Rosetta Stone

*Third Quarter 2016 Earnings Call*

**November 7, 2016**

Prepared Remarks

**Frank Milano**:

Good afternoon and let me welcome you to the Rosetta Stone third 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 third 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 the nearest comparable 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.

Our third quarter results show continued progress toward our goal of achieving profitable growth. The Company's ongoing cost reduction efforts enabled us to deliver the 7th consecutive quarter of year-over-year improvement in operating expenses, reaching a low we have not seen since the first quarter of 2009. As these results demonstrate and this call is intended to illustrate, the entire Rosetta Stone team is focused on executing our strategy as we work towards profitability and positive cash flow and position the Company for future growth.

The third quarter has traditionally been the peak sales quarter for our Literacy segment, reflecting the beginning of the new school budget year for Lexia's customers, and Q3 2016 certainly did not disappoint. Reported revenue growth at Lexia totaled 52% year-over-year, increasing that segment to another quarterly record high, as bookings grew 28% year-over-year. Adjusted for the impact of purchase accounting, Lexia's pro forma revenue approached $10 million in a quarter for the first time, a 28% increase from the third quarter last year.

Lexia's growth is being driven both by expansion into new schools and deeper penetration of our existing school clients. At the end of September, Lexia was active in over thirteen thousand schools, of which almost three thousand were under unlimited site licenses. The number of unlimited site licenses increased over 35% year-over-year, as we are focused on growing our whole school relationships and deepening the role we play in their literacy curriculum.

We are able to grow in large part because teachers and students find our products effective and engaging. In October, student log-ins exceeded 20 million for the first time ever in a month, a 32% increase from the same month last year. These factors also recently led to Lexia Reading Core5 being named as the overall winner of the 2016 T.H.E. Journal Readers Choice Awards, receiving top honors from voters as the product deemed "Most Valuable In Our Schools." Chrome Books came in second, by the way.

We are starting to feel the impact of the investments we have made to transition Lexia's business model toward more direct sales, with 75% of bookings coming from the direct channel in the third quarter. This remains an ongoing process and while the majority of our sales and support personnel are still relatively new, I believe the investments we are making have positioned Lexia for another record year, with the infrastructure capacity to support their continued growth for the foreseeable future.

Turning to the E&E Language segment, this was a milestone quarter, with the successful launch in September of our new Catalyst™ product for the Enterprise market. Catalyst is our most comprehensive language solution to date, providing corporations and their learners' placement into targeted learning paths across 24 languages, plus a robust reporting suite to track progress and measure return on investment. It also provides a better experience for everyone from the salesperson to the administrator. I was pleased that *PC Magazine* gave Catalyst an excellent rating and featured it as the startup tool of the month. There is a great deal of excitement surrounding this successful launch, given the potential for Catalyst within our existing customer base and the opportunity to expand our impact in the Enterprise language learning marketplace.

As you probably know, last month we reported that Judy Verses would be departing. Judy was a valuable member of my executive staff and a key member of the team that delivered Catalyst to the marketplace. I want to thank Judy for her five years of service to everyone at Rosetta Stone. With Judy's departure, I have asked Matt Hall, who was serving as the head of our North America Enterprise and Education language sales effort, to lead our global direct sales organization, reporting directly to me.

Turning to the Consumer segment, top-line revenue declined 12% year-over-year and bookings declined 27% year-over-year, as conversion rates in our U.S. Consumer business did not meet our expectations and as we continued to manage our media investment. We are working to address this as we focus on optimizing the profitability of our Consumer segment, and building a more sustainable and predictable business.

To accomplish this I want to do two things. First, we have begun to test our ability to create a true renewal-based subscription model in Consumer. While we have been shifting to the sale of subscription products from our box-based and perpetual download products over the last few years, we have historically focused on selling only long-term 24- or 36-month subscriptions at a price equivalent to our perpetual products.

