



Rosetta Stone

Investor Day 2018

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C O R P O R A T E P A R T I C I P A N T S

John Hass, *Chairman, President & CEO*

Thomas Pierno, *Chief Financial Officer*

Dr. Liz Brooke, *Chief Education Officer*

Matt Hulett, *President, Language*

Nick Gaehde, *President of Lexia Learning*

Michael Horn, *Co-Founder, Clayton Christensen Institute for a Disruptive Innovation*

C O N F E R E N C E C A L L P A R T I C I P A N T S

Matt Hewitt

Luka

Sofia

Marcus

Steve

Greg Spils

Jerry Huang

Gregg

P R E S E N T A T I O N

Female Speaker:

Good morning. I think we're going to go ahead and get started.

Today, before we begin today's presentation, I would like to remind all participants that our presentation today will include forward-looking statements. These statements are subject to a number of risks and uncertainties that could cause actual results to differ materially. A description of these risks and uncertainties and other factors that could affect our financial results are included in our SEC filings, including our most recent annual report on Form 10-K and quarterly reports on Form 10-Q. We expressly

disclaim any obligation to update or revise any forward-looking statements except as required by law. Today's presentation and discussion also contains references to non-GAAP financial measures. A reconciliation of GAAP to non-GAAP measures is available in this presentation or in our press release, which is posted on our website at www.rossettastone.com.

With that, I will hand the presentation over to John Hass, Rosetta Stone's Chairman, President and CEO.

John Hass:

Good morning. Welcome.

On behalf of the entire Rosetta Stone team, our Board of Directors, including David Nierenberg and Jessie Woolley-Wilson, who are with us here today to blended learning from the classroom to the cloud, the 2018 Rosetta Stone Investor Day.

Now, we have a lot to share with you today, including a few things that we haven't talked about publicly before, and we're really excited to do that, so let's get started. I'm going to quickly walk you through what we have in store. In just a moment, I'm going to turn the podium over to Tom Pierno, our CFO, to walk you through our Q3 results which were just released. I will then come back and share my keynote address, our thoughts, our vision for the future of this business; a business and a vision which is grounded in the Company that we've talked to you about over the last year or two, but which we believe can do much more, and we'll talk to you about what we believe we can do going forward.

When I'm done, I'll ask Nick Gaehde to come up and share his thoughts and vision for literacy K-12 business. Nick will also announce two exciting new initiatives that we'll talk about publicly in detail for the first time today. Nick will be joined by Dr. Liz Brooke. Liz is our Chief Learning Officer. Liz will talk to you about how we are changing lives through literacy and blended learning in the classrooms across the U.S. We're very fortunate that Liz will also have the opportunity to have a conversation with Michael Horn. Michael, for those of you that don't know him, is really one of the leading thinkers in the K-12 space. He is the co-founder of the Clayton Christensen Institute for Disruptive Innovation, and importantly for us today, the co-author of the book *Blended*. I'll come back to that in just a moment.

After that, Matt Hulett and his team will come up and talk about our language business and the vision that we have for them. We're going to share with you some really exciting new product innovations on the Consumer side which I think you'll be really impressed with, but what I'm most excited to have Matt share with you is a new way of learning, a way that we believe is the way language learners want to learn but have not been able to in the past, something that we're excited to talk to you about for the first time today. When Matt is done, I will come up and share a few final words. Now, just to cover a couple of the logistics for the day, we'll take Q&A after the Q3 overview. We'll do it again after the K-12 section. We'll then take a break, probably about 15 or 20 minutes. We'll take Q&A again after the language section. Then I'll come up and share my final thoughts.

We do have gift bags for you when they leave, it includes a copy of Michael's book, as well as a license for one year for any language in the Consumer business. We should have you out of here before 12. Polls have now closed on the East Coast for about 10 or 11 hours, so you should be free to be here. Again, I'm really happy to have you here. I look forward to a great day, and I look forward to lots of really good conversation with you.

With that, let me turn it over to Tom.

Thomas Pierno:

Great. Thank you, John, and good morning, everyone. I'm very excited to kick off our Investor Day with a brief summary of our Q3 performance and our full-year outlook. First, I want to remind everyone that we filed our 10-Q and earnings release this morning and have posted on our supplemental data document and slides to our Investor Relations website. There is a lot of detail in those documents, but for today's discussion, I'm going to focus on the highlights. Also, you'll hear us refer to sales today, as a reminder. When we say sales, we made a signed contract or transaction, the majority of which are paid upfront that we then recognize as revenue over the duration of the license activation term.

There were many things that we are pleased with this quarter and a few things that need more work. Starting at the top, our ongoing sales, and when I say ongoing, I mean before last year's SOURCENEXT's licensing and discontinued Fit Brains sales, grew by 11% or about \$7 million in Q3. We're thrilled with this milestone, which has not happened since 2014. This growth was driven by another record-setting quarter in our Literacy segment, which is 100% Lexia, and where sales grew 37% to \$34 million, which included nearly \$4 million for the renewal and expansion of Lexia's agreement with Utah, where Lexia was selected as a preferred provider in a state-funded reading improvement initiative. To put Lexia's third quarter in perspective, that \$34 million is more than their entire 2015 full-year sales.

