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PRESENTATION

Operator

Greetings, and welcome to the Rosetta Stone Inc. Fourth Quarter and Full Year 2017 Results Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Frank Milano, Investor Relations for Rosetta Stone Inc.

Frank Milano

Good afternoon, and welcome to the Rosetta Stone Fourth Quarter and Full Year 2017 Earnings Conference Call. We have posted to the Investor Relations section of our website at www.rosettastone.com the earnings release that went out after the market closed and the slide presentation that accompanies today's call. We have also posted supplemental information and analysis on our website. This supplemental information will not be read on the conference call.

In keeping with Slide 2, today's presentation contains forward-looking statements within the meaning of the applicable securities laws. These statements may include, but are not limited to, statements related to our business strategy, financial guidance or projections related to our business and other plans, objectives and related estimates and assumptions. Forward-looking statements are based on the company's current assumptions, expectations and beliefs and are subject to certain risks and uncertainties that could cause actual results to differ materially from our present expectations or projections. We expressly disclaim any obligation to update or revise any forward-looking statements except as required by law. You are encouraged to read our cautionary statements, risks and uncertainties more fully described in the company's filings with the SEC, including those described under the section entitled Risk Factors in the company's most recent periodic filings.

Today's presentation and discussion also contain references to non-GAAP financial measures. The full definition, GAAP comparisons and reconciliation of those measures are available in the presentation or in our press release, which is posted on our website at www.rosettastone.com. Our non-GAAP measures may not be comparable to those used by other companies, and we encourage you to review and understand all of our financial reporting before making any investment decision.

I will now turn the call over to John.

Arthur Hass *- Rosetta Stone Inc. - Chairman, CEO & President*

Thank you, Frank, and greetings, everyone. I'm joined today by Nick Gaehde, the President of our Literacy business; and Matt Hulett, the President of our Language business; as well as our CFO, Tom Pierno. I will frame the conversation and share my perspective, but I also want you to hear directly from Nick and Matt about our plans for the business.

Let me begin by sharing a few highlights of our performance in the fourth quarter and all of 2017, as detailed on Slide 3. Sales at Lexia accelerated in 2017, up 24% year-over-year and 21% in the fourth quarter. Ongoing cost containment resulted in a 12th consecutive quarter of year-over-year expense reduction, with total operating expenses reduced by over $120 million in 2017 even after our investments in Lexia compared to total operating expenses in 2014. By the end of the fourth quarter, we largely completed the transition of our direct-to-consumer language business to a full SaaS-based model. More on that in a few minutes.

We had a fourth quarter profit of $2.4 million or $0.10 per diluted share compared to a loss of $5.6 million or $0.25 per diluted share in the year ago period. The fourth quarter profit was due in part to a onetime noncash benefit of $5.5 million from the Tax Cuts and Jobs Act that Congress enacted in December. Even so, when taken together, as shown on Slide 4, our results without the tax benefit generally met or exceeded our raised guidance expectations. As we did last quarter, we have posted a detailed review of our financial results on our website.

Rather than review the quarter in more detail on this call, we would like to spend our time talking about 2018, the year in which we expect sales to begin to grow again and operating cash flow to emerge. How did we get to this turning point?

Turning to Slide 5. Over the past 3 years, the team has built a business with reach, relevancy and recurring revenue. The Consumer Language business has transitioned from predominantly onetime, CD-based sales to a more sustainable and predictable subscription-based business. The language product portfolio for both enterprise and our consumer customers has been revitalized with more innovation on the way. Lexia, step by step, has introduced a K-12 literacy product portfolio of world-class instruction, assessment and implementation and support solutions, and we have been successful in building our high-retention Literacy business, reaching more than $47 million in sales in 2017, putting Lexia in a path to more than double sales again by 2020.

Turning to Slide 6. Four key elements are creating shareholder value at Rosetta Stone. First, we are building an increasingly valuable K-12 franchise. The attractiveness of the K-12 marketplace draws a regular stream of new competitors that very few break through the way Lexia has. With a portfolio of complementary products that address a broad set of needs in the schools and districts we serve and an increasingly capable sales force, Lexia is poised for continued strong growth.

Second, in 2018, with the new management team in place, we expect to return our language franchise to growth for the first time in 4 years while maintaining healthy contribution margins. Over the last 3 years, we narrowed the focus of both language businesses and improved their product offerings while prioritizing expense reductions over sales growth. Now it is time to grow again. And while the increase in language sales may start small in 2018, as we complete the transition of consumer to a full subscription model and continue investing in product innovation, we expect growth to accelerate.

Third, we are now at a stage where almost all of the company sales will be subscription-based, providing Rosetta Stone for the first time in our history a growing base of more predictable, recurring sales. As we walk you through our outlook, you will see that as sales accelerate, they will significantly exceed GAAP revenue in 2018. To remind you, when I talk about sales, I mean a signed agreement or, as we have called them, bookings, the vast majority of which are paid upfront and are therefore close to cash. This is also equivalent to revenue plus the change in deferred revenue. As the business inflects and sales grow again, reported revenue will trail as the recognition of sales are deferred and recognized over the subscription period.

