Second Quarter 2015 Earnings Call

August 5, 2015

Prepared Remarks

Frank Milano:

Good afternoon and let me welcome you to the Rosetta Stone second quarter 2015 earnings conference call. I am Frank Milano, the investor relations contact for Rosetta Stone. I am joined today by John Hass, our Interim President and Chief Executive Officer, and Tom Pierno, our Chief Financial Officer. John and Tom will discuss the operations and financial results for the quarter and we will open the call to questions after our prepared remarks.

Our second quarter earnings release went out 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 Financial Measures.”

Now here’s John.

John Hass, Chief Executive Officer:

Thank you, Frank, and good afternoon everyone.

Tom will provide the detail on our second quarter results but let me say that I am pleased, but not satisfied, with our performance, driven by outstanding growth in our Lexia Literacy business, strong profitability in our Consumer segment and greater efficiency across the Company.

Let me remind everyone why we are aggressively accelerating our strategy. By focusing on our E&E businesses we accomplish two things – we are able to reach the majority of the worldwide language and literacy market that consists of people learning through schools, learning centers and their place of business rather than on their own, and by contracting with these institutions earn a more stable stream of recurring revenues.

In the first quarter I laid out three priorities:

- Optimize the profitability, rather than the size, of our Consumer business;
- Work to deliver the right products to efficiently grow our E&E business; and
- Simplify and increase the efficiency of our business overall.

I am happy to report meaningful progress towards each of these goals.

During the first and second quarter we significantly managed down our Consumer marketing expense by 38%, or $8.1 million year-over-year, while also reducing Consumer headcount worldwide by almost 50% as part of our announced restructuring. As expected, Consumer revenues fell with marketing dollars but we increased the segment contribution from this business 19% over the first quarter of 2015 and increased it 14% year-over-year. In a demonstration of our increased efficiency, as a percent of revenue, Consumer segment contribution margin was 38% in the second quarter of 2015, up from 25% in the same period last year and 26% in the first quarter of 2015, as the benefits of restructuring efforts took hold and we also had our highest return on media in some time.

Moving forward we will continue to look for opportunities to earn rapid payback as we make incremental product investments to improve the consumer experience, and continue to optimize marketing spend and find additional ways to increase efficiency, such as shifting even more of our sales to digital delivery.

Let me turn to our Education and Enterprise businesses, where I will start with Literacy as we are making substantial investments in this very attractive business.

Literacy revenues grew in the second quarter year-over-year, benefitting from purchase accounting impacts along with strong growth in Bookings and continued high renewal rates for our Lexia Reading Core5 product. Why is this business so attractive?

First, it sits squarely in the sweet spot of two of the fastest growing areas in education – personalized learning and the need to improve literacy as the foundation to learning. There also continues to be substantial funding focused on improving literacy in this country.

Secondly, our product works very well and this is increasingly being realized in the marketplace. Lexia Reading Core5 is helping at-risk and on-target students improve their reading skills by up to two or more grade levels and our methodology has been proven effective in numerous studies published in peer-reviewed journals. In the past we spoke about the success we had in helping kids in Kansas, where students in grades 1 through 5 – that were reading below grade level – gained two grade levels in Core5 by the end of the school year by using the program as prescribed. More recently, we announced mid-year results from Berwyn South School District 100 in Illinois, which showed significant progress among students who were categorized as 'high risk' of not meeting end-of-year benchmarks. When they consistently met their personalized recommended minutes on the program, the number of at-risk students was reduced by more than half.

Efficacy wins. We see this in the rapidly growing number of kids we are helping. In June we had over four million student logins, an increase of 45% from June of 2014.

Finally, despite our growth we still have less than a 5% share of the total marketplace in the highly fragmented U.S. English Language Arts marketplace. We estimate U.S. schools spent more than $440 million on digital English Language Arts curriculum last year, with the market growing 5% annually due to federal spending and philanthropic investments to improve literacy.

We are making significant investments in distribution and products to take advantage of this great opportunity. To elaborate, Lexia has historically sold its products through third-party resellers. Last year we took a first step to transition a small number of these territories to a direct sales force. We are finding this to be a very good investment. For example, the average deal size we are seeing from our direct sales team is significantly higher than what we saw from the resellers they replaced. In addition, by owning our customer relationships we gain greater insight into customers' needs, drive penetration of our best-in-class products, capture implementation fees and potentially improve margins.

In early July we continued this transition by informing the majority of our remaining resellers who controlled approximately 1/3 of our core U.S. marketplace and represented less than 20% of our Literacy business in total, that we would be terminating our agreements with them. We are now completing the hiring of a direct sales force to take their place. A number of our best resellers will remain with us and provide good balance to our business. We are excited about what this step will mean for us.