However, by offering only high up-front price products we have limited our audience and created a business with relatively little expectation of an ongoing cash renewal stream. To potentially address this opportunity, early in the fourth quarter we began to offer shorter duration Consumer subscriptions, in addition to our longer-term subscriptions. These shorter duration subscriptions, if we are successful in achieving an adequate level of renewals, allow pricing that has the potential to open up new customer segments. We are watching this initiative closely and will continue offering shorter duration subscriptions if they do not have a meaningful detrimental effect on near-term cash flow in the Consumer business.

In addition to building a sustainable subscription base in our core marketplaces, I believe we have to access new marketplaces where our inherent strengths in brand, content and tools in the language space can be successful. This includes identifying additional distribution channels and partners in the U.S. and around the world. I am optimistic about our future opportunities in this area and look forward to reporting back to you as we move forward.

Before I turn it over to Tom, a few comments on our ongoing efforts to reduce expenses. I would currently expect that for 2016 we will have reduced consolidated operating expenses by approximately $75 million versus their level in 2014, while investing heavily in Lexia and the products that will drive future success in our Language businesses. These reductions have been realized by simplifying our business, eliminating less-productive media spend, closing offices, exiting non-core markets and making the hard decisions to do without in areas that are not critical to serving our customers. I would like to thank everyone here at Rosetta Stone for their continuing efforts.

That completes my portion of this call and I will now have Tom take you through the details for the quarter and our outlook for the year.

**Tom Pierno, Chief Financial Officer:**

Thank you, John, and good afternoon everyone.

I want to begin my portion of today's call with a discussion of an additional metric we are introducing this quarter to provide further insight into the operating characteristics of the E&E Language and Literacy segments. Annualized recurring revenue – or "ARR" – is computed using the annualized value of subscriptions at the end of the period, separate from services like training and implementation. ARR is a performance metric used to assess the health and trajectory of our E&E Language and Literacy segments, which we believe cuts through the differences in the types of licenses and deal sizes in our businesses and aids in understanding our segment results.

ARR for the Literacy segment at September 30th was $32.8 million, which was up 13% year-over-year, reflecting the continuing growth in this business even as we transitioned our distribution to direct sales. ARR in the E&E Language segment at September 30th was approximately $60.0 million, which was down 3% year-over-year. The relatively flat E&E Language ARR reflects, in part, our decision to exit direct sales in France and certain other geographies, which we announced in March of this year.

We present ARR as a statistical measure rather than a non-GAAP financial measure. ARR should be viewed independently of revenue and deferred revenue, as ARR is a performance metric and is not intended to be combined with either of these items.

I will now review Q3 revenue and earnings, and I ask that you please turn to slide 3:

- Total revenue declined $1.1 million (or 2%) year-over-year, to $48.7 million.
- Consumer segment revenue declined 12% year-over-year to $21.6 million, primarily reflecting a decline in the direct-to-consumer channel and the sale of our Korea entity in the third quarter of 2015.
- E&E Language revenue declined 6% year-over-year to $18.3 million, as a decline in the Enterprise category – both in the U.S. and in Europe – more than offset an increase in the K-12 category.

- As John mentioned, Lexia revenue was a record high $8.8 million, up 52% year-over-year, and bookings grew 28% to $17.9 million, which was also a new high in quarterly bookings, as the transition to more direct sales produced meaningful results in their seasonally strong third quarter. As a reminder, Lexia's results include the impact of purchase accounting on acquired deferred revenue. Adjusting for this impact, Lexia's pro forma revenue was $9.7 million in Q3 2016, compared to $7.6 million in the same quarter a year ago, and Lexia's pro forma revenue growth was 28% year-over-year.
- The net loss improved 25% year-over-year to $5.5 million or 25-cents per diluted share. In the year-ago period, the net loss totaled $7.3 million, or 34-cents per diluted share. The net loss this quarter included pre-tax charges of $0.2 million for restructuring and a non-cash $1.0 million charge for impairment, and the net loss in the year-ago period included pre-tax charges of $0.1 million for restructuring and a non-cash $0.4 million charge for impairment. In the third quarter of 2016 we impaired $1.0 million of capitalized R&D for product that no longer aligns to the Company's strategic direction.

