Fourth Quarter 2011 Investor Webcast

February 29, 2012

Prepared Remarks

Steve Somers, Investor Relations: Good afternoon and let me welcome you to Rosetta Stone's fourth quarter 2011 earnings call. I am Steve Somers, Vice President of Investor Relations and I am joined today by Tom Adams, Rosetta Stone's Chairman and Steve Swad, our new President and CEO to discuss the operations and financial results for the fourth quarter and our outlook.

In addition to our commentary, we have made our 4Q11 Earnings Results press release, supplemental financial information and a slide deck supporting this webcast available on our IR website at investors.rosettastone.com. Please review them to find important additional information.

[Safe Harbor]

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. A detailed discussion of such risks and uncertainties is contained 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. Please note these forward-looking statements reflect our opinions only as of the date of this presentation and we undertake no obligation to provide or publicly release the results of any revision to the forward-looking statements in light of new information or future events.

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, Chairman:

Thank you Steve, and good afternoon to everyone. Thanks for joining today's call.

I am very pleased to announce that Rosetta Stone finished out 2011 on a positive note. Fourth quarter revenues came in at $80.5 million, a record for the company, while operating EBITDA was $10.7 million, ahead of our guidance. There was particular strength in our US Consumer business, as our web channel expanded and we continued to shift to an increasingly online and digital distribution and offering model.

As you are aware, late last week, our Board of Directors named Steve Swad as CEO while I moved into the Chairman role so this is my last earnings call with you. Steve is a first rate executive that has worked closely with me, the Board and the senior management team over the past 15 months. He is keenly aware of our opportunities and challenges and will be able to hit the ground running, as he drives towards furthering the company's success. I believe the company has a bright future in the years ahead under Steve's leadership. I know that he is thrilled by the opportunity.

It has been an incredible honor to lead Rosetta Stone over the past 9 years. We've gone through some tremendous changes even as our company's mission has remained powerful and constant. I believe that there continues to be a massive opportunity for growth as the company continues to build on its brand and innovation leadership platform.

Our fundamentals are sound and we remain the leader of technology-based language learning solutions. We continue to innovate and adapt to consumer preferences, moving more online and multi-device, and offering live and social elements to our solutions. We've expanded internationally, and now record almost 20% of our revenues from abroad. As such, I believe that we're well positioned to take advantage of our brand equity, international presence, institutional footprint and our strengthening US consumer business.

Before giving Steve the floor, I would be remiss if I did not say that I will very much miss being a part of Rosetta Stone on a daily basis. The company is full of dedicated and passionate employees and has developed a large and engaged customer base that has spread the word about Rosetta Stone. So to all of you, thank you for allowing me to be an integral part of the Rosetta Stone story and I believe that the best is yet to come and we are only at the beginning.

And with that let me turn the call over to Steve.

Steve Swad, Chief Executive Officer:

[Introduction & Overview]

Thanks Tom and welcome everyone. I am pleased to be addressing you today in my new role. Before I get into the discussion of the quarter's results, let me start by recognizing Tom for his tremendous efforts and leadership as CEO for Rosetta Stone over the past nine years. Tom took a very small company, with a unique product, and grew it from $10 million in revenues to almost $270 million. He was responsible for introducing the Rosetta Stone brand and building it into a household name. He led the introduction of new products and services and expanded the company into international markets in Europe, Asia and South America and took the company public in 2009. His engaging spirit has created a passionate and dedicated culture at Rosetta Stone and he has clearly left his mark. I want to thank Tom and I look forward to working with him and the Board as we move to the next phase for Rosetta Stone.

As I look ahead, the main pillars and themes for the company will stay largely in place as the external forces and trends haven't changed. Our strategic focus will continue to be on:

- new innovation to bring language learning to more people easily and conveniently across more platforms
- international growth, especially in Asia and South America, and
- expanding our position in institutional markets;
- Underlying all these themes is a continued focus on English.