Finally, we will leverage these more predictable sales to improve cash flow in 2018 and in years to come.

Moving forward, as shown on Slide 7, the pursuit of 2 objectives will guide our business. As Nick will detail, Lexia's objective is to continue to build its position as the literacy expert in K-12. This is a big, important marketplace that no one clearly leads today, and we can. And with that leadership, our objective for the language team is nothing less than to be the global leader in digital language sales.

Turning to Slide 8. The value of our Literacy business continues to increase. In 2017, sales grew 24% to $47.5 million, and we expect it to be able to continue to grow Literacy sales at a mid-20% annual rate for a number of years. Moreover, we expect sales growth to drive margin improvement.

Turning to Slide 9. Our language business improved product quality, and more competitive pricing is providing language-learning customers a better value proposition than at any time in our history. It wasn't that long ago that our customers were buying a box of CDs for a relatively high onetime price. Now they access our solutions on multiple devices with a choice of affordably priced subscriptions. And as we complete the transition to 100% subscription, we expect sales to accelerate and customer acquisition economics to be attractive.

Turning to Slide 10. In 2014, we were largely a onetime consumer language business that wasn't making money. Over the last few years, we took the necessary steps to reduce costs aggressively and walk away from less profitable sales in language, freed up cash to invest in our high-growth Literacy business. This led to both decreased sales and lower operating expenses. As you can see from this slide, in 2017, we saw moderation in the sales decline even as we worked to finalize the transition to SaaS in consumer. In addition, we achieved further cost reductions even as we continue to invest in Lexia. Going forward, 2018 will be the turning point as we return to growth with a more sustainable sales model and improving cash flow. There is much to be excited about and much left to do.

I would now like to turn it over to Nick to give you a greater sense of the opportunity in our Literacy business.

Nicholas C. Gaehde - *Rosetta Stone Inc. - President of Lexia Learning*

Thank you, John, and it's great to speak with all of you.

Turning to Slide 11. John has previously talked with you about the large and seemingly intractable literacy crisis in the United States, a literacy crisis that is the primary source of poor overall academic performance and low graduation rate. We've also talked about how large the opportunity is with approximately 100,000 U.S. public schools, of which we are in about 12,000 today, and literacy as the largest single curriculum segment and the gateway to all learning. Given this opportunity and to achieve the objective of strengthening our position as the literacy expert, we need to have both effective products and broad reach. We're committed to scaling our business and achieving our mission of impacting the lives of millions of students. Bottom line, we believe the literacy problems in our country are not impossible to address, but it will take the right solutions implemented effectively. Lexia has a 34-year history and a core competency of doing just that, leveraging the technology to build research-proven literacy assessment and curriculum solutions that support educators and students.

As shown on Slide 12, the first major product milestone in building our current product portfolio was the launch of Lexia Reading Core5 on the myLexia platform in 2013, a product that will receive its third major upgrade this summer. Core5 serves the literacy needs of students of all abilities from pre-K through 5th grade.

Turning to Slide 13. The launch this past January of PowerUp Literacy provides Lexia an additional dimension in meeting the broad needs of schools and school districts. PowerUp is an instructional solution for nonproficient readers in 6th through 12th grade. This is an attractive opportunity that meets a great need, a need that remains significantly underserved. The addition of PowerUp rounds out our suite of literacy curriculum solutions. Our product suite also includes RAPID, our K-12 computer-adaptive assessment. These solutions are supported by world-class services that promote customer success and student achievement and deepen our partnership with educators and school administrators. With PowerUp, we now have a suite of products that are exceptional on a stand-alone basis and even more powerful when used together. These products give schools the ability to significantly improve student outcomes, and this comes at a time when schools are embracing digital products that personalize learnings to meet the individual need of an increasingly diverse student population and provide educators with the data they need to make individualized instructional decisions.

Critically, the breadth and quality of our products also fundamentally changes the dialogue we have with our customers. The customer meeting moves from selling a single solution to true consultation. The conversation focuses on the needs of the customer rather than the features of a product. Let me share a few examples. Perhaps a 3rd grade classroom teacher needs a better understanding of the literacy levels of incoming students. By administering the RAPID assessment, a teacher will have the data to understand each student's needs, real-time information that is most predictive of future reading success. A primary school principal in a big urban district with large class sizes and a broad range of literacy levels needs a solution to meet the unique learning needs of each student. Core5 works in an adaptive, personalized and engaging way to increase the ability of a teacher in the classroom to improve each student's literacy proficiency. And for a district superintendent focused on closing the graduation gap, PowerUp Literacy improves academic success and college readiness.

