced the impact of budget pressures at the national level. During our last call, I mentioned that we had two contracts that totaled a little less than $2 million that were signed in Q2 last year that we thought would be renewed in Q3 this year. One of those contracts was with the US Marines. Since then, we've received notice that the Marines contract, which was just over $1 million annually, and our US

Army contract, which was about $5 million, will not be renewed due to budget restrictions. This is a serious disappointment, and we're working to claw back some of that business by demonstrating our value with high usage rates and high satisfaction scores from armed forces personnel and by specifically targeting smaller deals with certain portions of those agencies. It's too early to determine whether we'll succeed in reversing some of this loss, but our team is making a solid case.

On the positive side, we saw growth from increases in average deal size and successful up-selling of TOTALe in the education and corporate sectors. In addition, I'm encouraged that our entry into higher education markets is achieving results, including signing the largest university deal in our history. Overall, we're continuing to target and win larger deals. Further, we've already signed a couple of institutional contracts in Brazil, through an office we just opened in May.

since the institutional opportunity is considerable and bookings from this segment contribute to our growing subscription business, we plan to continue to focus investments into our sales and marketing efforts.

Slide 12 shows results for the US consumer market. Bookings were $36.8 million, down 5% from last year, in line with our expectations. The decline is attributable to lower kiosk sales. In fact, excluding the impact of kiosks, US consumer bookings were flat year over year, which is a good sign.

We believe our new pricing contributed to the stabilization of our US consumer performance. In addition, we moved to shorter, more frequent TV spots, which also seemed to elevate sales. We've instituted new pricing, with Level One at $179, a three-level set at $399, and a five-level set at $499. This compares to pricing ranging from $249 to $749 last year, with frequent discounts of 10-20% driving the bulk of sales.

Let me walk through some highlights of our distribution channels in the US, starting with kiosk, the smallest channel. We've continued to reduce our domestic kiosk count, closing less-profitable locations and those with less desirable brand impact. In Q2, we reduced our kiosk count in the U.S. by a net 27, and bookings declined sharply as we sold, on average, more units per location over fewer locations.

Our retail channel returned to a more stable level during the quarter. Bookings in the US were down, primarily because one of our large retailers let inventory tighten. On a sell-through basis, which removes the impact of changes in inventory levels, we estimate that bookings would have been up single digits. Again, a sign of stabilization.

Last and largest, our DTC channel is benefiting the most from the price testing and the changes we've made in our media approach. This channel achieved bookings growth in Q2, mostly from strong traffic and improved conversion on the web. This suggests that our two largest channels in the US are more stable now than they were a few quarters ago.

Now let's move to the cost side for our total business. Gross margins of 83% were in line with our expectations.

Sales and marketing expense increased 38% to $40.5 million from a year ago. As in the last two quarters, most of the increase was related to spending to generate growth in international bookings. This quarter, our yields from that spend were down compared to last year, particularly in Europe. In the US, we increased spend a few million dollars to support our brand with emotional advertising targeting highly-educated, high-income consumers. Excluding this initiative, direct sales and marketing expenses in US consumer were flat.

R&D spending increased 4%, to $6.4 million, as we released the iPad app and ReFLEX for the Korean market. General and administrative costs were $13.8 million, down from Q1 but up 11% from a year ago. The bulk of the increase was to support our international expansion and strengthen our executive team. During Q2, we executed on our program to control spending, and we'll continue to manage costs. We'll direct investment dollars toward initiatives to drive shareholder value, and will continue our efforts to improve our leverage in Asia.

Net-net, the Operating EBITDA reduction was driven primarily by the mix shift to international consumers, where we currently have lower margins than in our US consumer and worldwide institutional markets. With time, we expect those margins to expand as the brand strengthens, marketing yields improve and new product launches leverage our infrastructure and G&A.

Moving to the GAAP numbers, slide 13 lays out revenue and net income. As with bookings and operating EBITDA, the top line was up – a bit more than our guidance anticipated – and the bottom line was better than expected.

You can see on slide 14 that we ended Q2 with $45.7 million of deferred revenue on the balance sheet. About 40% of that relates to consumer and 60% to institutional. 94% of this deferred revenue is current, which means we expect to recognize it as revenue over the next 12 months, and more than 60% of it will be earned in the next six months.