We expect to largely carry out our strategy through internal efforts, but also be more open to leveraging our brand through partnerships, alliances and select acquisitions to grow and enhance our product portfolio and market presence.

Rosetta Stone has great assets including leading technology, infrastructure and international presence that I believe we can leverage. Even as we build upon these assets we will pursue a more balanced approach to growth with emphasis on margins and profitability as well as top line growth. We will become more disciplined in the execution of our plans and deliver upon them in a way that drives shareholder value.

As I assume my new role, we will be conducting a fresh assessment of the company's critical areas over the next few weeks and I expect to share my vision and strategy for the company in approximately 75-90 days.

That being said, the primary areas that I will be focusing the company on are:

1. further stabilizing the US Consumer market,
2. regaining positive momentum in Asia
3. taking steps to improve margins across all of our businesses, both in the US and internationally, and
4. Examining and evaluating ways to help grow our institutional business.

While it will take some time to carry out this assessment, there are some opportunities for short-term actions to improve performance that I will be looking to effect quickly, like eliminating marketing investments that have low expected yields and better leveraging our worldwide G&A infrastructure.

[Fourth Quarter Overview]

Now let's move on to fourth quarter results.

From a high level, the performance in the fourth quarter was an encouraging one for Rosetta Stone. We saw continued signs of stabilization and progress in our US Consumer business, helped in part by lower price points and more effective marketing. We experienced good momentum within our web channel and more effectively managed our kiosk and retail channels. Our Institutional business made nice strides by signing several new contracts to close out the year slightly ahead of our earlier expectations. In our International Consumer business, we produced good results in Europe, but weakness in Asia continued. Although we registered some improvements, soft results from both Japan and Korea reflect the challenges in both markets as we continue to adjust our marketing and pricing to re-invigorate growth for TOTALe while we continue to broadly adjust our ReFLEX approach for Korea. As we commented during the third quarter call, our issues in Asia do not have quick fixes and that remains the case today.

From a financial perspective, the strong results we experienced in our US Consumer business helped grow fourth quarter revenues 8% versus last year to $80.5 million, which were the highest in the company's history. The better than expected fourth quarter enabled Rosetta Stone to bounce back from a soft third quarter and produce full year revenues of $268.4MM, which was up almost 4% from 2010. On a bookings basis, the fourth quarter saw an increase of 4% while full year bookings were down 2%.

This better-than-expected performance allowed us to exceed our guidance metrics across the board with Operating EBITDA coming in at $10.7MM for the quarter.

What was most encouraging about this quarter was that our US Consumer business, which began to show signs of stabilization and modest growth in 3Q, continued its improvement with bookings up 5% year over year. Direct-to-consumer sales grew a strong double-digit in the quarter, led by strong website visits and conversion, driven largely by successful email campaigns around the holiday season.

As we mentioned on the last call, we expected our kiosk channel to see further declines as we have been paring down the number of kiosks we operate, particularly in the US. We continued to shrink our kiosk count in the fourth quarter, closing an additional 23 locations, which reduced kiosk revenues, but increased revenue per location by 24%. In the first quarter of 2012, we have reduced another 46 and expect to trim that number more as we move through 2012.

Our retail channel performed well in the quarter with sell-through units to consumers up almost 30%. Results were driven by lower, more effective price points, expanded distribution into Canada during fourth quarter, and the addition of new partners such as Best Buy that helped offset the loss of Borders.

Consumer units for the quarter were very strong, up 28% year-over-year, while average net revenue per unit was down 20% to $313. While we saw a benefit in mix shift to more S5s, discounting and lower price points for all our products caused a decline in the average order value from last year and last quarter.