Slide 4 reflects the segment contribution margins for all three segments. The Literacy segment contribution margin was $0.9 million (or 10% of segment revenue) in the third quarter 2016, compared to $0.2 million (or 3% of segment revenue) in the year-ago period. This improvement – both in terms of margin dollars and as a percent of segment revenue – was due to purchase accounting impacts on prior period deferred revenue.

On a pro forma basis, Literacy segment contribution declined 100 basis points year-over-year to 14% in Q3 2016, as we made additional investments in sales and marketing to support Lexia's transition to a direct sales model. I would also remind you that, as part of this transition, a greater share of Lexia's total sales and marketing costs are direct sales and support salaries, which are accounted for as period costs – as compared to reseller commissions, which are deferred and amortized over the contract terms along with the associated revenue.

The E&E Language segment contribution margin totaled $7.9 million (or 43% of segment revenue), compared to $5.9 million (or 30% of segment revenue) in the year-ago period. This improvement – both in terms of margin dollars and as a percentage of segment revenue – reflects a year-over-year reduction in direct operating expenses of more than 20%, due to the 2016 Restructuring Plan that we initiated in March 2016.

Consumer segment contribution margin in Q3 2016 totaled $6.2 million (or 29% of segment revenue), compared to $5.8 million (or 24% of segment revenue) in the year-ago period. This improvement – both in terms of margin dollars and as a percent of segment revenue – was realized by reducing Consumer investment in less profitable sales and marketing by more than 15% year-over-year in response to the lower conversion rates experienced in the quarter (discussed previously). On a year-to-date basis, Consumer segment contribution declined approximately 200 basis points year-over-year to 23% for the 9-months ended September 2016.

The chart on slide 5 depicts sales and marketing, research and development, and general and administrative expenses, which declined $5.9 million or 12% year-over-year in the third quarter – extending the trend to seven consecutive quarters of year-over-year improvement, even as we continue to increase our investments in Lexia. All three operating expense categories were lower year-over-year; G&A expense was just below $10.0 million (a reduction of $2.1 million, or 17% year-over-year). Sales and marketing expense totaled $27.2 million, which was down $3.1 million (or 10%) year-over-year, and research and development expense totaled $6.3 million, which was down $0.7 million (or 10%) year-over-year.

Turning to the balance sheet on slide 6, deferred revenue totaled $145.0 million at September 30, 2016, an increase of $2.2 million since December 31, 2015, and an increase of $5.6 million or 4% year-over-year. Of the September 2016 total, $115.7 million (or approximately 80%), was short-term and will be recognized as revenue over the next 12 months.

We ended the third quarter with zero debt and $32.2 million of cash and cash equivalents. The ending cash balance was down approximately $2.1 million compared to the third quarter last year, but compares favorably to the $33.4 million in net losses incurred during the past 12 months. We made $1.0 million of cash restructuring payments in the third quarter, increasing the year-to-date cash payments to $3.1 million for the restructuring plan announced in March 2016. In addition, we paid out $2.9 million in the third quarter for the adjustment to the suggested retail value of our Consumer products, which we discussed on the second quarter conference call.

The non-GAAP highlights of the business can be found in the charts on slide 7 and the reconciliation of the GAAP metrics to the non-GAAP financial measures can be found in the appendix on slide 12. Starting with the net loss and Adjusted EBITDA chart on the left, third quarter 2016 net loss totaled $5.5 million, compared to the net loss of $7.3 million in the year-ago period. As a reminder, the net loss in Q3 2016 included pre-tax restructuring and impairment charges totaling $1.2 million, and the net loss in Q3 2015 included pre-tax restructuring and impairment charges totaling $0.5 million. Total Adjusted EBITDA was positive $2.4 million, a $4.0 million improvement compared to negative $1.6 million in the year-ago period.