In addition, ongoing Consumer Language sales at \$16 million were flat relative to Q3 2017, also the first time that's happened since 2014. Consumer sales stabilized even as more of our sales came from shorter-term subscriptions, where a larger part of the value we expect to realize will come through future renewals. Partially offsetting this was a sales decline of \$2 million in our Enterprise and Education, or E&E, Language segment to \$17.5 million, which was partially driven by a \$0.5 million unfavorable foreign exchange impact, along with lower operating performance that I will discuss in a few minutes. The Company recorded \$42.8 million in revenue, down about 7% from prior year, as 20% growth in Literacy revenue was more than offset by Language revenue decline of 16%, largely from the accounting treatment of the consumer transition to 100% SaaS that we have been executing.

We posted a net loss of \$6.5 million driven by our investment to drive sales growth at Lexia and because of the accounting of consumer SaaS sales and an Adjusted EBITDA just shy of break-even at negative \$700,000. We ended the quarter with \$32 million in cash and no debt.

Now, let me go a little deeper into the performance of the Literacy segment. We were very pleased with Literacy's 37% sales growth, which was in line with our expectations, and an increase from the lower growth rate seen in the first-half of the year, reflecting the ongoing shift of Literacy sales into the third quarter that we haven't seen for the last couple of years, as Lexia services moved to the center of schools' literacy curriculum and consequently follow school cycle for operating budgets. Literacy's ARR, Annual Recurring Revenue, grew 13% to \$48 million in Q3 2018 versus Q3 2017. As a reminder, Lexia has a growing implementation services business that is included in sales but which we exclude from ARR.

In Q3 2018, the mix of implementation services were approximately 17% of Lexia's sales. For the full-year 2018, we expect that mix to be 10% to 15% of their total sales, which would be similar to the 2017 full-year mix. Lexia's strong retention rate of 93% continues to underscore its importance to its school customers, and it has been 90-plus percent for over two years straight, roughly the period over which Lexia transitioned resellers to a direct sales and implementation team for most of the U.S. Lexia's renewal rate of 100-plus percent, its fifth consecutive quarter of 100% or more, reflects the success of Lexia strategy to enter districts and expand over time as they demonstrate positive outcomes for students. Further, at the end of Q3, Lexia was in nearly 13,000 U.S. schools, reaching over 3.4 million students.

We have also been extremely pleased with the reception of Lexia's newest product, PowerUp, which was launched in the beginning of this year and has already surpassed our 2018 year-end expectations for the number of schools using it.

The power of Lexia's portfolio products is strong and growing. Lexia remains on track to deliver sales approaching \$60 million this year. That would represent an increase of approximately 25% from 2017. I will also note that while we have been building out sales support areas, we continue to expect to achieve this growth with little additional direct sales heads versus last year. If we achieve our direct sales expectations for the year, sales per average sales rep will grow from approximately \$875,000 in 2017, to approximately \$1 million in 2018.

Turning to our language business, let me start with our Consumer segment. As I mentioned earlier, we couldn't be more pleased with how the Consumer team has stabilized ongoing sales for the first time since 2014, while navigating challenges created by the transition to 100% SaaS subscription sales in Q3, particularly in the retail and homeschool channels, which, combined, are expected to be about 10% of 2018 consumer sales.

Consumer added 30,000 net new subscribers in Q3 2018 which brings our total subscribers to a record high of 447,000 at September 30. Note that nearly all of the sequential growth came from short-term subscriptions, which we define as one year or less in duration. This growth follows the introduction of three- and six-month subscription options on our website last year, as well as in mobile app stores earlier this year.

You can see, on the right-hand side of the slide, that short-term subscriptions are now almost 65% of our total units sold in Q3 this year, up from less than 10% in 2016. Our unit volume and mobile is approaching that of our web business. However, the mobile channels tend to deliver more shorter term subscribers with an associated lower LTV than the web channel, which is reflected in the lower LTV per unit on the bottom left of this slide, as we attempt to optimize the tradeoff between unit growth and expected LTV per unit. In Q3, consumer net LTV added was also up year-over-year growing to \$6.6 million versus \$6.3 million in Q3 2017. Remember that our goal in consumer is to maximize and grow the aggregate dollar amount of net long-term value created each quarter. We could operate consumer at higher LTV to cap ratios but would sacrifice aggregate value created in doing so. We're pleased with our consumer business after accounting for essentially all fixed and variable sales and marketing costs. That's both people and marketing dollars.

We produced \$6.6 million in net value through initial sales and expected future renewals. We are maintaining our latest guidance for consumer for the year given that we are seeing continued momentum in our direct-to-consumer channel, as well as some positive signs in our retail channel moving into the peak Q4 holiday season. We see a continuation of the stability in the consumer business which we expect will become more of a trend leading the future growth. We believe the transformation of our consumer business is largely complete and it is now positioned to be a solid platform on which to build the exciting new services that Matt and his team will be discussing shortly.

