Rosetta Stone

First Quarter 2016 Earnings Call

May 4, 2016

Prepared Remarks

Frank Milano:

Good afternoon and let me welcome you to the Rosetta Stone first quarter 2016 earnings conference call. I am joined today by our Chairman, President and Chief Executive Officer, John Hass, and our Chief Financial Officer, Tom Pierno. 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 first quarter earnings release went out after the market close and is available on our website at www.rosettastone.com. In addition, we have posted the slide presentation that accompanies today's call to our website, which you should find helpful as we discuss the Company's results and our outlook for 2016.

In keeping with the Safe Harbor statement on Slide 2, I will 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. We expressly disclaim any obligation to update or revise any forward-looking statements, whether as a result of new information, future developments or otherwise, except as required by law. 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 that could cause our actual results to differ, please read the Company's SEC filings, earnings release and presentation, including the paragraphs beginning with the words, "Caution on Forward-Looking Statements" and "Non-GAAP Financial Measures," which are available on our website under the "Investor Relations" tab.

I will now turn the call over to John.

John Hass, Chief Executive Officer:

Thank you, Frank, and good afternoon everyone.

The financial and operating improvements we have made in the business over the past year were evident in the year-over-year comparisons again this quarter, and I want to thank the team for staying focused on executing the plan we have established to transform the Company. Change is never easy and we are transforming virtually every aspect of our business – as we continue to work to increase efficiency, reduce complexity, sharpen our focus, and improve profitability.

Operationally, this quarter we continued to realize the benefits of the actions we have been taking as part of the $65 million in annualized cost savings that we announced in 2015, with a first quarter reduction in selling, administrative and research expenses totaling $13 million before restructuring and other nonrecurring expenses. Over the 12-months ended March 31, 2016, selling, administrative and research expenses declined $62.4 million compared to the previous 12-month period before restructuring and other nonrecurring expenses and even as we continued our investment in Lexia. While we are pleased with this progress, everyone here understands the work to find more efficient ways to operate is never finished. We will continue to scrutinize spending and work to realize returns on the strategic investments we are making to enhance our products, improve learner outcomes, and grow the business.

This quarter, we began accelerating our work in the E&E Language segment to improve its profitability and position it for future growth, which we outlined in the fourth quarter earnings release and discussed on last quarter's call. We expect these actions to result in a reduction in force of approximately 150 people, representing approximately

17% of the total full-time workforce at December 31, 2015, leading to approximately $19 million in annualized cost savings, when fully realized. Excluding Lexia, where we continue to invest to grow that business, we realized a 6% headcount reduction year-to-date, and a 23% headcount reduction year-over-year; Tom will talk more about the restructuring work we accomplished this quarter.

We also continued to make progress this quarter towards releasing a major update to our flagship mobile language app in our Consumer business and expect it to be in the App store shortly. The beta of our new E&E Language product continues to progress well, as we head towards the second phase of our wide Beta release early in the third quarter and its commercial launch in the fall, prior to the peak fourth quarter corporate selling season. Finally, Lexia expects to release the kindergarten through 2nd grade portion of its RAPID assessment product this summer. With this summer's release the RAPID assessment will span K -12th grade providing the most meaningful data while minimizing the time away from instruction. You should also look for a completely redone Lexia website to be released in the next two weeks or so. It does a terrific job of laying out the solutions we provide to help kids of all skill levels get reading faster through motivating, personalized learning paths and how we make teachers more effective through easily accessed and simply interpreted student data and research driven materials to provide direct instruction and intervention. It's an exciting time at Rosetta Stone, especially with this being the first time we will have major product releases in all areas of our business in a single year, and I expect continuous improvement to be the core of our future growth.

In addition to product investment, we are building our Lexia literacy business to take advantage of the exciting opportunity we have to serve more schools, teachers and children. In fact, more than 1.7 million students used Lexia in March. We have aggressively hired to build a direct sales force and related supporting infrastructure to expand and deepen the reach of our literacy business and although it takes time to hire, ramp-up and make a new sales team fully productive, I am very happy that 55% of total bookings in the first quarter came from direct sales, up from 26% in the same period in 2015.

