FOURTH QUARTER 2014 EARNINGS CALL

March 11, 2015

Prepared Remarks

Frank Milano: Good afternoon and let me welcome you to Rosetta Stone's fourth quarter 2014 earnings conference call. I am Frank Milano, the investor relations contact for Rosetta Stone. I am joined today by Steve Swad, our President and Chief Executive Officer, and Tom Pierno, our Chief Financial Officer, who will discuss the operations and financial results for the Fourth quarter and our outlook for 2015. Also with us is Judy Verses, President of our Global Education & Enterprise segment. Judy will be available during the Q&A portion of the call. Steve will also provide some additional commentary about the business and the strategic agenda for the rest of the year. We will open the call to questions after our prepared remarks.

Our fourth quarter earnings release went out just after the market close and is available on our website at www.rosettastone.com.

I'll remind everyone that certain statements will be made today which are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Given the uncertainties of forward-looking statements, our actual results may differ materially from anything we say in these forward-looking statements. We can give no assurance as to their accuracy and we assume no obligation to update them. We also use non-GAAP numbers in our presentation. For further information on the definitions of those numbers, the GAAP comparisons, and their reconciliation to GAAP numbers, as well as risks and uncertainties, please read the company's SEC filings available on our website and today's release, including the paragraphs beginning with the words, “Caution on Forward-Looking Statements” and “Non-GAAP Performance Measures.”

Now here’s Steve.

Steve Swad, Chief Executive Officer:

Thanks, Frank and welcome everyone. Tom will be walking you through the details of the quarter and I am going to talk to you about the aggressive strategic actions we are taking to transform and reposition Rosetta Stone. Our focus going forward will be on serving the needs of serious Corporate and K-12 learners that are seeking clear and measurable outcomes, with an emphasis on those learners who need to speak and read English.

Under this strategy, we will be investing to enhance our suite of products to deliver tangible and measurable outcomes that will not only enormously benefit our customers but significantly benefit shareholders. The quality, predictability, and overall level of earnings will improve with these actions and shareholders will benefit from our business model shifting more to software as a service with increasing, high-margin renewable revenue and expanding operating margins.

We are in early innings and have made steady progress with the Education and Enterprise business. Only a few years ago we had bookings of just $60M and now we are guiding to more than double that amount. Similarly, our deferred revenue balance was about $30 million and now it is well over $120 million. And we have seen improvements in renewal rates and significant progress from Lexia. This strategy focuses the entire company on the serious learner and will create value for our shareholders.

Let me walk you through the specifics.

Over the last few months, the management team began working closely with one of the leading consulting firms in the education space to refine our strategy. During this process we had active oversight by our board of directors. To take this company to the next level, the core decision we have reached is to pursue our largest opportunities for value creation – by accelerating and prioritizing our focus on serious Corporate and K-12 learners. That focus will also carry-over to the Consumer side of the business, where we will prioritize more serious learners, rather than trying to address the entire Consumer marketplace. And for the first time, the product focus of our E&E segment will be fully aligned with the Consumer segment – worldwide.

This strategic decision – to refine and accelerate the next phase of our value creation strategy – is based on several items:

- First and foremost, there is a large and growing market for English literacy and English language learning in K-12 and global corporations. As part of our strategic review, we have estimates of these markets to be well in excess of $1.2 billion – and growing – with Literacy alone exceeding $400 million. These markets are benefitting from English being the world's language and the broad need to teach kids how to read. These markets are also expanding from a broader shift to personalization and digital online learning. In addition, both K-12 and corporate customers have demands that recur each and every year, making them more attractive with a higher and more predictable return on investment. This demand profile also fits well with our suite of products which deliver results – and our brand, which is known and respected around the world. So while the Rosetta Stone Brand was built in the Consumer segment, this strategy leverages that asset for high returns in the Global E&E segment.
- Q4 served to validate the tremendous opportunity in the Global E&E segment. Specifically, the traction we are seeing in Literacy highlights the untapped potential in this marketplace, and the high renewal rates demonstrate the fact that our product is serving the needs of our K-12 customers;
- Much like the progress we have seen with Lexia, we also are seeing expanded opportunities to deliver English language learning around the globe. We believe product investment and a focus on English language

learners will accelerate the growth in our E&E Language business, serving educators and corporates alike.