Now, I'd like to talk to you about our E&E language segment performance which I'm putting in the "needs more work" category. While Consumer stabilized for the first time since 2014, E&E underperformed our expectations. We expect this trend to continue into Q4, so we are lowering our sales guidance for the year for E&E by \$8 million which changes our full-year outlook to \$58 million which is \$6.8 million less than 2017 sales. I will talk more about our full-year view shortly but let me first walk you through E&E's Q3 performance. E&E sales were \$17.5 million, a decline of \$2.3 million or 12% in Q3 2018 versus the same prior-year quarter. Within this, approximately half of the \$2 million sales decline was the absence of custom content sales with most of the balance driven by \$0.5 million unfavorable foreign exchange impact that came through the UK and resellers outside of the U.S., along with lower sales from our affiliate channel. E&E ARR was \$54.5 million in Q3 2018, down 2% sequentially and 4% from Q3 2017.

We've traditionally not discussed the distinct verticals within E&E beyond K-12 in North America corporate. But we'd like to share some additional detail to help you bridge our revised guidance and some of the work we're doing to improve segment performance going forward. Our E&E business is made up of a number of different sales verticals with different buying cycles and underlying industries. Besides selling to K-12 schools and corporations, we serve the public sector, as well as custom content sales that historically had been primarily the Native American tribes seeking to preserve their language.

We also sell through affiliate channels in the U.S. which sell our products through their networks of enterprise customers. Two of those verticals are not traditional SaaS-based strategic businesses for E&E. First is the custom-content vertical which are largely non-recurring and not included in our ARR disclosure. We continue to believe in the positive social impact of preserving native languages. However, our focus is primarily on our more traditional SaaS businesses. Second, sales through corporate affiliate channels, which, because we don't control the customer relationship, are also viewed as non-recurring and also excluded from ARR. Historically a profitable channel for us, and one which we expected to be larger in 2018 than it will be, it is not a core focus as we look to build direct relationships with corporations to serve their critical language learning needs.

Of the year-to-date, E&E language sales decline of \$3.9 million year-over-year. About half was from these two non-strategic verticals with most of the rest coming from a \$1 million impact from foreign exchange. For the full-year 2018, of the \$8 million reduction in sales from our prior guidance, almost half is from these non-strategic verticals. Overall, the theme of our language business in 2018 year-to-date is that those areas where we're focused on building strong recurring revenues in big markets like U.S. direct-to-consumer sales and corporate and E&E have had good success while areas like consumer retail and custom content that are not contributors to ongoing ARR or subscriber growth have been weaker-than-expected. We're not happy about the lower-than-expected performance in these areas but are pleased with the progress in our core business.

Let me conclude my remarks this morning with our guidance for the year. First, we're confirming our consolidated revenue guidance of \$173 million with Lexia increasing \$52 million, offset by E&E language decreasing \$60 million. We're also improving our guidance for net loss and Adjusted EBITDA by \$4 million to negative \$25 million and negative \$2 million respectively and lower-cost seen in Q3 and expected in Q4. I'd remind everybody that the reason GAAP performance deteriorates compared to last year, even as we expect sales to grow, is due to the temporary effects of the conversion of our consumer business to a full subscription sales model that we expect to lap as we move through the first-half of 2019. We're also confirming our latest sales guidance for literacy and consumer. We now expect consolidated sales to be approximately \$184 million which represents our first sales growth after three years of declines. We now expect to end the year with cash of approximately \$39 million. While this is \$6 million lower than previously estimated, primarily due to lower sales now expected for E&E, it represents an increase of \$18 million from our seasonally low point at the end of Q2. Remember, our cash flow matches the seasonality of our sales where we are a net user of cash in the first half of the year when sales are lowest, and generate cash in the back half following the large Q3 sales which has become our peak sales quarter of the year on the strength of our K-12 businesses.

With that, I will ask John, Matt, and Nick to join me for any questions you might have before handing it back to John.

John Hass:

(Inaudible) questions which we'd be happy to, of course.

Male speaker:

Where are you in this transition from (inaudible)?

John Hass:

We're going to use mic's during the course of the day today for the people that are on the webcast.

Male speaker:

We're basically 100% done with our transition from CD to perpetual products, both for the web channel and the mobile channel.

Male Speaker:

(Inaudible) you talked in your comments—you spoke in your comments about LTV declining because it's more mobile, less web. I guess I'm trying to figure out, where do you think lifetime value bottoms as we continue to go through this? Or is this the bottom if we're all the way through it?

Matt Hewitt:

I'll take a shot and then invite Tom's thoughts. We see a stabilization right now in terms of where we are in the web and the mobile channel.

Thomas Pierno:

Yes. I think that's right. Hopefully, it's still—I think that's right. In terms of how we look at LTV and CAC, as I said, we're managing it from the perspective of maximizing aggregate value, and so those are levers for us. If we think that there could be more aggregate value created with a lower LTV and then obviously lower CAC, we would do that. It's something that is something we're testing all the time, different pricing, different durations in combinations of media spend, and those are the levers that Matt has in the business with—from a consumer perspective in terms of maximizing aggregate net LTV added. Thanks.

John Hass:

Yes, we're very happy with the LTV per unit. As you know, Steve, it's a significant premium to our peers in the U.S. market and we test and learn. If we could, as Tom said, if we could drive more value by lowering price and growing, the offset to that, of course, would have to be subscribers growing faster. We would certainly think about that. There may even be strategic benefits to doing that. We've decided not to do that up to this point, but that's always an option. I think we feel comfortable with where it is now. If it were to ever be meaningfully lower, I think it would be because we made a strategic decision to drive subscriber count faster. All right. I hope you're not (inaudible). Yes, we're going to wait for the mic.

