THIRD QUARTER 2011 INVESTOR WEBCAST

3 November 2011

Prepared Remarks

Steve Somers, Investor Relations: Good afternoon and let me welcome you to Rosetta Stone's third quarter 2011 earnings call. I am Steve Somers and I am joined today by Tom Adams, Rosetta Stone's CEO and Steve Swad, our CFO to discuss the operations and financial results for the third quarter and the outlook for the rest of this year. Before getting further into the call, please let me take a minute to introduce myself. I recently joined Rosetta Stone as Vice President of Investor Relations from GSI Commerce, where I headed up investor relations and corporate development for the past couple of years. I've led IR at companies in the telecom and internet spaces since 2003 and previously worked on both the buy-side and sell-side, the latter at DLJ. Elizabeth Corse has ably handled the IR function at Rosetta Stone for the past year and will help transition the role to me before moving on to her next engagement. I am personally very excited about having joined the company and am very much looking forward to meeting and working with you over the coming weeks and months.

With that let me make you aware that our press, supplemental financial information and a slide deck supporting this webcast are available on our IR website at 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. After producing two quarters of financial results that were in line with our expectations, 3Q results were disappointing, coming in below our expectations for revenues and operating EBITDA, primarily as a result of challenges in Asia and the institutional segment. Much of this softness will likely continue into 4Q, so we expect to achieve lower financial results and performance for 2011 than we had previously forecasted. Despite the challenges in the quarter, there were positive developments within the US Consumer segment as it continues to stabilize, generating results that were in line with guidance. Direct-to-consumer sales grew year-over-year, as we experienced increased visits to our website and significant growth within our new Hispanic target market. Even though retail sell-through was stable in the quarter, average order values and inventory levels declined, reducing our overall bookings. While U.S. Consumer was in line, the international and institutional businesses turned in softer performances, leading to the overall weaker company results. Historically, our international and institutional markets have experienced strong growth and we continue to believe that these growth prospects are significant. In particular, we believe that many of the current challenges are related to factors that we will address over the coming quarters.

The weakness in our International business in the quarter was primarily due to softer than expected sales in Asia. Our simultaneous launches of TOTALe and ReFLEX into the Korean market got off to slow starts with both offerings selling significantly less than expected. To recover momentum in our Korean business, we decided to first focus on bringing TOTALe back to similar levels of sales that we had enjoyed with Version 3. We did, in fact, drive up sales of TOTALe as the quarter progressed – and TOTALe is now demonstrating good growth momentum. However, this concentrated focus on TOTALe meant that we did not do as much for ReFLEX. We have now turned our attention to increasing ReFLEX adoption, while preparing this innovative new product for eventual launch in other Asian markets. This product has a different target market in Korea than TOTALe and we will be adjusting our pricing, messaging and channel mix for this product in Korea, which may take further time to test and refine. Therefore, it is still premature to predict short term sales for ReFLEX, even though we continue to believe that it will be a very successful new product line for us long term. Supporting our view of its ultimate success is that ReFLEX's usage rates remain consistently high and we are seeing learner conversational proficiency improvements.

Separately and for altogether different reasons, Japan also saw softness as certain tactical price changes we made in the quarter did not yield the expected results and retail sales were softer than expected. We're making adjustments to this important business and expect to recover our momentum in Japan over the coming quarters, but don't foresee an immediate reversal in the fourth quarter. Since both Japan and Korea are markets that each have two times the aggregate language learning spend of the US, as well as being businesses that have 3-year CAGR of 75%-plus for us, we are highly focused on returning these markets to stronger growth.

Beyond Asia, results from our institutional business were weaker as softness in US government sales continued and larger sales orders that we anticipated to occur in the third quarter in the education and corporate areas were pushed back to later quarters. In addition, we entered the fourth quarter with a smaller pipeline than usual. However, we are pleased to have brought on a strong new leader, Judy Verses, for our institutional markets and expect that we will soon return this business to robust growth rates.

Clearly, our operating and financial performance in the quarter was not acceptable and not where it needs to be. We have been and continue to focus on near-term actions that will stabilize and address our current tactical issues. These include re-working messaging, making organizational changes and tweaking our value proposition.

Even as we are acting in the short-term to address current deficiencies, we are exploring a shift in our business model to one that will position the company for long-term success and a return to revenue and profit growth. As today's consumers alter their consumption patterns towards digital channels, we are focusing on the development of delivery models that will allow customers to access our products on-demand, across multiple devices and in ways that are more affordable to more people. As such, we are analyzing the most effective way to move our business towards these digital distribution and consumption trends and will get back to you with our longer term strategy after we test and validate our plans.