Broadening the range of literacy needs we address exponentially expands the potential lifetime value of our customers. Let me show you how this can work on Slide 14. Before the introduction of Core5, we typically served the supplemental intervention needs of schools by providing a set of individual licenses. With the introduction of Core5 in 2013, we moved into the large general education market. This allowed us to focus on selling site-wide licenses for the entire school, increasing the contract value of those schools. And at the end of 2017, we had 3,300 schools with whole school licenses. In year 2, we demonstrate our ability to significantly improve student performance. Other schools take note, and we find the opportunity to expand into more schools across the district, in this example growing 4 site -- growing to 4 site-wide licenses and increasing sales tenfold. In year 3, as we establish our reputation at the district level, opportunities open up with our portfolio. The district pilots RAPID as the formative assessment solution and PowerUp at the middle school even as we continue to expand Core5. And finally, in year 4, as the successful pilot concludes, we implement RAPID and PowerUp and complete the Core5 implementation in elementary schools district-wide. In total, a thirtyfold increase in the sales from where we started in year 1. Now this sequence will not occur in every district we serve, but we're focused on replicating it as far and as often as we can.

But if we're going to broadly impact the greatest number of students, we also need to expand our reach. As a result, over the past 2 years, we have invested heavily in building out the direct literacy sales force while continuing to work through independent sales partners in a few regions. As shown on Slide 15, in late 2015, we announced we would be converting most of our U.S. territories from independent resellers to a direct sales model. In 2016, we began to hire the team and build out the structure we would use going forward. And during 2017, we took a number of steps to fill out our capabilities necessary for success. We put in place a sales support team to increase efficiency, and we hired a national accounts team to improve our relationships with larger districts. These investments are the drivers of future growth.

Ultimately, turning to Slide 16, my experience in K-12 tells me to sustain success, solutions have to improve student proficiency. Lexia programs have proven to improve learning outcomes required by federal mandates under the Every Student Succeeds Act, ESSA. Our research -- our rigorous research portfolio extends the highest levels of evidence under ESSA needed to evaluate instructional programs. I'm also proud to tell you that in our most recent analysis of over 712,000 students in grades K through 5 who used Core5 with fidelity during the 2016-'17 school year, over half, 53%, who started working on skills 2 or more grade levels behind their grade level substantially reduced their risk of reading failure, ending the school year working on skills in their grade level or reached their end-of-year grade level benchmark in Core5. So while I have been President of Lexia for 13 years, I believe our current combination of effectiveness, validated by unmatched levels of third-party published research and large-scale demonstrations of student improvement are creating momentum in the business that is broader and more sustainable than at any time in my tenure.

With that, I would like to now turn the call over to Matt Hulett to walk you through the outlook for our language business.

Matthew N. Hulett - *Rosetta Stone Inc. - President of Language*

Thanks a lot, Nick, and good afternoon, everyone. While I don't have the advantage of Nick's time with the company, having joined Rosetta Stone only 6 months ago, I have the benefit instead of being able to really take a fresh look at everything we are doing in the language business from the perspective of someone that has run a wide variety of both consumer and enterprise software businesses. Like Nick, I manage a team that has a tremendous amount of passion for what they do every day and a business that has an incredible set of assets, ranging from a world-class brand, depth, breadth of content over 25-plus languages from beginner to advanced levels, incredibly popular live tutoring services and a fantastic set of technology assets. And while I like much of what I've learned, I also see significant opportunity to improve and build on our current position. So let's take a look at some of the building blocks that are in place on Slide 17.

As John mentioned, in 2014, our Consumer Language business was primarily a onetime CD box sale utilizing high marketing spend and price discount to maintain unit growth. Simultaneously, our consumer business was also competing with our enterprise business, which was offering a series of products without clearly differentiated value propositions in the corporate marketplace. To address these issues, a number of steps were taken to build a more contemporary, sustainable language business. With the introduction of Catalyst at the end of 2016, we could operate a differentiated enterprise product with a distinct value proposition that enables us to compete for larger enterprise opportunities. Our Consumer Language offering was rebuilt in 2016 and 2017, including new native apps for both [iOS] and Android, and we're super excited about that. And over the last year, we transitioned to traditional subscription pricing on the web and, in January of this year, in the iOS App Store, moving the business away from onetime CD sales to building a more learner-focused and financially predictable and sustainable SaaS business model.

Of course, we still have substantial work to do. As expected, after our global cost reduction, sales fell in our Enterprise & Education business in 2017. This is not acceptable going forward, given the size of the market and our brand recognition and our ability to meet customers' needs. Over the last few weeks, we've moved the strength in the team through 4 key hires: a new head of sales for our Enterprise & Education segment; a new head of product management; our first dedicated head of reseller sales to oversee our business in most overseas marketplaces; and finally, a new head of our U.K. office. With these new hires and the rest of our leadership team, I believe we now have the team in place to drive future growth in E&E.