Male speaker:

I was just curious, on the countries you operate, you mentioned pricing. I'm just curious how you're seeing that. Are you able to get price increases anywhere or are you looking with offsets because that obviously drives your margins, and so I'm just—I'm not familiar with every region you're operating in, so maybe you can just give a little color in terms of the competitive market space and how you're addressing the pricing issues, trying to either lower to get more customers and drive the volume, or if you're increasing pricing anywhere because your product is just so good.

John Hass:

Matt should add to this. We're primarily a North American consumer business today. We do tend to be a premium priced product in every market. We're in most markets around the world, tends to be relatively small. What I think you're going to hear about today from Matt and his team is the approach that we would like to take to drive LTV per customer higher, especially in non-U.S. markets. We think it gives us the chance to drive LTV per customer higher and grow much faster non-U.S. markets than we are today, where we're not a particularly large presence, and you're going to hear a lot more about that at about an hour and a half.

Matt Hewitt:

I'd just to add to that. Most of our pricing for the consumer business has been relatively uniform in terms of our premium in each market, and so we have been thinking about what optimizations we need to do by market because they're variables from premium products to different products that we don't see in the United States. We're doing a lot of testing still.

Male speaker:

I can see you want to expand outside so that's why I was seeing what little tidbits of information you can give me on the international markets, and I guess you're going to be talking about that later.

John Hass:

You bet. Yes?

Male speaker:

Morning. I just have a follow-up question on Consumer. Congrats on Lexia, but I'll just dive in the Consumer just to better understand it. The business there has stabilized for the first time in three years. How about breaking that down by segment a little bit, like you did E&E? For example, what is direct-to-consumer, what percentage is retail customers like Best Buy and Amazon, how are those businesses going?

Thomas Pierno:

Yes, I'll start and then hand over to Matt. We don't break down that. The way we do—but I talk about retail in general being about 10% retail and home school together being about 10% of total sales, and so that is the minority of the business. Really, the majority of the business, and has been the engine of our consumer business for a long time, is direct-to-consumer, and now mobile, growing mobile business, which as I talked about is now approaching the volume of our direct-to-consumer web business, and we look at that as an ecosystem. We see them kind of playing together as ways to fulfill, ultimately, consumer demand wherever they are. If they're on their mobile device and they go to an app store, we're there. If they're on their computer and then they want to go to the website, we're there as well.

Matt Hewitt:

Yes, I think that's right. I think what we've learned since January—really, I say since January because, just to remind everybody in the audience that in January, there was only one way to buy our mobile product in the app store, it was a \$199 download. We were the highest, one of the highest priced products in the app store, especially for the education category. Since then, we have three, six, 12, and 24-month buying options. We've learned a little bit more, much more quickly, about how to parade out pricing and get more awareness and trial on the product. But we have seen an ecosystem effect. Per what Tom is saying, we've seen buyers that look at what our pricing is on the web and mobile, and have

made appropriate purchases based on where they feel most comfortable to buy. We don't break it out for that reason because we do see a lot of overlap. The retail business, as Tom mentioned, (inaudible) business. It's a good steady channel but we obviously see higher growth in D-to-C.

Male speaker:

Last quarter, you talked about some success on the corporate side in E&E. What's the pipeline look like going into Q4 in that business and do you think, just a higher level question, ex these two segments that you're de-emphasizing, is E&E fundamentally a growth opportunity for you?

Thomas Pierno:

I'll say, I'll start with the growth opportunity. Yes, we see that as a growth opportunity in kind of what we call the core areas that we're looking at, and I'll let Matt talk about the corporate success.

Matt Hewitt:

Yes. We're seeing more growth in the global 500 accounts that's been a more of an area of focus for us, both in North America as well as EMEA and we have good sales teams in the EMEA. We don't comment on pipeline per se, but we do definitely see more interesting deals coming out of multinational accounts. We see it as a growth opportunity.

John Hass:

Okay. Any other questions on the quarter? Right. Thank you. Thank you, Matt, Nick, Tom. All right. Now we are going to get started with the rest of our Investor Day with you.

What I'd like to do is make sure that you leave today, and this is what we will do as a team, with a full understanding of our businesses as they are, but what we really want to do is stream our vision for the future. As I said, a vision for a future with a very different Rosetta Stone than the business you knew or may have known just a few short years ago. But to get to that future, I think it's helpful for you to understand where we've been and what we've tried to do over the last few years.

When I became CEO in early 2015, we established a few priorities to get us going. The first was to work with the team to define a mission for the Company, to change lives through the power of language and literacy education. Those are very few simple words but they truly mean everything to us as we think about the future of this business. By obligating ourselves to change lives, we're making a commitment to produce positive outcomes for our learners across all of our businesses that are clear and demonstrable. By focusing on language and literacy, we're making a statement that we will be true to the DNA of our company, a company that values the centrality of communication, to how all of us live and work, and come together as global citizens. With a mission to guide us, we next turned to trying to allocate our investment dollars to their best use. From 2014 to 2017, that meant reducing expenses in our language business, until we had the products, the strategies, and I think most importantly, the team in place to drive growth going forward. That led us to reduce expenses by about a \$120 million from 2014 through the end of 2017.