In addition to our investment in growing distribution, we also announced the introduction of our first stand-alone assessment product. Our RAPID assessment product fills a big need in the market for a more valid, reliable and efficient reading assessment. The new RAPID assessment and the Assessment Without Testing™ methodology in our Lexia Reading Core5 curriculum product deliver critical information to educators that informs instruction and reduces the burden of the assessment process, giving back valuable instructional time. In the next two months we will also be introducing important upgrades to our flagship products – Lexia Reading Core5 – including five additional languages for directions (adding to current Spanish directions) and a new generation of myLexia, which is the accompanying educator portal. We will be introducing new instructional resources and new Lexia Instructional Connections, which will provide teachers with strategies and routines to structure individual and group activities.

We believe our Lexia business can grow education SaaS Bookings to more than $100 million, with Adjusted EBITDA margins in excess of 20%, over the next five years and we are taking the steps to deliver these results.

The E&E Language business is an area where we must improve execution and improve profitability. This will require delivering the right product in the markets with the best opportunities in an efficient way. To do this, we are doing a number of things, including:

- First, by the end of the year we will release the beta of our new unified language offering, which will give our corporate customers a digital learning solution for their multi-faceted language learning needs. This is a significant first step in aligning our product with the global corporate customer base.

- Second, we are focusing on consolidating the three technology platforms we operate today into one single platform for primary development. This will significantly reduce the amount of maintenance we are carrying and allow us to accelerate product development and innovation more quickly.

Moving next to our efforts to simplify and improve the efficiency of our entire Company, we have taken a number of steps with more underway. On the first quarter call I said that I thought Rosetta Stone was doing too many things in too many places.

To begin to address this:

- We recently reached agreement to transfer our Korean consumer business to new owners in return for an ongoing licensing relationship. While we see a good end-market opportunity in Korea, we don’t need to manage the business ourselves and employ the people needed to participate in it. This agreement will replace the cost and cash burn previously associated with doing business directly in Korea with ongoing licensing fees.

- During the second quarter we reached a similar deal, but with a new partner, in Japan. Rosetta Stone is a well-known brand in Japan, an extremely attractive marketplace, given the millions of people who want to learn English as a second language. In Japan, we found a trust-worthy partner and have licensed our technology to help them grow their existing learning center business under a new Rosetta Stone Learning Center brand. Like the transaction we have structured in Korea, we will replace the expense and cash burn previously associated with trying to do business directly in Japan with ongoing licensing fees.

These are both nice intermediate-term opportunities and importantly they have little financial risk as we continue to simplify our business and improve our core focus. There should be more opportunities for us to leverage our strengths in brand and technology to entrepreneurs in markets where they resonate. To this end, while I can make no assurances one will be found, we are looking to license our Kids Reading and Story Time content and technology to an appropriate partner.

Simplification isn't just about strategic focus. It is also about how we run our business on a daily basis. For example, we have reduced the number of retail partners we work with globally by 67% and have centralized management of our worldwide Consumer business to reduce overhead.

Let me update you on our ongoing expense reduction work.

Across the Company we are working hard to reduce expenses without impacting areas of revenue opportunity. In March, we announced and, have since completed, $50 million of annualized cost reductions, consisting of both cuts in fixed costs and media spend.

We have now concluded our first round of additional areas of intended cost reductions. We have identified approximately $12 million of annualized cost savings beyond those announced in March. These expenses are largely non-revenue and cash impacting and include reorganizing management areas, and closing or downsizing offices. For example, we closed our San Francisco office during the quarter and moved those employees to other offices or to working from home, eliminating unnecessary contracts or operating expenses. Most of the benefits from these identified reductions will be realized in 2016. We are not finished and will continue to work to identify areas of incremental efficiency.

Bottom line, we will be successful by focusing on a narrower product offering across both our Consumer and E&E businesses in order to provide outcomes that are effective and delight customers. This focus will help us be more efficient and lower our breakeven point. Finally, we will allocate capital with even greater scrutiny to those areas with the greatest value creation potential.

With that let me turn it over to Tom to walk through the financial results. I will then cover a few additional topics before we take questions. Tom?

Tom Pierno, Chief Financial Officer:

Thank you, John, and good afternoon everyone.

Consistent with what we had indicated in May, there are fewer non-GAAP financial measures in the second quarter earnings release and the slides that accompany this afternoon's call as we move rapidly to emphasize GAAP-based metrics.

- GAAP revenue was $51.4 million in the quarter, down $7.0 million sequentially and down $5.9 million year-over-year, driven by our Consumer segment. The revenue decline was anticipated, following our decision to manage the Consumer segment for profitability and cash flow. Foreign exchange impacts reduced revenue in the second quarter by $1.4 million, or 24% of the change.