In consumer, we can already see the progress from the changes made in recent years. As shown on Slide 18, sales of CDs and digital downloads as a percentage of our total unit sales declined from 84% in 2014 to 46% in 2017. The shift within 2017 was especially dramatic. By December, our direct-to-consumer business was largely only selling subscription products. We currently expect perpetual product sales to be less than 5% of the total unit mix in 2018. You can see the significant change in this mix of our subscriptions as sales move from long-term initial subscriptions of 2 or more years that are unlikely to renew, which are shown in blue, to subscriptions of a year or less, which -- much higher renewal rates, as shown in yellow. In fact, we believe short-term subscriptions will be more than 50% of total unit sales in 2018, up from less than 10% just 2 years ago. This is a huge change in how our business works with very [positive] implications.

The success of our SaaS transition is dependent on 2 factors: providing a greater variety of subscription options to improve our value proposition to more people and retaining those learners long enough so that their lifetime value is attractive. To date, we are doing both. The number of short-term subscribers, as shown on the left-hand side of Slide 19, has accelerated over the last year; while the expected average LTVs, or lifetime value, across our consumer portfolio, as shown on the right, have stabilized at a very attractive level. As shown on Slide 20, the combination of attractive expected LTVs and a growing subscriber base led to a significant improvement in net lifetime value added in each quarter of 2017 [relative] to the same quarter in 2016. In fact, Q4 2017 was 33% higher than the same period in 2016 and higher than any period in the last 2 years. Net lifetime value added and the expected lifetime value of all new customers in the quarter less the total acquisition costs in the quarter to acquire them, this is the key metric by which we measure value creation in our Consumer Language business, and the trend is very positive.

The shift to a competitive subscription pricing model is really the foundation upon which we are building a consumer business with sustainable value and growth potential. So where do we go next? So let me tell you about a few things you should expect from us.

First, our customers are moving to learning on mobile devices, and we are meeting them there. As you can see on Slide 21, we're approaching a tipping point where nearly half of our customers are using Rosetta Stone solely on mobile devices, a threefold increase over the level in Q1 2016. While the Web remains important, you can understand from this rapid progression that app stores are increasingly critical as a place of discovery and purchase. So 2018 for us will be the year of maximizing our mobile opportunity or, as we like to call it internally, becoming mobile awesome.

Until a few weeks ago, a learner's only option in the Apple App Store was to buy a lifetime subscription from us for $199. It is really a testament to the quality of our almost five-star rated language app that we did well in the App Store even at a price point that was disconnected from a typical App Store pricing experience. Now when you go to the iOS App Store, you will find a more traditional range of subscription pricing offerings, as you can see on Slide 22. As we have found in our Web business, we expect this array of subscription-based offerings to broaden the funnel and lead to improved conversion rates.

Second, as highlighted on Slide 23, we are focused on improving the learner experience. We believe we offer learners the best alternative to get them speaking with confidence. This is at the core of what learners are looking for in everything we do, from immersion-based teaching to our patented TruAccent speech recognition. But we can't stand still if we are going to help our learners reach their goals. During 2018, you will see us introduce important new features and functionality, and you should look for more innovation, too.

Bottom line, as you turn to Slide 24, I believe the objective of being the largest seller of digital language learning solutions in the world is within our grasp. In addition to improving our mobile capability and potentially expanding consumer internationally, we will look to grow globally in our enterprise business where we build on the opportunity Catalyst provides. We have outstanding brand recognition and trust, and we have new products with a better price value proposition for learners than ever before. Going forward, we will build on this by enhancing the experience of people who look to us for language learning by making their experience more personalized, engaging, effective and relevant.

And with that, let me turn the call back to John.

Arthur Hass - *Rosetta Stone Inc. - Chairman, CEO & President*

Thanks, Matt. So you heard from Nick that we have the tools in place to continue mid-20% sales growth at Lexia, and from Matt that we expect both segments in the language business to start growing again in 2018. That means we expect sales to grow in all parts of the company for the first time since 2014.

Let me break it down by each of our segments. In Literacy, as shown on Slide 25, our retention rates, which have historically exceeded 90%, will continue to provide us a solid base upon which to grow. Sales have nearly tripled since the year before we bought Lexia, and annual recurring revenue has more than doubled since the beginning of 2015 to $43 million at the end of 2017.

On Slide 26, the transition of our consumer business to approximately 95% subscription-based sales with a heavier weighting of shorter-term subscriptions that provide renewal opportunities is creating a more stable and predictable business for the company overall. So while we are forecasting sales growth in 2018, this dramatic transformation of our consumer business will have a temporary albeit significant negative effect and in recognition of GAAP revenues in 2018. Let me provide some context for this change and why there is nothing to worry about and, in fact, much to be excited about.