While we allocate investment to our best opportunities for growth, we continue to focus our turnaround efforts on improving efficiency, reducing complexity, and increasing profitability across the board. Achieving and sustaining long-term profitable growth is our objective, and the Company's improving performance these past four quarters suggests we are on the right path – with more work to be done. I remain confident that we have the right team in place and have identified the right priorities for us to successfully accomplish this mission.

That completes my portion of today's call and I will now turn it over to Tom.

Tom Pierno, Chief Financial Officer:

Thank you, John, and good afternoon everyone.

I will begin with a review of the Q1 highlights:

- Total revenue declined $10.4 million (or 18%) year-over-year almost entirely due to the decline in Consumer segment revenue which fell 37%. Lexia, which we are now separately reporting as the Literacy segment, generated revenue growth of 82% year-over-year or 38% on an adjusted basis, which excludes the effects of purchase accounting on acquired deferred revenue. Reported Literacy segment revenue was $7.6 million for the first quarter, or $9.0 million on an adjusted basis. Foreign currency had a negative impact on total revenue in the quarter of $0.5 million, or approximately 1%.
- The net loss improved $12.4 million (or 62%) year-over-year, to a loss of $7.5 million, or 34-cents per diluted share. The net loss this quarter included $2.8 million of pre-tax restructuring charges and other related costs. By comparison, the net loss in Q1 2015 totaled $19.9 million, or 95-cents per diluted share, which included $6.7 million of pre-tax restructuring and impairment charges and other related costs. Excluding these restructuring and impairment charges and other related costs, the after-tax net loss would have been $4.9 million in the first quarter this year, compared to $13.7 million in the year-ago period.

- Finally, we ended the quarter with $43 million in cash and cash equivalents and no debt.

Turning to slide 3, total revenue was $48.0 million, down 18% year-over-year, driven by the decline in our Consumer revenue partially offset by an 82% increase in Literacy segment reported revenue. As expected, Literacy segment bookings declined slightly in the first quarter, due to the inclusion of the Kansas Reading initiative in the year-ago period and the time required to ramp-up of Lexia's newly hired direct sales team. The slight decline in Q1 bookings was anticipated in the full year 2016 bookings growth outlook of approximately 21%, which we communicated on our March earnings call. We expect bookings growth to resume in the seasonally stronger second and third quarters.

Consumer segment revenue declined $13.2 million due to the shift in the pricing and promotion strategy we announced in March 2015, to focus on Consumer's bottom line by lowering costs and optimizing the amount of media spend – meaning that we were running the Consumer business for most of the year-ago period as we had prior to the March 2015 strategic realignment. In addition, the increasing trend toward Consumer subscription sales continued in the first quarter 2016, as the subscription unit mix increased to 25% of sales, up from 23% in the year-ago period. While the mix shift had a negligible effect on the overall Consumer revenue decline in Q1, we continue to expect the full-year 2016 impact on year-over-year revenue will be approximately $16.0 million, increasing throughout the year, as we project an estimated 50% of unit sales from subscriptions, up from 24% in 2015.

As we said previously, we prefer subscription sales even while the shift has and will continue to impact revenue recognition and reported Adjusted EBITDA as subscriptions sold directly through our website do not require physical inventory and they save us the expense of packaging and distribution, as well as providing a better customer experience that is accessible anywhere through the cloud and is always up-to-date. As a reminder, unlike many other subscription-based companies, we are paid upfront for our subscription sales so there is no cash impact from this transition. In addition, as we complete the move to predominantly subscription sales we believe it should lead to more stable reported revenues as we build and recognize deferred revenue over time.

Finally, E&E Language segment revenue decreased $0.7 million due to lower results outside of North America, which included a $0.3 million year-over-year unfavorable impact from foreign currency. Within North America, K-12 revenue increased 9% year-over-year, which was partially offset by declines in the Corporate and other verticals, resulting in a net North America increase of $0.3 million (or 2%) year over year.