At the same time though, we saw a pretty compelling opportunity to invest in what was then a small business, Lexia Learning. Lexia, if you go back to 2014 had one main product, about 20 direct salespeople and did about \$23 million in sales or about 7% of total sales for the company that year. But we saw in Lexia the hallmarks of a K-12 business with tremendous opportunity. Great outcomes for students, supported by over 30 years of experience in research and driving terrific outcomes for learners in the classroom, wonderful customer retention and we decided to invest in it.

Fast forward to this year, Lexia now has a full suite of outstanding literacy products, about 45 commissioned salespeople and we expect it to produce roughly \$60 million in sales this year, almost a third of total Company sales. Because, over the last 24 months, we have served over 4 million students in over 15,000 schools and in almost 3,000 U.S. school districts, we believe we have the opportunity to do much more and that's what we're going to spend today talking to you about.

In our language businesses, after getting our costs under control, we wanted to, and we have, re-imagined our product portfolio, principally for adult learners in our consumer space and in the enterprise business, moving us to a place where not only is the current product more compelling but our ability to innovate and adapt is enhanced. More recently, we have transitioned our consumer business to 100% subscription. No longer selling boxes of CDs, and as a result, not only do we provide a better customer experience, we're able to provide a full portfolio of subscription prices, importantly, opening us up to a broader demographic of customers and creating for the business more predictable and sustainable revenues than we've ever had in this business before in the 25-plus years of the Company. For the first time, as you've heard from Tom, in Q3, sales were stable and we expect them to grow in the fourth quarter.

But ultimately, the most important priority for us was to build the right team. This meant supplementing a world-class K-12 literacy team with key hires in product management, and more recently, customer success. While our language team was reconstituted to lead a business that is at one time more mobile, innovates faster and it's now 100% subscription based. Matt, with over two decades of experience, with companies ranging from Expedia to startups; Greg Spils, who you'll hear from later, running our product management, came from companies like Amazon and Rhapsody; Christina Kozlov, most recently from Zillow to manage global brand marketing for us; and Jerry Huang, who you will also hear from, the former COO of iTutor, one of China's largest virtual language learning companies, to run our global language business, to name just a few. I believe this is the right team for our Company going forward.

Now for those of you here listening online, our focus on these priorities over the last few years has driven the investment thesis that you know. An investment thesis based in a powerful and growing literacy business, a stabilized and profitable language business, all leading to emerging SaaS growth and improving cash flow. But that's not why we're here. We're here because we believe we can do more. We believe we can do much more than that and today we're going to show you how. To be more, we're going to leverage what I believe to be the two principle underlying assets of our business in a much greater way than we have in the past: our amazing presence in K-12 schools and the Rosetta Stone language brand. What more can we do to leverage both the broad presence and the incredible reputation we have in schools? What more can we do to leverage what I think is the most iconic language brand, not just in the U.S., but, really, around the world?

Well, first, I believe a key to unlocking these assets is to allow our two businesses, really, for the first time, to collaborate and leverage the strengths that each bring to the Company. To leverage our strengths, we will lean into our ability to build world-class blended learning products and services. You are going to hear a lot about that today. That theme, working collaboratively to build adaptive blended learning products, underpins all of the new initiatives that we'll talk to you about.

Now to be clear, and for those of you that followed us for a few years, I think you understand this, we have not historically asked, or frankly even allowed, our businesses to work closely together. We wanted to give each of them the room to take advantage of their own opportunities and address their own issues. But now we believe with much of that work behind us, we're looking at Rosetta Stone from a new point of view and we're going to take a new approach going forward, that maximizes the best of who we are as a Company.

With this new perspective and to leverage our K-12 opportunity, we're announcing two things publicly today. First, we have decided to build a new product to directly address the needs of non-native English speaking students in our schools. This opportunity fits all of the characteristics we look for in our K-12 business. It is large, it is growing, it has dedicated funding and most importantly, it meets the needs of schools that are not well met today. To meet this need, we are building a product that we believe will be highly differentiated in the marketplace, utilizing the capacity and capability of our literacy team to build it up, get personalized blended software for K-12 schools, along with the language education capabilities, existing market share, and brand of the language business. We expect this product to reach a much bigger market than our current K-12 English language product and to have improved operating and financial characteristics similar to those of our current literacy products. Nick will talk to you in more detail about our plans and Liz will share a glimpse of one of the truly exciting differentiating features of this product later today, something that we believe will be differentiating not just for English learners in schools but in K-12 generally. I think you're going to think it's really cool.

To make sure we take full advantage of this product and other products as we go forward, we're announcing one other thing today in K-12. The second initiative is the intention to transfer all of our dedicated K-12 language sales resources to our current literacy segment in order to form a larger, more powerful K-12 group under Nick's leadership. When completed in 2019, we will be bigger, with approximately 75 dedicated K-12 salespeople under common leadership. We will have a broader product portfolio with world-class products in both literacy and language, and we will grow faster as new English language sales add to the already outstanding underlying growth of the literacy segment. Net sales of our current K-12 English language products in our E&E segment, we expect to continue to be reported in that segment as they are reliant on the systems of the E&E segment and the language business generally. Only sales of the new K-12 language product that are built on Lexia's myLexia platform will be reported in what is currently the literacy segment. Fully transitioned, we see an even larger business growing even faster with superior retention rates and producing great outcomes across the board through best-in-class products in what is today our literacy segment.