If you would turn to Slide 27. Three stages have defined the evolution of Consumer Language to date, the profound and improving implication for everything from the demographics of our customers to the economic and income stability of the business. Stage 1 was the legacy Rosetta Stone characterized by onetime sales of relatively highly priced computer-based product with all of the expected lifetime value of a customer received at the time of sale and revenue recognized immediately. This model primarily attracted older and more affluent customers. It was volatile both economically as it lacked renewal opportunity and from an income statement perspective.

The second stage ran from 2015 to the end of 2016 when we sold long-term subscriptions alongside the continued sale of perpetual products. This had the advantage of providing customers a mobile-oriented product, and it created more stable revenues. But because these were long-term subscriptions sold at the same price as a box of CDs, renewals were low and our potential customer base remained narrow.

The third stage of our evolution began in earnest last year with the sale online of shorter-term subscriptions at a lower upfront cost. This is having a number of positive impacts on the business. More pricing options have broadened the demographic profile of our customer base. As you can see, the percentage of our customer base made up of people less than 35 years of age exceeded 40%, up from only 30% just a few years ago. Shorter-term subscriptions also provide us for the first time a meaningful renewal base, increasing predictability. And while the average initial sales price is a little lower than for a nearly 100% perpetual product portfolio, the LTVs are very competitive.

And the shift to shorter-term subscriptions is continuing this year with what we show as Stage 4 on the right-hand side of this slide with the introduction of short-term subscriptions in the iOS and Android app stores, further improving our customer demographics. And with a 100% subscription business, we will build both a larger renewal base and deferred revenues, creating a business with greater predictability.

To realize these benefits, GAAP revenues will fall temporarily. Slide 28 lays out the recognition of revenue for every year since 2015 and the estimated recognition of revenue this year. This shows the temporary decline in revenues driven by 2 factors: First, we sold a lot of 3-year subscriptions in 2015 and 2-year subscriptions in 2016, but the revenue contribution of both year sales largely ended in 2017, making for a difficult year-over-year comparison in 2018. If we focus on the column labeled 2018E, you can see the falloff of this year in the amount of revenue we expect to recognize from sales in 2015 and 2016 in the second set of circled rows. As importantly, during the course of 2017, especially earlier in the year, we were still selling a substantial amount of perpetual products, the revenues of which were recognized immediately. With the transformation to SaaS now substantially complete, we begin 2018 with only a small amount of perpetual products still being sold. As a result, almost all revenue will be recognized over time, decreasing the amount of revenue recognized in consumer within the year. You can see in the row circled at the bottom of the slide that the amount of revenue recognized within the year a sale is made is expected to decline from 54% in 2017 to 44% in 2018. Consequently, we expect consumer revenue to fall about $14 million this year. Beyond 2018, these effects will normalize and revenue growth will accelerate.

With that, let me share our guidance for the full year 2018 on Slide 29. As I've said and as you can see on the bottom of the slide, we expect sales, shown here as revenue plus change in deferred revenue, to increase across the company led by Lexia, where we anticipate sales for the year to approach $60 million, an increase of around 25%. We expect E&E Language sales to grow about 2% for the year to $66 million. We expect Consumer Language sales will also increase approximately 2% before normalizing for SOURCENEXT to approximately $71 million. This includes an estimate of the negative onetime effect of finalizing our transition to being a consignment seller to our retail partners of $1.5 million then expected falloff in sales of [big brands], which has been deemphasized of approximately $2 million and is relative to the significantly declines in recent years. In total, this implies consolidated sales of approximately $196 million, an increase of $14 million or organic growth of roughly 8% over 2017.

Despite the growth in sales as a result of the transition in the consumer business I described, GAAP revenues are expected to be lower than 2017 by about $12 million or 6% to approximately $173 million. This includes revenues of approximately $50 million for Lexia, an increase of about 15%. We expect revenue growth will trail sales growth with Lexia because we are estimating that based on recent trends, approximately half of Lexia sales and approximately 60% that's expected full year sales growth will come in the third quarter, resulting in more of the revenue from those sales being spread into 2019 and beyond. Similarly, despite projected sales growth in E&E Language, we expect GAAP revenues to fall approximately $3 million from $65 million to $62 million as the expected growth is recognized as revenues in future periods. And in Consumer Language, we expect revenues to fall about $14 million to $61 million.

GAAP expenses will increase this year as we invest to grow the business even as GAAP revenues fall due to the timing of revenue recognition with the SaaS transition. We expect sales and marketing will increase across the business and in all 3 operating expense categories at Lexia as we recognize the full year effect of the investments made in 2017 and we continue to make additional investments this year albeit at a much lower rate.

The combination of the fall in revenues from the consumer SaaS transition and the increase in expenses will lead to a significant transitional decrease in GAAP net income. We expect GAAP net income for the year to be a loss of approximately $29 million versus loss of approximately $7 million in 2017 before the onetime tax benefit.