Turning to the free cash flow chart on the right, net cash provided by operating activities totaled $6.5 million in the third quarter 2016, compared to $7.3 million in the same quarter last year. Capital expenditures, which primarily relate to capitalized labor on product and IT projects, totaled $3.7 million, up from $2.1 million in the third quarter last year. Lexia accounted for slightly more than half of the increase year-over-year, reflecting the heightened level of investment we are making to support their growth over the long-term. Free cash flow was positive $2.8 million in the third quarter, down from positive $5.2 million in the year-ago period, reflecting lower bookings and higher capital expenditures. In addition, Q3 2016 included $3.9 million of cash payments related to the restructuring and the adjustment to the suggested retail value of our Consumer products, which I just discussed.

With respect to full year 2016 guidance, we continue to expect total consolidated revenue will be approximately $190 million. Our outlook for Lexia is also unchanged with revenue of approximately $32 million and bookings approaching $40 million.

We continue to expect E&E Language revenue of approximately $70 million. Consumer revenue will be approximately $88 million, unchanged from our prior guidance, on bookings of between $85 and $90 million, as we expect a greater mix of perpetual license sales will largely offset the impact of lower bookings on projected Consumer revenue. Our prior full year bookings outlook was approximately $100 million for Consumer. The lower Consumer bookings outlook is the result of the conversion rate challenges discussed earlier, which the team is working to address.

As a reminder, Rosetta Stone is paid upfront for the subscriptions at the time we book the sales transaction – so there has been no cash impact from the transition from product-based to subscription-based unit sales. Note, however, that the roll-out of shorter duration subscriptions that John described earlier could change the near-term cash implications for the Company and this is something we will be watching very closely over the coming months.

For the full year 2016, we expect the GAAP net loss will total approximately $37 million, compared to our prior net loss guidance of approximately $42 million, and we now expect an Adjusted EBITDA loss of approximately $5 million in 2016, compared to our prior full year guidance of an Adjusted EBITDA loss of approximately $10 million. The expected improvement in both the GAAP net loss and the Adjusted EBITDA loss reflects the 7-quarter trend in year-over-year operating expense reductions, which is expected to continue in Q4 2016.

We continue to expect total 2016 restructuring expenses to be approximately $6 million. We also will be recording a $1.6 million non-cash charge in Q4 related to the exit of our Corporate headquarters in Arlington, VA – where we have just completed a move to a less expensive, more size-appropriate space in the area, resulting in cash savings over the next two years of approximately $1.5 million.

Finally, we continue to expect to end the year with approximately $35 million in cash. Our cash guidance includes an estimate of approximately $1.5 million in Q4 2016 related to the E&E Language restructuring, and we anticipate approximately $300,000 to $400,000 will carry-over into 2017. I mentioned earlier that we paid-out $2.9 million in the third quarter for the adjustment to the suggested retail value of our Consumer products. We anticipate making the final $1.4 million in payments during the fourth quarter.

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

**John Hass, Chief Executive Officer:**

Thank you, Tom.

Because we have no additional scheduled calls with you until we report full year earnings I wanted to share with you our plans for meeting with investors. Over the last year we have focused on operating the business and making the appropriate changes to create a business with a more appropriate cost structure that can be leveraged to produce profitability and cash flow as the investments we are making in Lexia and Language take hold. While we will continue to do this, we are intent on having an active investor relations calendar in 2017. I am excited about sharing the story of a growing, high-renewal Lexia business that is changing kids’ lives through the power of literacy education and the opportunity that we have before us to leverage the greatest language learning brand in the world into new opportunities in the consumer, K-12 and corporate marketplaces.

With that, Operator, would you please open the line for questions.