Now, one of the reasons I'm personally confident of our ability to build a new English language learning product is the success that we've had in leveraging our ability to design and build adaptive learning products across the Company. You're going to hear a lot about blended learning today, and there's a reason for that. We want to make sure you walk away with a clear understanding of what it means and why it works, because we want to be the leader in developing these products. For me, blended learning is conceptually clear because it reminds me of how we learned as a kid. At its most basic, it combines time on task, in this case, through software, with the expert instruction, in this case, through a teacher in a classroom. It reminds me also how I learned to play tennis, to try and make it simple analogy. I played with a friend, or I practiced against a backboard, and once a week, I took a lesson from a pro. But in a modern blended learning version of my tennis learning experience, imagine now that when I saw my pro, they knew in real-time everything about my current performance, and they received an ongoing assessment of how good I would be in the future. Just as importantly, when I went back to hitting against the wall, instead of being a static experience, the wall adapted to me, returning the ball at a pace that was appropriate for my current skill level, challenging me to cover more and more of the court as my ability improved, and helping me when I faltered. If you would ask my wife, I would be a much better tennis player had that been my experience growing up.

Fortunately, that is exactly what Lexia's products do in classrooms today, and that is what our new K-12 language learning product will do for English learners in the future, combine the power of adaptive software with an expert, in this case a teacher, who is equipped with the data and the information to provide personalized instruction to the student. But what has me really excited about the future is that to achieve these goals, we will leverage the best of our Company, regardless of where a capability or an asset sits, whether it's the adaptive blended learning software development expertise in K-12, the

assessment expertise, speech recognition engine, or 10 years of experience in hiring, training, and supporting online tutors that exist in our language space, and of course, our iconic brand.

One of the ways I'm looking to develop this cooperation across the business is through an announcement I made this morning with the support of the Board. Starting January 1st, Nick Gaehde and Matt Hewitt will become co-Presidents of Rosetta Stone Inc. while I continue as Chairman and CEO. While Nick and Matt will continue to lead their respective businesses, I am looking to them to help me maximize the opportunity across the Company, build on the sharing of assets, best practices, and talent.

A moment ago, I mentioned online tutors. It's not something we've talked about much in the past. Why? Because as we leverage the best of Rosetta Stone, our ambitions will extend from the classroom to the cloud. Our goal is to bring adaptive blended learning experiences to the cloud for English language learners around the world, leveraging our software learning expertise, substituting for the teachers in the classroom, our language tutors and bringing it all together with the data and information that optimizes their experience. This is the product that language learners know they need but don't have. Consequently, today, they piece it together on their own. They combine offerings from companies that are software-based, like ourselves, with services from companies that are providing online virtual tutoring, or more likely, they're still using an offline tutor in a classroom, but this isn't just about bringing that together and making it easier for a learner. Fundamentally, it's about making it better. When a student pieces that experience together for themselves, they lose what is most powerful about blended learning: the information in the data that bring the teacher, in this case, the tutor, together with the software to drive outstanding outcomes, that tennis analogy that I mentioned. No one company in language learning today is bringing that experience together in the way that we believed we can.

We also believe that we can bring these capabilities together for a learner at a lower cost than they're able to do on their own. This is not just an idea. You will get an overview of the strategy and the product in this space from Matt and Jerry a little bit later. We're preparing to test this product in a large non-US market next month. As we leverage our presence in K-12 and the Rosetta Stone brand, and as we share across the Company what makes each of our businesses special, our investment thesis will change. No longer will our future investment in K-12 be limited to literacy. We want to be the expert in K-12 literacy and language. I believe we have the products and the capacity to increase the growth of our K-12 sales as we bring our new English language learning product online. I'm very confident of this.

Now, I also believe we have stabilized our U.S. consumer language business, but acknowledge that we have more work to do in parts of E&E. But, most importantly, for the future of Rosetta Stone's language business, I believe we can develop the right language product for a global consumer marketplace; a marketplace that I said knows what it needs, but doesn't have anyone providing it today in the way that we can; a marketplace that is both much larger and more attractive than our core North American-U.S. market; a market that, if we do this right, will finally be deserving of the Rosetta Stone language brand.

We expect these opportunities, the progress in our current core business, and the new initiatives that we'll discuss in a lot more detail today, to both accelerate growth and increase intrinsic value across the business. We have a lot to share with you today. You're going to hear a lot of interesting things, so I'd like to get us started. Let me introduce Nick. Nick will start us off. Nick is the president of Lexia and will soon be the co-president of Rosetta Stone. Nick has led Lexia for over 13 years and most recently has overseen the growth in the business, the introduction of many additional new products, and the growth of our direct sales force. Nick is a leader in the K-12 business industry-wide, and I'm very happy to have him as a partner. With that, I'll turn it over to Nick.