To position the organization for success we are doing four things:

- First, we are taking immediate action to reorganize our business around our E&E segment;
- Second, we will be focusing our product investments on building effective, personalized English learning experiences that deliver clear and measurable outcomes;
- Third, we are beginning to right-size the entire cost base of the Company, with the first steps being:
    - Optimization of our media spend and other marketing costs in Consumer sales and marketing;
    - Rationalizing our Consumer product investment to focus on areas of tight alignment with serious learning and E&E; and
    - Reducing G&A.
- Fourth, we are cutting back on the number of new business initiatives we take on – particularly in Consumer – to improve focus and enhance efficiency.

Let me provide color around each of these four items.

Effective today, we are increasing the responsibility of Judy Verses, President of our Global E&E segment, to include the functions necessary for success in E&E. Specifically:

- Nick Macey, our Chief Product Officer, will now report to Judy;
- Nick Gaehde, who runs Literacy, will report to Judy and will be increasing his responsibilities to include the language portion of our K-12 business. With this change, Nick will now lead our Literacy and Language business in the K-12 space; and,
- Rob Mercer, who runs E&E Language Sales for the Americas, will assume responsibility for the Global Enterprise portion of the business. With this

move, Rob adds Europe, the Middle East, and China to his existing sales responsibility here in the Americas.

In addition, IT and Business Development will now fall under Judy's leadership. This change:

- Will align our product development teams with our customer-facing sales and service organizations to ensure clear alignment with customer needs; and,
- Will result in incremental integration opportunities.

On the product side, we will focus on improving our products' effective, personalized English learning experiences. Specifically, we will focus on creating a single language learning experience for our customers, through the extension of our assessment capabilities, integration of the three major language products in our portfolio, and the enhancement of reporting tools to be oriented towards demonstrating learning outcomes.

These investments will help learners get to the right place in our solution set, evaluate their progress over time against recognized international standards, and will provide administrators with high-quality tools to measure progress and ROI. In support of this effort, we will integrate our Foundations, Advantage, and Advanced English for Business products into a single platform, making it easier for learners and administrators to use our products, and provide a single solution that will allow us to continue to bring new, innovative features to the market for all of our customers.

Starting today, we are also repositioning our Consumer business to focus on more serious learners, such as non-English speaking consumers, home-schoolers, and small business managers. We will offer Language and Literacy products that change the lives of our customers. We will emphasize English, but also offer other languages to satisfy the needs of those that are serious about learning. In contrast to casual learners – who have come to expect free mobile apps to meet their needs – more serious learners need and will pay for products that deliver tangible results and measurable outcomes. Our focus on this portion of the Consumer marketplace is a natural complement to our E&E business. It strengthens the E&E business by increasing the marketing and brand equity with a common message and value proposition that benefits both our E&E and Consumer businesses. In addition, by targeting the serious learner we expect to be more disciplined with pricing relying much less on discounting. This too will support the E&E business. In addition, our product investments will go further under this plan as products developed for E&E will be lightly modified and marketed to the serious consumer. Again providing for improved returns.

As part of this repositioning effort, we will be accelerating the migration of our Consumer business to digital, with a target of delivering over 80% of our Consumer products digitally by the end of 2015, up from roughly 60% digital today.

In addition, Tom and I will be working to streamline operations to reflect this focus. To this end, today we announced that we are reducing our global non-E&E workforce by approximately 15% and reducing other product, sales and marketing, and G&A costs, resulting in annualized operating expense savings of approximately $50 million. We expect to record a Q1 2015 charge of $7 million, which we anticipate will be largely cash separation payments. The cost savings from these actions will be reinvested into growing the Global E&E segment and are expected to largely offset top-line declines in the Consumer segment. Essentially, the next phase of our strategy rewards investors by emphasizing the Global E&E segment, and funding this growth from the cash generated by our Consumer segment.

To ensure this focus is crystal clear, we will stop or significantly slow down a number of initiatives – particularly on the Consumer side of the business. Specifically, we will reduce the number of marketing and promotional campaigns we run, focusing more on brand messaging that withstands the test of time, and less on promotional pricing. We will pull back from small retailers, reduce our investment in Europe and temper our marketing and product investment behind Kids Reading.

Over the past 18 months, we have successfully built a strong foundation for growth in E&E. Taken together, our acquisitions of Livemocha, Lexia, and TellMeMore have established a robust SaaS platform that has proven attractive to both educators and corporate businesses. We have expanded our product suite with our Foundation and

Advantage offerings to reach a broader population of more serious learners, with demonstrated success – both domestically, and internationally – from our dedicated sales force and from this product alignment.