Despite the strong results from the US, which drove overall global consumer revenues higher, international consumer results continued the softness that we experienced in the third quarter and were down 15% year-over-year. On the positive side, both Germany and the UK posted record results with solid unit growth and very strong holiday season promotional campaigns. However, the strength in Europe was offset by a continuation of issues in Asia that we identified last quarter. While we saw some improvement in Japan, results were down versus last year and we continue to work on adjusting our messaging and pricing to re-invigorate growth in that market as the new creative and lower pricing did not generate the expected lift. In Korea, softness in the home shopping channel for TOTALe and the slow start to the launch of our conversational English product, ReFLEX, continued throughout the fourth quarter, where unit growth has come in well-below initial expectations. Although usage and learner feedback for specific segments are very good, we believe we will need to continue to make further product enhancements and adjust messaging, pricing and distribution in the coming quarters to better reach our target market. If you recall, in Korea, we historically sold the vast majority of our core product through the home shopping channel. For the launch of ReFLEX, we also utilized this channel, but quickly discovered that it was not well-suited for ReFLEX's younger, professional target market. We expect most ReFLEX buyers to purchase online and building our online brand presence in that channel will take some time. As we noted during the third quarter call, our challenges in Japan and Korea do not have quick fixes and that remains the case today.

Similar to our US Consumer business, our Institutional business also closed out the year on a positive note, signing several contracts to exceed our expectations for the quarter with bookings and revenues up year over year. Our increased focus on larger deal size continued in the quarter with an almost 75% increase in average deal size. While the Institutional business is subject to budget cuts in Government and Educational channels, we have been laying the groundwork for improvements in the Corporate and Education channels over the coming quarters. For 2012, we are shifting our Institutional messaging to give it a more distinct selling identity within the general

Rosetta Stone brand and are focusing on signing more multi-year deals. We expect that these efforts will pay off over the longer-term with a larger and more predictable revenue stream.

Overall we were encouraged by fourth quarter results for the company. However, some of these positive developments, particularly in the US, do not change our view that the future of the company remains largely online. As such, we are repositioning ourselves to draw down resources in kiosk while redirecting them to our growth channels.

At the same time, we continue to look at how we can move online and become easier and more convenient for the customer. To that end, we continue to test different approaches to determine how to best deliver our products to customers. The objective of this shift to online is to adapt to the customer preferences towards digital and reframe our value proposition. In doing so, we expect to be more dynamic and innovative and be able to reach new customer segments. In fact, last week, we moved completely to online product offerings in Germany and have pulled all of our CD-ROM based products. This will allow us to look at what happens across all channels from a holistic perspective utilizing a simple, unified offering of 25 Euro per month for a 12 month commitment. It is too early to comment on preliminary results at this time and we will keep you posted on this comprehensive country-wide test.

Now let me turn the call back over to Steve Somers, who will review our financials in detail.

Steve Somers, VP IR:

[Review of results vs. guidance]

Thanks, Steve. The strong operating performance that we achieved in the fourth quarter translated into outperformance versus our guidance for all operating and financial metrics. Bookings and net revenues exceeded the high end of our range on the top line, while Operating EBITDA came in at $10.7MM compared with guidance of negative $10MM to $2MM. Results for the quarter include a $4.9MM non-cash charge for the cancellation of our Long Term Incentive Plan or LTIP, which we noted as a possibility during our third quarter call. This charge is already excluded from Operating EBITDA but included in our GAAP EPS number. On a comparable basis, loss per share was $0.09 compared with guidance for a loss of $0.43 to $0.25. Free cash flow, which we define as net cash provided by operating activities less capital expenditures, was a positive $5.4MM compared with our guidance for negative free cash flow.

[Bookings Review]

Moving to what drove our results for the quarter; total worldwide bookings were $84.8MM, an increase of $3.0MM or 3.7% compared with a year ago, while bookings for the full year were $273.2MM, a decrease of $6.7MM or 2.4% compared with 2010.

For the quarter, US Consumer bookings were much stronger than expected, increasing almost 5% and representing the first quarter since 1Q10 that US Consumer reported a year-over-year increase. As a point of clarification, the U.S. consumer business includes results from Canada now that we began selling into our northern neighbor in the fourth quarter and whose sales contributed about $400,000 to the quarter, adding almost a point of growth. International consumer bookings decreased 3.9% due to weakness in Japan and Korea, while global consumer bookings in the quarter increased 2.9%.