As John mentioned earlier, we announced the E&E Language restructuring on our March 2016 earnings call. As a result of the actions taken to date, which have resulted in an initial 6% Company-wide headcount reduction, we incurred a $2.4 million pre-tax charge for restructuring – primarily severance – in the first quarter, of which approximately $0.4 million was paid in Q1. We continue to anticipate our planned 2016 restructuring actions will reduce headcount by approximately 17% of the Company's full-time workforce of 855 people at December 31, 2015, resulting in an estimated $5 million to $6 million charge if our intentions are fully realized. We estimate that by focusing more tightly on Enterprise and K-12 in the U.S. and northern Europe and flattening our development and support structure, we will realize approximately $19 million of annual expense reductions, if our plans are fully realized. As a reminder, it will take time to exit certain geographies so we expect the full benefit of these changes will not be realized until later this year and as we head into 2017. These reductions will be partially offset in our consolidated headcount by growth at Lexia as we continue to shift investment to scale that business faster and further.

Slide 4 reflects the rising segment contribution margins for the three segments, even with declining Consumer segment revenue. Before I speak to the data on this slide, I want to note that we have updated the presentation of Segment Contribution resulting in certain costs now being allocated to our three segments as part of "Segment Contribution" that had previously been unallocated. All prior periods presented have been conformed to this current presentation and can be found on slides 14 and 15 in the appendix.

The E&E Language segment contribution margin, excluding Lexia, increased to $6.1 million or 33% of segment revenue, up from $4.2 million or 22% of segment revenue in the year-ago period. These results were driven by an overall 17% reduction in direct expenses year-over-year. Consumer segment contribution percentage was 22% of revenue, which was up slightly year-over-year compared to 21% in the year-ago period, despite the decline in revenue that reduced segment contribution dollars. The Literacy segment reported contribution margin percentage was positive 14% in the first quarter 2016, compared to minus 3% in the year-ago period, in part because of the effects of purchase accounting. On an adjusted basis, excluding purchase accounting effects on acquired deferred revenue and deferred commissions, Lexia's segment contribution would have been 20% in Q1, compared to 18% in the year-ago period.

Current contribution in the Literacy segment is impacted by the significant investments being made to support long-term growth at Lexia, such as the headcount additions to grow their direct sales and customer support teams. With a total staff of approximately 150 people at March 31, 2016, headcount at Lexia increased 7% year-to-date, and increased 59% on a year-over-year basis. In addition, the year-over-year improvement in Lexia's segment contribution was lower than it otherwise would have been because, as we grow the mix of direct sales, we are recognizing more of our sales and marketing expenses at the time of sale – as a period cost – than we did when we sold principally through resellers when more of the selling cost was deferred and recognized over the contract period.

The chart on slide 5 depicts the sharp year-over-year reduction in sales and marketing, research and development, and general and administrative expenses, which declined 26% year-over-year in the first quarter even after our growing investment in Lexia. Lower sales and marketing expense was the single largest contributor to the overall cost savings, down $9.4 million year-over-year, which was driven by reductions in our Consumer segment given that for most of the first quarter last year we were running our Consumer business as we had prior to the March 2015 strategic realignment. The year-over-year reductions in R&D and general and administrative expenses were $2.4 million and $5.0 million, respectively. Note that lower restructuring and other nonrecurring expenses contributed $3.7 million to the overall decline in the first quarter.

As John indicated, over the past twelve months ended March 31, the net decrease in operating expenses, before restructuring and nonrecurring expenses, was $62.4 million (or 24%), contributing toward the $65 million cost savings target we had previously announced. I emphasized the word “net” because while we have been reducing overall operating expenses, we have also been investing in adding sales, support and product personnel at Lexia as they expand their direct sales channel, support services and product portfolio.