With this realignment plan, we are excited about the competitive gains we will make in the marketplace with a product, salesforce, and customer support completely dedicated to meeting and exceeding the needs of our customers.

The financial elements of this plan are also promising. In this quarter's investor presentation, we provided a fully allocated P&L for our E&E business for 2014.

It shows a business with $113 million of bookings and an Adjusted EBITDA loss of $15 million, including a G&A allocation of $30 million. This enterprise business with recurring subscription revenues and high gross margins is attractive as it has significant potential. In 2015, for the E&E business, we expect double-digit booking growth rates and E&E EBITDA losses to decline by single-digit millions as we continue to invest behind products for Lexia and English language learning as well as sales and marketing. While we still have work to do to flesh out our plan, we believe bookings will grow at an accelerated rate and operating margins of this business will reach low double-digits by 2017 as renewals improve, sales from assessment and our new English literacy and language products penetrate the marketplace and we get operating efficiencies from sales and marketing and G&A.

In 2015, we will be managing the Consumer business to focus on the serious learner, complement E&E, and generate cash. We expect the consumer bookings to decline to between $110 million to $130 million as we focus on the most profitable portion of the consumer market. Over the next few years we believe Consumer bookings will be about $50 million to $75 million and operating margins will be about 10 percent. We think the business can stabilize at that level and be a solid complement to the E&E business.

Our high-level success metrics in 2015 are:

- One. Double-digit bookings growth for E&E;
- Two. 75% renewal rates for E&E Language;

- Three. 90% renewal rates for E&E Literacy; and
- Lastly. Between $8 million and $12 million of Adjusted EBITDA.

We know that the renewal rates for the E&E Language business need to improve. The product investments we are making will help, the emphasis on English will help, and making some changes to our customer support will help. We believe this rate will go up with time.

We know we have work to do to on the E&E business as our sales and marketing is too high for the level of bookings. We will drive higher yield from our sales and marketing spend by moving more of our marketing to digital, increasing the size of our inside sales teams, making our field sales teams more efficient, gaining efficiencies from the new organizational structure, and increasing the level of high-margin renewal revenue.

We also know our G&A is high for a Company of our size. It supports an international public company footprint that needs to become more efficient. We have taken steps today but will continue to develop ways to right-size our cost base.

While we have made significant progress with our strategy and have begun to operationalize it, we still need some time to develop more detailed multi-year plans. Once we fully flesh out these plans and have specific metrics to share, we will plan to host an Investor Day event to walk you through more details about the plan. Between now and then we will keep you posted and updated as part of our quarterly earnings call.

Before I pass it back to Tom, let me reiterate how excited I am about this plan and how excited I am about the decisive steps we are taking today which I believe will begin to unlock value in this company.

With that, I will pass it over to Tom.

Tom Pierno, Chief Financial Officer:

Thanks, Steve and good afternoon, everyone. As Steve said at the top of the call, I'm going to be talking with you in more detail about our results in Q4.

Let's begin with a few highlights:

- First, total bookings were $96.6 million, up 15%, and Adjusted EBITDA was $12.7 million, up 66%;
- Second, the quality of our bookings continued to improve as the Global E&E segment bookings grew 20% over Q4 last year. E&E Literacy continued to deliver strong growth, up 24%, driven by strong sales and renewal rates in excess of 90%, marking the fifth consecutive quarter of double-digit growth since the Lexia acquisition was completed in August 2013. For the full year, Global E&E segment bookings increased 48%, mainly due to acquisitions which we integrated successfully. We ended the year managing a business that was nearly 50% larger than last year;
- Third, we delivered double-digit gains from the U.S. Consumer website, driven by a record number of product units and subscriptions being sold. We exited the year with over 60 percent of our Consumer Web business coming from digital products, although at a lower price point than we had expected coming into the quarter; and
- Fourth, we ended the year with $64.7 million in cash, which is just about $3 per share.

North America Consumer sub-$200 pricing, while providing a strong lift over Q4 2013, fell short of our expectations based on our prior testing. In addition, organic E&E Language growth was less than the high single-digit percentage that we expected, as we were impacted by currency movements, and lower E&E Corporate bookings partially attributed to the lower Consumer pricing.