Slide 15 highlights a summary balance sheet. You can see that our ending cash and short term investments is $115.1 million, or about $5.50 per share. That's down by a total of $5.6 million, principally due to lower operating results.

Our balance sheet remains strong, and our team remains committed to keeping it strong. This is an important element of our value proposition for investors.

Our guidance for Q3 is on slide 16. We're anticipating bookings of $70 to $75 million, driven by strong bookings growth from international consumers of 40-60%, driven by growth in all countries, but especially Korea with the launch of TOTALe and ReFLEX. For worldwide institutions, we expect our bookings to be flat to down 10%, as the Army contract will not renew. Excluding the impact of Army, our guidance would be up 12-22%, which gives you an idea of the kind of growth we anticipate in the education and corporate sectors. For US consumers, we anticipate bookings declines of 12-17% as growth in DTC is offset by continued weakness in kiosks and lower retail sales.

For the third quarter, we expect revenue of $65 to $70 million. With lower bookings from worldwide institutions, a strong-margin market, and continued investment in our international expansion, including increased marketing spend as we launch ReFLEX, we expect net loss in a range of negative $4 to negative $1 million, or negative 24 to negative five cents per share. We expect Operating EBITDA to be $2 to $7 million, and free cash flow to be positive for the quarter.

On the last call I indicated that we were beginning discussions with our retail partners about ways to improve cash flow, reduce credit exposure and increase inventory control, and that there might be a P&L impact. At this point, our discussions are going well, and I am not expecting any meaningful impact – but the discussions are not final.

Our guidance for the full year 2011 is on slide 17. For the year, we continue to expect bookings to be up in 2011 compared to 2010. In particular, we anticipate a decline from US consumers to be more than offset by 40-50% increases in bookings from international consumers and worldwide institutional customers, combined. We anticipate that growth in South Korea will accelerate in the last half of the year as ReFLEX and TOTALe take hold.

We also expect revenue to be up in 2011.

Since we're experiencing softness in the US consumer market, we are anticipating lower operating income and Operating EBITDA compared to 2010, with Operating EBITDA positive for the year.

Our cost-management initiatives bore results in Q2, and we remain committed to spending only where we see clearly defined opportunities to drive our growth. I believe G&A will range between Q1 levels of $14.8 million and Q2 levels of $13.8 million for the remaining quarters of the year. Audit and legal costs are expected to drive most of the variability between quarters.

We also expect free cash flow to be positive for the year.

Let me summarize our current position from a CFO perspective before we go back to Tom. I see one negative and four positives in our current position. The negative: we face a serious headwind in the government segment of our institutional markets, and the loss of the Army contract. However, education and corporate are performing well, and we're hopeful we can retain relationships with some of our clients within the Army umbrella.

The positives: first, our efforts with US consumer are showing results, and I believe we can build on the progress we've made. Second, our opportunities internationally, both with consumers and with institutions, are genuinely exciting. Third, I'm looking forward to adding cash to our balance sheet in the second half of the year, and further improving our strong financial position. Fourth: the launch of ReFLEX and TOTALe is very encouraging.

With that, Tom's going to wrap up now, before we take your questions.

Tom Adams, Chief Executive Officer: Like Steve, I am very pleased with our financial performance in Q3, as we moved toward stabilization in US consumer, achieved good results in education sales and strong growth in international consumer. At the same time, we are continuing to make progress in terms of innovation with the launch of our iPad app, which looks great on the tablet, and the launching of ReFLEX. With TOTALe, we offer the most effective technology-based solution in the marketplace for beginning learners worldwide, and with ReFLEX, we now have a breakthrough solution for making millions of Asians conversational in English.

The growth I am addressing represents a huge opportunity, not just related to teaching Spanish to Americans. It is increasingly shaped by our ability to teach English to the rest of the world. I am off to Korea next week and am very excited about all of the activity there and its implications for what we will be doing in Japan and China in the coming quarters. We are only just beginning to penetrate some very large markets even as we consolidate our position as the leader in our home base here in the US.

I'll stop there, and we'll assemble the queue for your questions.