Before Steve goes into further detail on the quarter's results, I want to address our announcement last month that I will be transitioning to the role of non-executive chairman of the board at Rosetta Stone. I made this decision after several months of careful thought, when our current chairman, Laurence Franklin, indicated a need to reduce his time commitment to Rosetta Stone given his relocation to Europe and the full-time responsibilities of a CEO in his new role. I have enjoyed every moment of my nine years as CEO here and am looking forward to ensuring a smooth transition to my successor and continuing my involvement on the board.

In the meantime, I continue to be very engaged in the company and have the benefit and support of a great management team. Together, we are making progress on our strategy. We're already far along in innovating and deploying powerful new technologies such as speech recognition and integrating live native speakers into the language learning experience for now while continuing to bolster our premium position in the marketplace.

So now, we're driving improvements in convenience, shifting to more digital distribution, and reengineering our cost structure. We are driving growth through our expansion of our English language training solutions in our International and Institutional sales and marketing activity. I remain confident that these efforts will yield great results over time.

Now Steve will review our financials in detail.

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

I'll open by saying I too am disappointed in our financial performance for the quarter. Bookings from international consumers and worldwide institutional customers were below our expectations, which resulted in the top-line missing our guidance. Operating EBITDA was also lower than we expected as a result of the bookings miss.

The net loss was better than we expected as our tax benefit was higher than expected.

Let's now dig in to what drove these results beginning on slide 6, where you can see the international consumer business grew just 20%, when we expected 40 to 60 percent growth. Most of the softness was in Japan, where tactical pricing changes proved ineffective, website conversion was down and retail sales were lower than expected.

Growth in Korea was solid, but still well below our expectations. As Tom mentioned, consumer uptake for our new offering, ReFLEX was less than expected. It's a unique product designed to improve a learner's speech "reflex" and we still need to refine our pricing and messaging in the TV shopping channel and drive deeper penetration of our on-line distribution channels. In Europe, bookings grew nicely, with strong growth continuing in Germany.

From a contribution perspective, the slowdown in Japan and Korea drove negative net contribution for our international consumer market for the quarter. As a reminder, net contribution is one of our internal profitability measures that represents bookings less direct cost of goods sold and direct sales and marketing costs.

Our top priority in international consumer is to fix the sales issues in Japan and continue fine-tuning our go-to-market approach for ReFLEX in Korea.

Worldwide institutional had a challenging quarter. As we noted on last quarter's call, the US Army decided not to renew its Rosetta Stone contract in response to sharp budget cuts. That $5 million contract had a significant negative impact on the results, as you see on slide 7, with bookings down 17% to $18.6 million. Excluding the impact of the Army deal, bookings would have grown 6%. Our sales team did a great job growing average deal size and upselling TOTALe, which is gaining traction in the institutional marketplace.

The US consumer business performed largely as anticipated. We saw continued improvement in our web sales as both visits and conversion rates increased. We attribute this improvement to our new pricing, positive results from our five-pay installment program and effective email marketing.

Our retail channel always shows a difference between sell-in – sales to our store partners – and sell-through, which is sales by those stores to learners. In this quarter, unit sell-through increased, but sell-in, which is the dollars we record on our P&L, declined as average order value declined and stores reduced inventories.

We continue to scale back on kiosks, shutting down a net three locations during the quarter, for a net 66 total closures in the last year, as sales through that channel have declined.

Now let's move to the cost side of our business, where consolidated gross margin of 82% was in line with our expectations.

Sales and marketing expense increased 17% to $39.8 million from a year ago, driven mostly by increased marketing investments internationally and increases in worldwide institutional. Spending to reach US consumers was down meaningfully this quarter compared to last year. Sales and marketing yields in the US consumer, institutional and international consumer markets were down this quarter. In the US, lower kiosk performance and retail performance is negatively affecting our bookings returns on sales and marketing spend.

Internationally, Asia brought down returns on spend and institutional returns on sales and marketing spend were lower because of the loss of the Army deal and investments in the sales force and marketing programs. We're working to reduce or reverse this in future quarters as we work to improve the recent trends in Asia and drive higher yields in all our markets.