Turning to our segment results, and starting with our Global E&E business, fourth quarter bookings totaled $28.8 million, up $4.7 million or 20% year-over-year. Inside that total, Language bookings totaled $23.7 million, while Literacy totaled $5.1 million. In terms of bookings growth, Language was up $3.7 million or 19%. Literacy was up $1-million, or 24% year-over-year.

The E&E Literacy growth rate was at the midpoint of our guidance. Once again, Lexia's stellar performance was driven by strong new business as well as high initial renewal rates above 90%, including the impact of upsells. Lexia also hit a milestone in usage during Q4 – active students increased 30% year over year, with November being the highest month ever for Lexia. In addition, a national analysis recently conducted by Lexia showed that 75% of students in grades 1 – 5 that were reading below grade level and used the Lexia program at prescribed levels, gained two or more grade levels of reading skills by the end of the school year. These are fantastic results, and we couldn't be more pleased with Lexia's performance.

Organic growth is communicated because we adjust prior period actual results as if we had acquired Lexia and TellMeMore on January 1, 2013. Fourth quarter organic bookings growth for Global E&E was up $400,000, or 2%. Literacy was the same as our reported actual performance – up $1-million, or 24% year-over-year. Language was down $600,000, or down 2%. About three points of this decline was due to currency impacts in the quarter, and we estimate another four points were lost due to the impact of lower holiday promotional pricing in our Consumer business, which contributed to lower close rates in our E&E Corporate business starting around Black Friday. Regarding the level of currency impact relative to our Bookings, it is primarily the result of changes in the measurement of the unrecognized revenue on our balance sheet that is absorbed in current-period bookings.

For the year, we delivered $113.2 million of Global E&E bookings, or approximately $115 million on a constant currency basis – which was in line with our full year guidance. Inside this total, Language bookings were $90.1 million, up $22.1 million or 33% over the prior year. Literacy bookings totaled $23.1 million, up $14.8 million or 178% over the prior year's reported amount.

Full year organic bookings growth for Global E&E was up $6.4 million or 6%. Language was up $800,000 or 1%. Literacy was up $5.6 million or 32% for the year.

Now on to North America Consumer, which delivered $61.9 million in bookings in the fourth quarter, which was short of the guidance range of $64 million to $69 million. This was despite the fact that we delivered record high sales that were up nearly $10 million or 18% over last year's Q4. Unit volume grew 34% overall, driven by an 86% year-over-year increase in units sold from our website. As I said earlier, sub-$200 pricing delivered a significant lift in volume, although the increase was not as much as we had expected based on our earlier testing. In addition, we reduced pricing further than expected in the crucial last six weeks of the quarter. Our Call Center operations narrowed their year-over-year declines that we had experienced through the first nine months, posting a modest 5% decline in bookings in Q4 compared to the modest gains we had expected.

The decline in the retail channel was in-line with our expectations, reflecting a combination of lower prices and continued inventory management by our retail partners. This more than offset the positive effect of 17% higher unit volume sell-through to our end customers versus last year's Q4.

Our rebranded Rosetta Stone Fit Brains offerings improved this quarter with the scaling of a web-based subscription product, in addition to the existing mobile apps. We also continued to test and learn how to cross-sell Fit Brains as an upsell to our language products, with – at times – seeing over 30% take-rate for the Language customers offered a Fit Brains promotion. On a stand-alone basis, Fit Brains delivered its highest quarter ever in terms of bookings and downloads, consistently ranking atop the lists in Apple's iTunes App Store.

Turning to costs, we continued to make progress but – as Steve discussed – we recognize that we need to do even more. Our gross margins as a percentage of bookings remained stable as we continued to shift the NA Consumer business to lower-cost digital delivery, exiting the year north of 60%, up from 40% last year. We also made further progress to rationalize our cost base as we integrated TellMeMore and improved our operating efficiency. Segment Contribution – which we define as Bookings less direct COGS and Sales and Marketing costs – was down slightly for the combined Consumer segments in Q4 2014 versus last year. This was the result of higher NA Consumer bookings and slightly improved ROW Consumer Segment Contributions, being were more than offset by lower overall yields on increased investments in NA Consumer sales and marketing.