- GAAP net loss was $8.2 million, or $0.38 per diluted share. Sequentially, the second quarter net loss narrowed vs. Q1 2015 by $11.7 million or 57-cents per diluted share. On a year-over-year basis, the second quarter net loss improved $7.6 million, or 36-cents per diluted share. Bottom-line results improved due to a higher gross profit percentage and lower operating expenses, including a $7.3 million year-over-year reduction in sales & marketing, a $2.1 million year-over-year reduction in general & administrative expenses, and a $1.4 million reduction in research and development expense. Overall, operating expenses were down $10.7 million, or 18% lower than the year-ago period, reflecting the start of the $50 million strategic cost savings initiative we announced in March of this year, along with lower variable incentive compensation expense.

Turning to our segment results, and starting with our E&E businesses, second quarter revenues were $23.3 million, up $3.9 million (or 20%) year-over-year. On a constant currency basis, E&E revenues would have been $24.3 million, up $4.9 million (or 25%) year-over-year.

Inside the E&E total, Education revenue totaled $11.6 million, up $3.2 million (or 38%) year-over-year. Enterprise revenue totaled $11.7 million, which was down $600,000 (or 5%) sequentially and up $700,000 (or 6%) year-over-year. On a constant currency basis, Enterprise revenue would have been $12.7 million, up $1.7 million (or 15%) year-over-year.

Inside the Education total, we use the terms “Lexia” and “Literacy” interchangeably as 100% of our K-12 Literacy business is Lexia. Literacy revenue totaled $4.7 million, up $2.8 million (or 146%) year-over-year. Lexia again demonstrated strong quarterly results, continuing the trend we have experienced since the acquisition was completed in August 2013 as they benefitted from 46% growth in Bookings as well as purchase accounting impacts. The improved results reflect an increase of 85% in the number of individual student licenses year-over-year. As we have indicated on previous calls, we expect Lexia’s growth to remain strong but the percentage growth rates will slow as the impact of purchase accounting treatment on balance sheet deferred revenue is lapped over time.

Language revenue was up $1.1 million (or 6%) year-over-year. Reported growth in this segment was hampered on a year-over-year basis by $1.0 million of foreign exchange headwinds. On a constant currency basis, Language revenue would have been up $2.1 million (or 12%) year-over-year. A portion of this percentage growth also reflects the benefit of purchase accounting treatment on balance sheet deferred revenue for the Tell Me More acquisition, which will mitigate over time.

Note that, while Language revenues increased, Language Bookings were down $4.4 million or 19% year-over-year, driven by fewer multi-year, paid-upfront deals (we talked in Q2 last year about winning a 7-figure, multi-year deal in the U.S. K-12 vertical that made comparisons difficult this year) along with $800,000 in currency headwinds and residual impacts from our Q4 Consumer price promotions, although we have seen this become less of an issue.

Consumer revenue totaled $28.1 million, which was down $9.8 million year-over-year and in-line with our expectations. As John indicated earlier, revenue-based segment contribution improved to 38% (up thirteen hundred-basis points) year-over-year as a result of our strategic decision to focus on bottom-line performance. We have been pleased that our Consumer business has performed so well, with this being the first full quarter that we have run the business under the refocused strategy. In fact, the Consumer business increased Average Order Value from the fourth quarter of 2014 while simultaneously improving return on media spend.

We expect that we will continue to be able to manage the Consumer business to achieve our targeted bottom-line result, but I do wish to note that the Consumer business is highly seasonal, with revenue and media spend higher in the back half of the year compared to the first half. Thus, while we expect Consumer year-over-year margin improvements to continue for the remainder of 2015, the magnitude of improvement will narrow.

Turning to the balance sheet, we had $29.8 million of cash and cash equivalents, plus $123.2 million in deferred revenue at June 30, 2015. Of the total deferred revenue balance, $88.6 million (or approximately 72%), was short-term and will be recognized as revenue over the next 12 months.

Net cash used in operating activities was $13.3 million in the second quarter, compared to $4.5 million in the year-ago period. This $13.3 million included $5.2 million of cash payments which are not expect to recur, including $4.5 million related to severance expense and $700,000 related to consulting on the new strategy. The remaining $8.1 million primarily related to working capital as declines in payables and other current liabilities more than offset declines in accounts receivable.

Capital expenditures, which primarily relate to capitalized labor on certain product and IT projects, totaled $2.8 million, compared to $3.2 million last year.