Despite lower GAAP net income, we expect to see improvement in cash flow due primarily to an expected increase in deferred revenue of $22 million to $25 million. To put this in context, this is relative to a $2 million decrease before SOURCENEXT in 2017. In fact, we expect free cash flow will be positive on an organic basis this year, the first time we will achieve these results since 2012. Organic, as you [see here], is based on comparisons of 2017 before the $13 million of cash received from the SOURCENEXT transaction. We expect cash will be up approximately $5 million for the year, ending 2018 at approximately $48 million with no debt compared to $43 million at the end of 2017. Our 2018 ending cash includes an estimated payment of approximately $2 million for inventory returns related to our final transition from terms to consignment with the retail partners and the receipt of approximately $4 million from SOURCENEXT related to an amendment to our previously announced license agreement. You should still expect operating cash flow to be highly seasonal as we expect over 60% total sales in the third and fourth quarter of the year.

Given how close we are to the end of the quarter, we have included in the supplemental information posted to our website guidance for Q1. An overview slide is included here on Slide 30. I would remind you of 2 things: First, Q1 is by far our smallest quarter, with just 15% of estimated consolidated company sales for the year and only 7% of expected Literacy sales in 2018. We do expect a decline in Literacy sales in Q1 due primarily to the expected timing of sales within the year. Second, Q1 is also going to be the most difficult comparison in consumer as we were still selling a significant amount of perpetual product in the first quarter last year.

Because of the temporary transitional effects in 2018 I discussed, I want to share on Slide 31 our multiyear view of how we believe the business will grow and how both cash and GAAP margins will expand as we leverage this growth. I want to start by saying that our 2020 outlook remains unchanged. We believe Literacy sales will grow at an annual rate, 25% to 30% over the next 3 years as both the product portfolio and the sales force mature. We expect language sales growth will increase to 8% to 10% a year from 2018 to 2020 as the renewal base is built across both businesses. Because Lexia is now a much bigger part of the company, this will produce total company sales growth of approximately 15% over the next 3 years. Consolidated revenue growth should approximate 17% annually as we emerge from the down revenue year in 2018 driven by the consumer transition.

Finally, we expect adjusted EBITDA to be approximately $30 million in 2020 and importantly, cash flow to be somewhat higher as deferred revenue more than offsets CapEx.

In the last column, we look beyond 2020 to a period where growth remains strong but margins continue to improve. From 2020, we estimate that Literacy sales growth could flow to closer to 20%, while language maintains an approximate 8% to 10% growth rate. In this environment, we believe margins would improve significantly driven by Lexia's operational scale, producing adjusted EBITDA margins of 16% to 18% of revenues and growing each year.

So to wrap up, 2018 is the year this company has been working for. I said on these calls last year that I expected 2017 to be our point of inflection. What we have shared with you this afternoon I believe demonstrates that will be the case. Over the last 3 years, we focused the business, improved our language products, lowered expenses and freed up cash to build our core literacy portfolio and direct sales force, all while managing the transformation of Consumer Language to 100% subscription-based sales. Those steps are now largely behind us. 2018 and beyond are about achieving our objectives in language and literacy and growing Rosetta Stone profitably with reach, relevancy and recurring revenue. We have turned the page and are excited to move forward.

With that, we would be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Alex Paris of Barrington Research.

Christopher Huang Howe - *Barrington Research Associates, Inc., Research Division - Research Analyst*

This is Chris Howe sitting in for Alex. I had a question in regard to the adolescent learning literacy product. Last quarter, you had commented on it. Just wanted to see if there was any update to its progress and, I guess, how exactly that fits within Core5.

Arthur Hass - *Rosetta Stone Inc. - Chairman, CEO & President*

Sure, Chris. This is John. I'm going to turn it over to Nick to answer your question. Just to bridge the gap though, the adolescent literacy product was the internal name that we used for PowerUp, which Nick spoke a bit about on the call.

Nicholas C. Gaehde - *Rosetta Stone Inc. - President of Lexia Learning*

And so PowerUp Literacy was launched in mid-January. So obviously, not a lot of time in the market yet, but we've been really pleased with the early feedback we've received from schools and from students. It absolutely fills a need that is currently very much underserved, addressing nonproficient readers in grades 6 through 12. There is really nothing like it on the market right now as far as we've seen, and we've heard the same thing from our customers.

Christopher Huang Howe - *Barrington Research Associates, Inc., Research Division - Research Analyst*

Okay. And then as much as possible, the Univision partnership, any update to that? Or when would be your expectation for this partnership to start to generate material revenues for you?

Arthur Hass - *Rosetta Stone Inc. - Chairman, CEO & President*

Yes. Chris, thank you. We've never really spoken about any of our partnerships specifically and have agreed to do that here as well. We're very focused on the Hispanic space. Univision certainly is a very capable partner. I would say our -- the start of that have -- has not totally met our expectations at this point, but you should know that none of our guidance for 2018 and beyond in the consumer business is dependent on that partnership.