For the full year, Worldwide Consumer bookings decreased 2.6% to $211.4MM, reflecting a 9.7% decline in US consumer and a 26% increase in international consumer. However, these year-over-year changes are more indicative of performance for the early part of 2011 as the trends for the two geographical segments have reversed in the later part of the year with the US showing strength and international weakening.

[Consumer Channel Review]

From a consumer channel perspective, global DTC revenue increased 23% for the quarter, raising the full year growth rate to 15% for the channel as web sales were particularly strong. Even as we have reduced kiosks by 85 locations, or one-third, from a year ago to 174, global kiosk sales were off only 11% reflecting the improving yields of the remaining kiosks. As Steve mentioned, we continue to reduce our kiosk numbers so you should expect further revenue declines from this channel on an absolute dollar basis even as yields are improving.

Global retail sales decreased 5% in the fourth quarter, largely due to lower sell-in to retail partners as they built inventories of TOTALe in the fourth quarter of 2010.

However, sell-through units to consumers were up almost 30% for the quarter, reflecting a healthy channel for Rosetta Stone as retail still remains a key part of our distribution strategy.

[Institutional Review]

Global institutional bookings increased 7% in the quarter to $15.5MM from $14.4MM a year ago. The $1.1MM increase reflects a small decrease in US bookings offset by an improvement in international. Within the US, the modest improvements we experienced in the Corporate channel were offset by lower sales in the Education and Government channels. Full year bookings were $61.8MM, down $1.1MM or 2% versus 2010. US Corporate and Education actually registered double-digit bookings growth for the year, but was offset by the non-renewal of the Army & Marines contract for budgetary reasons in the third quarter within our Government business. International Institutional bookings increased at a high rate, albeit off a relatively low base, but showed nice expansion, including incremental sales from our recently opened Brazilian office.

[GAAP Revenue]

From a GAAP revenue perspective, total revenue increased 8% for the quarter to a record $80.5MM. Product revenues decreased 1% to $60.8MM with subscription and service revenue growing to $19.7MM compared with $12.7MM in the fourth quarter of 2010. For the full year, total revenue increased 4% to $268.4MM from $258.9MM. Bookings exceeded revenues for both the quarter and the year by over $4MM and reflects recognizing the online service portion of our product over time.

[Expense and Margin Review]

Gross margins for the quarter and year were 82%, only slightly lower than the 83% generated a year ago in the fourth quarter, but down from 85% for all of 2010. Gross margins for the year were impacted by the introduction of online coaching and support with TOTALe v4 that added incremental expenses to our cost of goods.

Sales and marketing expenses increased 11% to $43.3MM in the quarter, reflecting higher spending in both the consumer and institutional segments compared with last year. Consumer media spending increased in all geographies compared with a year ago and was a key reason for the outperformance of revenues in the quarter. As a percentage of revenues, sales and marketing was 54% compared with 53% a year ago and, in part, reflects spending in our lower-yielding international markets. For the full year, sales and marketing expenses totaled $161.5MM compared with $130.9MM in 2010, an increase of 23%. The significant rise in sales and marketing is primarily attributable to spending in international markets as we launched TOTALe v4 in both Japan and Korea and introduced ReFLEX into Korea. Year on year yields on marketing spend are down, but over time we expect yields on spend in Asia to improve and raise profitability.

Research and development expenses of $6.4MM in the fourth quarter increased $0.6MM or 10% from a year ago with full year expenses increasing 3% to $24.2MM vs. $23.4MM, representing 8% of revenues, flat with last year. The 2011 R&D spend was heavily weighted towards development of our ReFLEX product for Asian learners of English.