Turning to the balance sheet on slide 6, we ended the first quarter with zero debt and $43.0 million of cash and cash equivalents, which was favorable to our cash guidance, largely due to the timing of certain expenditures. That balance represented a sequential decrease of $4.8 million compared to December 31, 2015, which reflected both the customary seasonality in our business and the cash effect of severance and other restructuring related costs incurred during the first quarter 2016.

Deferred revenue decreased sequentially, reflecting the seasonally lower first quarter bookings – note that Q1 is historically the smallest bookings quarter of the year across all three of our business segments. At March 31, 2016, deferred revenue totaled $132.3 million, of which $99.3 million (or approximately 75%), was short-term and will be recognized as revenue over the next 12 months.

The non-GAAP highlights of the business can be found on slide 7. Revenue-based Adjusted EBITDA was negative $1.6 million, a favorable $5.1 million improvement compared to negative $6.7 million in the year-ago period, primarily reflecting the Company’s reduction in operating expenses.

Free cash flow was negative $5.1 million in the first quarter, compared to negative $15.7 million in the year-ago period. Net cash used by operating activities improved to $2.5 million in the first quarter 2016, compared to $13.3 million in the same quarter last year – in part – due to better working capital management. Capital expenditures, which primarily relate to capitalized labor on product and IT projects, totaled $2.6 million, a slight increase compared to $2.4 million in the first quarter last year.

As I mentioned at the start of my prepared remarks, given its increasing importance and focus for capital allocation, we are now reporting Lexia results separately, which we refer to as the Literacy segment. As a result, we updated the appendix slides 12 and 13 to show the previous 5-quarters of historical bookings and revenue results with Lexia removed from the E&E segment.

With respect to full year 2016 guidance, our outlook is unchanged, with Lexia bookings of approximately $41 million, and Lexia revenue of approximately $33 million, E&E Language revenue of approximately $70 million, and Consumer bookings of approximately $106 million, and Consumer revenue of approximately $79 million for total consolidated revenue of approximately $182 million.

The Consumer revenue outlook includes the one-time impact of $4 million to $5 million to adjust the suggested retail value of our Consumer products, as we price-protect the in-channel inventory at invoiced retailers, and, as highlighted by the difference between our estimates for bookings and revenues, our estimate of $16 million in lower revenues due to an increase in the unit mix of SaaS-based subscriptions; recall that we expect subscriptions will more than double to 50% of the unit mix this year, compared to 24% of the actual unit mix in 2015. We expect the revenue impact of this mix shift to be weighted towards the second half of 2016 as we emphasize subscriptions more and enter heavier “back to school” and holiday promotional periods.

For the full year 2016, we expect the GAAP net loss will total approximately $55 million. This amount includes the full after-tax effect of the $5 – $6 million E&E restructuring, plus the $16 million mix shift for subscriptions and the $4 – $5 million adjustment for in-channel inventory in the Consumer segment. We expect a Pro forma Adjusted EBITDA loss of approximately $6 million, before the effects of those Consumer segment charges, or an Adjusted EBITDA loss of approximately $27 million inclusive of those costs.

Our full-year outlook for cash is unchanged, in that we expect to be approximately break-even over the nine months ending December 31, 2016, after adjusting for the timing of expenditures I noted earlier, which benefitted our Q1 ending cash versus our prior guidance, but before the estimated impact of the adjustment to the suggested retail value of our Consumer products of $4 million to $5 million, and the remaining impact of the E&E Language restructuring, which we continue to estimate will total between $5 million and $6 million. I also want to remind everyone, our cash has historically been seasonal, so that we are a net user of cash in the first half of the year with our low point being between Q2 and Q3, thereafter becoming a net generator of cash in Q4. We expect this trend to continue.

That completes my portion of today's call. I will now pass it back to John.

John Hass, Chief Executive Officer:

Thank you, Tom.

I was very pleased with our progress in the first quarter. It reflects the hard work and dedication of everyone across the company to build better products, improve learner outcomes and spend money only where it can best be used to deliver positive returns for our owners. I expect more of the same as we progress through the year.

With that, operator, I ask that you please open the line to questions.