Christopher Huang Howe - *Barrington Research Associates, Inc., Research Division - Research Analyst*

Okay. That's helpful. I had a few more, I guess just some bookkeeping questions. What type of tax rate should we look for in 2018? And what was the NOL carryforward balance as of the end of the year?

Thomas M. Pierno - *Rosetta Stone Inc. - CFO*

Yes. This is Tom. So the NOL character -- federal NOL balance of 12/31 is about $129 million. And the tax rate, because of our NOL position, is only sort of tough to estimate. So generally, think of it in terms of our international cash taxes, which approximate about $1.5 million a year. So between $1.5 million and $2 million from a tax provision perspective is what we'd be guiding to 2018.

Christopher Huang Howe - *Barrington Research Associates, Inc., Research Division - Research Analyst*

Okay. And then this will be my last one. This is in regard to the recent press release about the announcement of George being added to the Board of Directors, and I was just reading some background on him and his experience at Cambium Learning. If you could just perhaps provide some additional color around the press release and if this could, in some way, interconnect with Rosetta moving forward.

Arthur Hass - *Rosetta Stone Inc. - Chairman, CEO & President*

Sure. So clearly, K-12 has become a much more important part of our business. Over the last 3 or 4 years, we've wanted to reflect that in the makeup and the composition of the board. George is someone that we've gotten to know very well over the last 6 months. As the press release says, he's worked with us as a consultant with an eye towards, frankly, joining the board at some point in the future. George is -- George's background is very sales and marketing focused, but he's a terrific all around K-12 executive with long experience at Houghton. And very relevantly for us as well, [he helped] to start and grow to $100 million a company called Cambium in the K-12 learning space as well, something that we're obviously looking to do with Lexia. And so I think he's been terrific to work with. I know Nick feels the same way. We can't wait to have him as part of the board. He's certainly already added a tremendous amount of value.

Operator

(Operator Instructions) Our next question comes from Bruce Goldfarb of Lake Street Capital Markets.

Bruce Goldfarb

Just a few questions. I'm filling in for Eric. In regard to -- percentage-wise, what do you expect billings mix to be in 2018 between Literacy, E&E and consumer?

Arthur Hass - *Rosetta Stone Inc. - Chairman, CEO & President*

Sure. So we've given on Slide 29 specific guidance, breaking it between Literacy and language. So you've got the Literacy sales of approximately $60 million and the language sales of approximately $137 million. In the script, we broke that down between the 2 with the consumer business being, I believe, $71 million; and the E&E, the K-12 language business and the enterprise part of that segment composing the rest of that $137 million, so $66 million.

Bruce Goldfarb

Great. In regard to direct-to-consumer, what are you targeting for the lifetime value of a consumer customer? And how does that compare to the LTV of an education or an enterprise buyer?

Arthur Hass - *Rosetta Stone Inc. - Chairman, CEO & President*

Yes. And so the unit target in the consumer business is obviously much, much lower, right. We're talking about an individual consumer here relative to a school or a school district or a corporation. What we've been targeting in terms of the LTV on the consumer side is really in the area of where we're currently operating, which has trended up into the low [1 80s], which we're very happy with for this business. And that's -- if we can maintain LTVs at that level, which I think are very strong in this industry, we would be very pleased with that going forward. It really allows us to invest in building that renewal pool, which even though I'd suggest -- even though sales are going to be much higher than revenues this year in the consumer business, that doesn't even take into account the, if you will, off balance sheet value that's being built in the consumer business as well as we grow the renewable pool of customers throughout the year and going into next year, something that we've never had. Really, we started to have it a little bit in 2017 and much more in 2018 and would expect to end the year with a much higher portion of our sales in any quarter coming from customers that were earned in prior quarters. And that's something we're certainly looking forward to [lend] a lot more stability to the business, a lot more predictability to the business and allows us to scale it.

Bruce Goldfarb

Great. And the last question related to gross margins. Given the shift to SaaS, what are you targeting for total company gross margins in 2018?

Thomas M. Pierno - *Rosetta Stone Inc. - CFO*

It ends up being approximately 80%.

Arthur Hass - *Rosetta Stone Inc. - Chairman, CEO & President*

I don't know if you heard that, Bruce, around 80%.

Bruce Goldfarb

Yes, that's great. That's great.

Operator

Our next question comes from Patrick Retzer of Retzer Capital.

Patrick Retzer

I'm not in a habit of being a cheerleader on these calls, but I have to admit you guys have done a wonderful job of initially slashing expenses, and the expense cutting continues while having the vision and skills to execute a transition to a SaaS-based model on the language learning business. And in the meantime, you've continued to grow Lexia at very impressive rates. My question is -- I mean, you've got about $43 million in cash, no debt. Going forward, your guidance, which has been detailed and you've met it or exceeded it but you intend to grow that, what do you plan on doing with the cash?