Nick Gaehde:

Good morning, and thank you, John. As John mentioned, our mission is to change lives through the power of literacy and language education. Let's talk about why that's so important in K-12. We have a crisis in education, a crisis where 64% of fourth graders are non-proficient readers. Let me repeat that. Two-thirds of fourth grade students are non-proficient readers. According to the National Assessment for Educational Progress, or NEP, that startling trend exists not only in fourth grade, but you can see it in eighth grade and in 12th grade in our students. NEP, which is an initiative run by the National Institute for Educational Science and the National Education Foundation, is looking at what students know across multiple subject domains. It's the only assessment that looks across multiple domains across the country. They've been measuring results since the 1960s. It's also known as the nation's report card. What NEP is showing us is that the trend we see has been in place for decades. That's despite the fact that the science of teaching reading is well understood.

In the 1990s, Congress brought together a panel, a panel of experts to take a look at the research. They looked at over a hundred thousand studies that looked at how reading was taught, looked at what the most effective methods were. The evidence was really really clear. What they found was that the best approach to teaching and reading was one that included explicit instruction in phonics, in phonemic awareness, systematic phonics instruction, methods to improve reading fluency, and ways to drive reading comprehension. Why is this so important? Consider the fact that 85% of curriculum in public schools is delivered through reading. If you can't read proficiently, you can't access the content you need in order to learn regardless of subject domain. Reading really is the gateway to learning.

Why has this been such a persistent problem in this country? Think about the classrooms today. Think about the diversity in classrooms. Think about the size of classrooms. There are a lot of obstacles faced by K-12 educators. First of all, teachers lack the resources they need in order to meet the needs of every single student in that classroom, to understand what those students need; their strengths and weaknesses. The only way they can do that is by having data that identifies student needs. The problem is, collecting that data is extremely time-consuming and costly. Even when educators have that data, they don't have the ability to connect it to instruction.

It's also true that we are asking schools and students to meet more rigorous standards. Whether it's a common core state or states that aren't common core now, the standards are higher and that's a good thing. Let's talk about the opportunity in K-12 and talk about, first of all, the structure of schools. We have about a 103,000 schools across the country and about 47 million students in those schools. But 51% are in primary grades, kindergarten through sixth grade, and about 49% in secondary schools, middle schools and high schools. The needs of those segments are actually quite different. If you think about primary schools and if you have children, you understand that from kindergarten through fourth grade, the primary task of a teacher is to help students learn to read. At about fourth grade, that flips actually, and now the objective is to have students read to learn. Unfortunately for a lot of students today given the proficiency we see in literacy performance, learning to read extends throughout a lot of the grades, through not just primary school but secondary school. Literacy instruction in primary schools is a whole group exercise, and then secondary schools, it's really small group or Intervention Services.

Now, how big is the market? According to the National Center for Education Statistics, spending in K-12 in 2016-17 was about \$460 billion, about 4.1% of GDP. The Software and Information Industry Association breaks that down and looks at just digital content and software, and estimates about \$10.4 billion is spent on those products and services from Pre-K through 12th grade. That's been growing at about 3.8 compounded annual growth rate since 2011. SIA segments that into really three categories; into instructional content where reading and mathematics dominate, and that's about \$3.3 billion. Instructional support, which is comprised of testing and assessment, that's about \$3.2 billion or 38% of the total. Then enterprise management, which is about \$1.9 billion. We serve both the instructional content and the instructional support segments, a total market spend of about \$8.4 billion in 2014.

What are the growth drivers in the industry? A recent study and report by BMO talked about the big growth drivers in the industry now. The first is learning outcomes. Providers like Lexia and Rosetta Stone are increasingly being asked to demonstrate the efficacy of the programs that they are providing to students in schools, to demonstrate and prove the fact that we actually have an impact on student performance. We've been doing research in schools since the 1980s. We can demonstrate the impact we have. Doing that kind of research with control and treatment groups, randomized samples, pre-testing and post-testing, that's not an easy thing to do. It's a competitive advantage for us and a real barrier to entry for others.

There is also an increasing acceptance of blended learning solutions which we'll talk about extensively today. Blended learning solutions, as John talked about this morning, that provide educators with the data they need to inform instruction and provide the students with the ability to practice those skills independently. Schools are embracing that because they are seeing that it works. It makes students more productive, and it gives teachers the ability to serve a broader range of students. Again, that's been what we have been doing since the 1980s, long before the terms "blended" or "personalized" were terms that were used in education. You have to understand how to build those products. Again, competitive advantage for us and a barrier to entry for others, a sustainable advantage.

There is also now greater use and acceptance of technology in schools, partly due to federal subsidies like the E-Rate program; schools are now wired to use digital content, to have access to online educational tools. Why do we believe that we are so well-positioned in this industry to continue the growth we've seen? In one word, it's because of results. Results we see in literacy performance in students that were working with, results that are significant and lasting. Let me talk about those results a little bit. First of all, those results are supported by independent, peer-reviewed research and scientific journals. Published research that now spans decades, outcome studies that show the effectiveness of our program, from kindergarten through 12th grade, outcome studies that prove the effectiveness of our program with students who have low vocabulary, who struggle with poverty, who have language-based learning disabilities, who are merging English language learners.