G&A spend increased 33% to $19.3MM for the quarter and 18% to $62.0MM for the full year. The increases in G&A for both the quarter and full year mainly reflect the impact of the cancellation of the long-term incentive plan, the bulk of which hits G&A. Excluding the $3.3MM impact of the LTIP cancellation, G&A increased approximately 10%, due largely to the transition expenses associated with our former CEO. There were other LTIP cancellation costs of $0.7MM in Sales & Marketing and $0.9MM in R&D, for a total impact of $4.9MM in the quarter. Total operating expenses increased 16% to $69.1MM for the quarter but only 8% excluding the cost of the LTIP cancellation.

[Operating EBITDA Discussion]

For the quarter, Operating EBITDA, which is EBITDA plus add-backs for stock-based compensation and the change in deferred revenue, came in at $10.7MM. This was better than our guidance, but still about 20% below prior year as a smaller change in deferred revenue drove the decrease. Adjusted EBITDA, which excludes the impact of the change in deferred revenue, increased 10% to $6.4MM. Operating EBITDA margin for the quarter was 13%, down from 18% a year ago, as increased spending, primarily for international brand building and coaching & product support costs, depressed margins. On a full year basis, Operating EBITDA was negative $2.5MM compared with a positive $44.7MM a year ago. The dramatic change in operating profitability from 2010 to 2011 is the result of slight gross margin compression combined with significant increases in sales and marketing internationally, and further spending in G&A to build out our infrastructure to support international expansion plans. It also reflects the smaller positive change in deferred revenue compared with a year ago, when we experienced a one-time bump in deferred revenue from the launch of v4 of TOTALe.

[Balance Sheet and Cash Flow Review]

Our balance sheet at year end remains healthy with cash, cash equivalents and short-term investments having increased $5.0MM to $116.3MM from $111.3MM at the end of 3Q. Despite a challenging operating year for the company, our cash position only decreased $6.0MM from a year-ago as we carefully managed our working capital and continued to grow our deferred revenue balance. Compared with year end 2010, we actively managed down our inventory by $3.2MM or almost one-third to $6.7MM as we focused more on our best-selling language products, while working down inventory of less popular languages and reducing our days on hand to more efficient levels.

[Guidance]

As we've discussed on the last couple of calls, Rosetta Stone is currently undergoing several transitions in its business and Steve is only in his first week as CEO. Given that backdrop, we are not in a position to provide guidance for the full-year 2012 at this time.

In terms of the first quarter, we expect results to be similar to those of 1Q2011, reflecting the seasonally smallest quarter of the year. We also expect that Operating EBITDA is likely to come out in a range of negative $9 to 13 million on bookings of $57 to $61 million and net revenues of $58 to $61 million. Net income is expected to be negative $9 to $11 million with basic earnings per share of negative $0.43 to $0.51 based on a share count of 20.9 million.

We expect the US Consumer business will continue to show signs of stability, improvement in Institutional will continue in the first quarter, while softness in Japan and Korea will remain as we search for the right mix in the model and reset our businesses there.

Let me hand the call back to Steve briefly before taking questions.

Steve Swad, Chief Executive Officer:

[Closing Remarks]

Thank you, Steve. Considering that we are coming off of a decent fourth quarter performance, it is important to note that the first quarter is our seasonally softest. That being said, I want you to know that I am very aware that we need to do better than minus $9-$13 million of Operating EBITDA in a quarter and we have a lot of work to do. I also fully recognize that we must go well beyond making tweaks to our business and must take decisive actions to put us back on the path for growth. As I said in my earlier comments, we are going to better balance short term margins and profits with investments for longer term growth.

With that, operator we are ready to take questions.

After Q&A

In closing, I think that the opportunity that we have at Rosetta Stone is vast. We've got proven technology, leading products and unparalleled brand equity in our space. We are present in the most attractive international markets and have a strong franchise in the US. It is our job to capture that opportunity and I will talk to you soon about a plan that does just that. We look forward to talking with you next quarter.