Arthur Hass - *Rosetta Stone Inc. - Chairman, CEO & President*

Being very shareholder-friendly with that, Pat, and thank you. We are very -- we've gone through 3 difficult but important years, and I appreciate you recognizing what we recognize, which is we've turned the corner, and we're very excited about what we see before us. We will certainly watch that cash balance. One of the things we have to be sensitive to is we are a very seasonal company. That cash balance will shrink during the first half of the year and then grow again over the last half of the year. So we have to be sensitive to seasonal low points. But in the future, as we come out of this year and move forward, I think there will be more flexibility in that regard. And certainly, we talked to the board about share repurchase. We think about ways to grow the business through product investment. We think about other ways to grow the business, but we do that, certainly, with you and other shareholders foremost in mind. So nothing to announce at this point, but certainly something that we're very aware of.

Patrick Retzer

Okay. Well, the stock price has doubled over the last 2 years under your guidance, John. So don't feel bad about having 3 difficult years. Certainly, the market and the shareholders have seen the wisdom that you've had in transitioning this. And as far as my folks are concerned, we plan on seeing the rest of it come to fruition.

Arthur Hass - *Rosetta Stone Inc. - Chairman, CEO & President*

We look forward to continuing that with you, Pat.

Operator

(Operator Instructions) Our next question comes from John Lewis of Osmium Partners.

John Hartnett Lewis - *Osmium Partners, LLC - Managing Partner, CIO, and Co-Founder*

I just want to echo what Pat said. I think you guys have done a heck of a job turning this business. And it's been a long haul and it looks like the transition to a SaaS model is here, and I just want to congratulate you on that front. And my question really centers around can you talk about any kind of large-scale, potential partnership opportunities in China or other large areas that could move the needle for you?

Arthur Hass - *Rosetta Stone Inc. - Chairman, CEO & President*

Yes, certainly. Thanks for the question, John. Can't talk about anything specifically. I would say we are very aware of the fact that language learning is something that is done around the world. And in fact, most of that takes place outside of the U.S. And there are huge markets for that outside of the U.S. We recognize some of that in our partnership in Japan last year with SOURCENEXT. Clearly, China is a substantial opportunity for us to look at both directly as well as through partnerships. We see that, we see the success of other companies that are Chinese-based companies. We are getting to know them well. We're excited to see what they do, but we believe we could bring pretty unique assets to those opportunities also, and so we're very aware of it. And certainly, while we've not included any opportunity like that in our outlook for this year or the future, that would certainly be the upside if we were able to find something that made sense for us.

John Hartnett Lewis - *Osmium Partners, LLC - Managing Partner, CIO, and Co-Founder*

Got it, okay. That's helpful. As I was looking at -- Permira took Renaissance private several years ago, and they have a detailed case study on their website on how they made 4x their money in less than 3 years. And it's an interesting -- they give 5 steps of -- first migrating to a fully SaaS business. They talk about one extremely accretive acquisition. And then they resold the business from an acquisition price of $440 million. So I think it's more around $1.2 billion, and I know it's for sale again. So I guess with that backdrop, given you guys have -- you're not the same EBITDA margins but very similar underlying unit economics and have revenue almost twice their Renaissance was when it was acquired, it would be great to see -- I know I understand the seasonal nature, but it'd be great to see a more aggressive share repurchase. And to that end, understanding your cash needs, have you ever considered going out and looking at any type of credit facility to potentially buy back stock?

Arthur Hass - *Rosetta Stone Inc. - Chairman, CEO & President*

So we do have an existing credit facility, and it's been there as we've gone through the turnaround of the business to provide support for us as we did that and as we tried -- progressively managed both expense reduction and investment in the business going forward. I think as we have more stability now and as we move forward, I think things like a credit facility or other alternatives would certainly be available to us. And they're certainly the kinds of things that we would look at, John, but we do have an existing facility today.

John Hartnett Lewis - *Osmium Partners, LLC - Managing Partner, CIO, and Co-Founder*

Again, it's really, honestly impressive to see the magnitude -- I think on the IPO, this was 95% CDs. And to get it to 100% SaaS with 3 different types of customers is truly impressive. So nice work, and I'm excited about where you guys are going.

Operator

At this time, I would like to turn the call back over to management for any closing remarks.

Arthur Hass - *Rosetta Stone Inc. - Chairman, CEO & President*

Thank you, operator, and thank you, everyone, for your questions and to Nick and Matt for joining us on this call for the first time. We obviously took a little extra time on this call, but I wanted to set the stage for the opportunity that really all of us see in this business. And I hope you found hearing directly from Nick and Matt to be helpful. I trust you can tell how excited we are for this year. We've turned the corner of this turnaround, and we are not looking back. So with that, I'd just say have a good evening. We look forward to talking to you again.

Operator

This concludes the -- today's teleconference. You may disconnect your lines at this time. Thank you for participating, and have a pleasant day.