E&E Segment Contribution increased about $1 million – up 8% – on 20% higher bookings, which was partially offset by increased investment in sales and marketing. Unallocated R&D and G&A costs declined approximately 16% and 19%, respectively, in Q4, even as we took on incremental costs from our acquisition of TellMeMore. This performance was achieved through targeted cost reductions and by pushing out a few initiatives. The combined result from all of these efforts was a net expansion of our Q4 Adjusted EBITDA margin to 13%, which was up from 9% last year.

Lastly, before we turn to the balance sheet, in connection with the strategic realignment around E&E, we recorded a non-cash charge in the fourth quarter of $18 million to impair the goodwill associated with the North America Consumer segment.

Turning to the balance sheet, we ended the year with $64.7 million in cash. Cash was up $15.3 million compared with $49.4 million at September 30, 2014. As we previously discussed, we put in place a $25 million revolving credit facility in the fourth quarter, and there were no borrowings against the line at year-end.

Deferred revenue increased to $128.2 million. This was a sequential increase of approximately $17 million and a full-year increase of nearly $50 million. This growth reflects the combined impact of increased bookings, plus the effect of fair-value purchase accounting impacts for the Lexia and TellMeMore acquisitions.

As a reminder, because purchase accounting requires that we write-down acquired deferred revenue – essentially to zero – there was no unrecognized revenue on the balance sheet to offset against the bookings now being generated by our sales team.

The ratio of short-term versus long-term deferred revenue was 74%/26% at December 31, 2014, compared with a ratio of 85%/15% at December 31, 2013. The increase in the percentage of long-term deferred revenue primarily reflects the growth in sales of the 3-year Consumer online product offering, where we generally are paid up-front for three years of online access. The increased number of prepaid multi-year deals in our E&E business also contributed to this mix shift, but to a lesser extent.

Free cash flow in the fourth quarter was $16.2 million, up from $9.3 million a year ago. The improvement reflects higher Adjusted EBITDA and better working capital management.

Turning to our outlook for 2015, we are refining the elements we guide on to better reflect the changes that Steve has described and how we are going to be focusing on and managing the business going forward.

Our full year 2015 outlook for Global E&E bookings is between $122 million and $130 million – representing growth rates of 8% to 15%. Total E&E GAAP Revenue is expected to be between $94 million and $100 million, which represents growth rates of 11% to 18%.

Consolidated Adjusted EBITDA for 2015 is expected to be between $8 million and $12 million. This Adjusted EBITDA reflects accelerated investment in product development and sales and marketing for E&E Literacy, which will enhance bookings growth in future years.

Turning to cash, the positive operating cash flow we expect to generate will be offset by approximately $10 million to $12 million in capital expenditures, resulting in roughly break-even free cash flow, before one-time items. Including the cash costs associated with the actions we outlined on today's call, we anticipate that our year-end cash balance will be down high single-digit millions to low double-digit millions from the $64.7 million at December 31, 2014.

As a reminder, our business is highly seasonal in terms of earnings and cash, with our strongest performance in Q3 and Q4. We expect this trend will continue in 2015 and anticipate being a net user of cash through the first half of the year, with positive cash generation toward the back-end of the second half.

For the first quarter of 2015 ending March 31, we expect to deliver Global E&E Bookings of approximately $17 million – representing a decline of 7% versus the same period last year. We estimate that currency is causing 3 points of this decline and lower U.S. Enterprise bookings is driving a good portion of the remainder on low levels of renewable accounts and fewer multi-year large deals. More importantly, this quarter represents less than 15% of our year, so the smallest movement of a customer contract can cause large swings in the growth rate. The renewal base is much larger in Q2 and Q3 in E&E and we are confident in our ability to hit our targeted growth rates of 9% to 15%.

We expect our Q1 2015 Consolidated Adjusted EBITDA to be approximately negative $10 million, versus negative $7 million in Q1 2014. Remember that Q1 is seasonally the slowest quarter for bookings across all of our segments. The cost actions we took today will help reduce our run rate starting in the second quarter and put us on a path for higher EBITDA levels.

With that I am going to pass it back to Steve.

Steve Swad, Chief Executive Officer:

Thanks, Tom.

I just want to reiterate three important points.

- One. The market for serious learning is large and we have plenty of room to grow.
- Two. Our E&E business has gotten stronger over the last few years and this shift is going to accelerate its growth.
- And three. We took important steps today around our organization and cost base to begin operationalizing this strategy.

With that, we will now take your questions.