We recognize many of our investors are focused on the Company's cash balance. We share that focus, and also want to remind everyone that our earnings and cash are highly seasonal. Historically, the first half of the year the Company has been net user of cash and the second half of the year the Company has produced cash. We expect these seasonal trends to continue and our guidance, which I will speak to shortly, also reflects the changing mix of our Bookings, shifting away from Consumer sales that typically turn to cash quickly, towards more E&E sales that have longer collection cycles, which we also expect to continue going forward.

We define each of our non-GAAP financial measures in the earnings release and the accompanying slide presentation. Non-GAAP results this quarter were as follows:

- Revenue-based Adjusted EBITDA was negative $0.3 million, an improvement of $8.7 million compared to negative $9.0 million in the year-ago period. The increase primarily reflects the Company's improved net loss in the second quarter 2015.

- Free cash flow was negative $16.1 million, compared to negative $7.7 million in the second quarter last year as improved Adjusted EBITDA was more than offset by the $5.2 million of non-recurring payments related to our previously announced restructuring activities and the $8.1 million of working capital changes that I mentioned a moment ago.

Effective this quarter, we are going to guide to GAAP revenue but no longer guide to Bookings (a non-GAAP financial measure). Accordingly, you should disregard prior Bookings guidance, as we are not updating previous statements made with respect to Bookings.

Similarly, you should disregard prior Bookings-based Adjusted EBITDA guidance, as we have reverted to a revenue-based definition of Adjusted EBITDA. This change is consistent with the fact that we will no longer communicate Bookings guidance.

To help you bridge the two metrics, under the Company's prior Bookings-based computation of Adjusted EBITDA, Q2 2015 would have been $1.2 million, an improvement of $1.1 million compared to $0.1 million in the year-ago period. For the full year 2015, the Company is now trending at $8 million, which is the low-end of our original Bookings-based Adjusted EBITDA guidance, communicated on March 11. In addition, the mid-point of the E&E revenue guidance (that I am about to communicate) is consistent with full-year E&E Bookings of approximately $115 million, due to lower than expected first-half Language Bookings.

Turning to full-year guidance, we anticipate full-year consolidated revenue to be approximately $220 million. Within this, we expect full-year E&E segment revenue of between $94 million and $100 million, including approximately $21 million from Lexia, and the full-year Consumer segment revenue of between $120 million and $125 million. Our estimate of E&E revenue represents growth of between 11% and 18%, driven by Lexia nearly doubling revenue year-over-year primarily due to the purchase accounting impact on prior-year revenue as well as expected strong 2015 Bookings growth. For completeness, the Company's prior guidance did not communicate a consolidated Bookings forecast.

We expect full-year revenue-based Adjusted EBITDA of approximately negative $20 million, which is an improvement of nearly $8 million (or 28%) compared to 2014. This outlook anticipates that the $12 million of incremental cost savings, which we spoke to earlier on this call, will not be fully realized until 2016. This revenue-based Adjusted EBITDA metric no longer adjusts for the change in deferred revenue or the change in deferred commissions, and a table that reconciles the new definition to the old definition for the trailing six quarters is included with the slides that accompany this call.

We continue to expect full-year capital expenditures of approximately $11 million, which is unchanged from our prior guidance. As a reminder, capital expenditures for us is mostly capitalized labor on long-lived IT and product development projects.

The full-year GAAP net loss is expected to total approximately $52 million. This outlook anticipates approximately $9 million (pre-tax) in restructuring charges and other related costs.

We expect to end 2015 with a cash balance in the mid-40's million dollar range, reflecting a small change to our prior guidance, primarily reflecting lower E&E Language Bookings that will also be more weighted towards the second half of the year. As I mentioned a moment ago, we had a number of discrete items affect the second quarter cash burn. Our full year outlook reflects a continuation of the favorable expense trend resulting from the initial $50 million savings initiative, plus a small portion of the incremental $12 million cost savings initiative we communicated today.

That completes my portion of today's call. I will now pass it back to John for some final comments before questions.

John Hass, Chief Executive Officer:

Thanks, Tom.

Finally, as you know, I agreed to serve as interim CEO. The board anticipates shortly retaining a search firm and beginning the formal search process to find the best person to help realize the full potential of Rosetta Stone. In addition, to provide the benefit of our board's expertise directly to the team, we have formalized board committees to work directly with the individual members of our leadership team. Our E&E business working committee is under the leadership of Caroline Tsay, and our Consumer business working committee is under the leadership of Jim Bankoff. The management team is excited to benefit from this even greater direct interaction as we execute the turnaround in our business.

We have determined that as we focus on executing this turnaround, we will hold the annual Investor Day in the new year.

As always, I will try and make myself and members of senior management available to you on an informal basis as we move through the year.

With that, I would like to ask the operator to please open the line for questions.