R&D spending decreased by $1.0 million versus a year ago to $5.0 million, which was lower than the more typical $6 million that we expect to spend in a quarter. General and administrative costs were $14.1 million, up 17% from a year ago, reflecting the investment in infrastructure we are building globally and increases in defense costs for pending litigation matters. Both R&D and G&A costs benefited from a reduction of our bonus accrual during the quarter.

Operating EBITDA was marginally negative as lower bookings resulted in the company not achieving the level we anticipated. As our customer mix increasingly shifts more toward international consumers, pressure on Operating EBITDA will remain a factor in our results since we currently have lower margins in our international consumer market than in our US consumer and worldwide institutional markets. We're working to improve our margins, but we also believe we need to invest outside the U.S. to establish ourselves in these geographies. Our goal is to strengthen the brand, improve marketing yields, and launch new products that leverage our existing infrastructure to expand margins and drive bottom-line results.

Moving to the GAAP numbers, slide 9 shows revenue and net income. Revenue was up 5% – a bit less than our guidance – while the bottom line reflected spending improvements in line with our expectations. We also recorded a larger tax benefit than we expected as we trued up our tax rate for the full year based on updated estimates of where our income will be generated and a research-and-development credit. We estimate our effective tax rate for this year to be in the 35-40% range.

You can see on slide 10 that we ended 3Q with $47.6 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, with more than 60% of this amount to be earned in the next six months.

Slide 11 shows balance-sheet highlights. Our ending cash and short term investments was $111.3 million, or about $5.35 per share. We anticipated adding cash in 3Q, but the lower-than-expected operating results and an increasing portion of our business coming from installment sales meant that we consumed about $4 million of free cash flow in the quarter.

Our guidance for Q4 is on slide 12. As it is each year, especially in the US, the fourth quarter is an important one, when Rosetta Stone is a popular gift during the December holidays. We are guiding bookings and revenue to a range of $65 to $73 and $64 to $70 million, respectively.

We expect bookings to be driven by continued stabilization in the US DTC channel, with further decreases in the retail and kiosk channels. In retail, you may recall that we shipped more than we sold last year, so we have a tough comparable. With kiosk, we expect the bookings declines we have seen all year to continue. After the holiday season, we'll continue to optimize that channel.

In international consumer, we are expecting softness to continue as we think it will take time for our actions to take hold.

For institutional we're forecasting a modest decline as headwinds continue in government and our pipeline of qualified leads in the corporate area is not as strong as we would like.

We'll continue to manage our G&A costs and US sales & marketing, while investing in international opportunities. We expect this will drive net income to be in the range of ($9) to ($5) million, or ($0.43) to ($0.25) per share. Operating EBITDA is forecast to be in the range of ($10) to ($2) million.

The compensation committee of the board is evaluating the effectiveness of our equity compensation plans including our long-term incentive plan. The Committee may consider taking actions regarding these plans that could result in a non-cash charge of up to $5 million. This guidance does not include any charge relating to these potential actions.

Our guidance for the full year 2011 is on slide 13. For the year, given the difficult operating results in 3Q, we believe bookings will be down year-over-year. In addition, the increase we expected to see in institutional and international sales has moderated considerably. Given these factors, we now anticipate that bookings growth from those two segments will be lower than the 40-60% we had anticipated at the beginning of the year.

We also now expect revenue to decline in 2011.

We continue to anticipate lower operating income and lower Operating EBITDA compared to 2010, but now expect that Operating EBITDA will be negative for the year.

Free cash flow for the nine months ended September 30 was negative $11.9 million. Given that, we now expect free cash flow to be negative for the full year.

It is disappointing to report these results to you. However, I am encouraged by the strengthening in the DTC channel and in our European markets. Further, a year into my role here, I'm continually impressed by the commitment and creativity of the team at Rosetta Stone. We are very aware of the areas of our business that require extra effort going forward, and we're working hard to improve our growth rates in Asia, drive growth in Institutional and achieve better yields on our marketing spend. I look forward to reporting more progress to you in the coming quarters.

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

Tom Adams, Chief Executive Officer: Rosetta Stone has some great attributes: our solutions are effective and highly regarded by industry experts and end-users. Our brand is very strong here in the US, and strengthening in key markets around the world. Our team is the best in the industry and we are building bench strength.

Challenges are a constant in any business. What matters is how we react. In this regard, I'm confident that we have the resources we need to meet those challenges, especially in transitioning Rosetta Stone to a new business model that takes full advantage of evolving technologies and user preferences. We see the shift in user taste as complementary to our long-term vision. Our team is committed to taking the actions necessary to correct course.

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