We also see the strength of our impact from independent organizations like LEAP, working in Chicago public schools. LEAP is a Gates-funded non-profit organization that identifies the best tools in education, helps schools pilot those tools and validates the effectiveness of them. We've been working with LEAP for over five years now, and last year LEAP published a report from the 2015-16 school year that showed at-risk students gaining 11 additional percentile points compared with typical comparison group, that's using an independent measure. That's moving students from the 50th percentile to the 61st percentile in one year. That's incredible progress in just 12 months. We also see our impact being supported at the state level, whereas Tom mentioned this morning, we've been working across the state and the state hired independent evaluator to look at the impact that we were having and other providers in the state were having, looked at, with Lexia, 60,000 students from kindergarten through third grade, over a 194 schools and found that at the end of the year, 90% of those students who met usage targets, used the software as prescribed, were reading at or above grade level. That led the state to approve Core5 as the only program to be used site-wide across all elementary school grades.

We also see results play out on a national basis. The 2017-18 school year, we looked at it over a 136,000 students, 136,000 students who were at risk of reading failure. At the end of the year, 67% of the students gained two years or more in the skills they were working on. Obviously our programs work. We've been at the intersection of technology and literacy now for over three decades and up until recently, we're focused on the elementary school market, helping those students from kindergarten through sixth grade acquire the foundational skills they needed to succeed. What we see in Core5 has set the standard for adapted blended learning in schools and just last week, one of the most respected journals in educational technology announced their 2018 Readers Choice award. We were voted the top overall technology, the best reading program, the favorite adaptive personalized learning tool, top educational game and the top

technology adopted in the last 12 months. In fact, we beat out Apple and Google as the top overall technology.

We've taken what we've learned over three decades, what you see in the Core5 product, and have invested in building now a comprehensive portfolio from kindergarten through 12th grade of assessment and curriculum solutions. First of all, we launched Lexia Rapid Assessment, that computer adaptive assessment from kindergarten through 12th grade in partnership with the Florida center for reading research which is part of Florida State University, one of the most pre-eminent research institutions looking at reading in this country if not the world. Just this last year, we launched PowerUp literacy for those non-proficient readers in middle schools and high schools, non-proficient readers who haven't had the kind of support they need to be successful, and all of those products sit on top of MyLexia, the data management and resource hub that educators need in order to hold themselves accountable, and inform instruction. Whether you're in the classroom, an administrator at the school level or at the district level, MyLexia gives you the right information at the right time to make sure that your students are progressing.

We wrap those products with services. A team of professionals who go out into schools and make sure those programs are implemented with fidelity. We also have a suite of online services that give teachers the ability to make sure they understand the data and understand how to support their students using this technology.

We've invested in two things over the past few years to continue to drive our growth, increasing our total market and making sure we have the distribution to scale, expanding our K-12 portfolio and building a national direct sales-force. In 2015, we launched Core5 version 2. That was the first big release since we introduced our flagship product in 2013. We also began the transition to a direct sales team. In 2016, we launched Rapid, that computer adaptive assessment for kindergarten through 12th grade, and we began to build that national team. In 2017, we enhanced Lexia as the data and reporting hub for educators, continuing to improve the simplicity of the data and make sure that that data provided teachers with clear action plans on how to help students. That same year, we added support services to our sales team to make sure that they actually had the time to do what they did best, building relationships, managing opportunities and closing business. Then this past year, we launched PowerUp. Again, PowerUp for middle schools and high schools and those non-sufficient readers, two-thirds of students who weren't reading at a proficient level yet. At the same time, we added a national strategic sales team. A team that's focused on bigger districts and bigger opportunities while we continue to expand our sales force.

What other evidence do we have that our investments are actually starting to pay off? The first is looking at the number of customers who are using more than one of our products. Using more than one of our products means we're deepening our relationship with our customers. It also means we're driving the lifetime value of our customers. Since the beginning of the year, the number of customers who have more than one product in their district has increased by 500%, from about 131 schools in January to now almost 800 schools.

Let me give you two examples of how our growth strategy is playing out in states across the country. The first is in a large urban district in Wisconsin and shows the effectiveness and power of our ability to land in a district, begin working with them, show them the power of our programs through the impact we're having with their students and then expand over time. In the first year, this district purchased two unlimited site licenses with implementation service. An unlimited site license allows the school building to give access to our program to all the students in the building. It allows them to embed our program in their core curriculum. By the third year, that district expanded to 15 Core5 unlimited licenses. Again, coming back and asking us to partner with them by purchasing services. By Year 5, they added PowerUp to what they were doing in their middle schools and high schools and now have 34 unlimited site licenses which made up about a \$300,000 a year annual contract value.

Now, that land and expand model has played out across districts throughout the country but given our K-12 product portfolio now and our sales capability, we also see the ability to help districts immediately. I'm going to give you an example from a large district in New York, whereas the result of ongoing challenges with their students' literacy performance and an RFP that we submitted, they saw an opportunity, an opportunity to make a difference immediately with their students. They chose to purchase 48 unlimited site licenses from the very beginning. Partnered with us in implementation services and that is \$446,000 annual contract value. Our ability now to make a difference in that district this year is immense.

We've talked about the power of our product portfolio and we've talked about our expanding sales capability. We're now in the hands of about 9% of students across the country. We've got good momentum and a footprint. Those 9% of students exists in about 14% of the nation's schools and those schools exist in about 22% of the districts. Now, obviously, we have a lot of room to expand in districts we're not in yet; about 78% of the districts across the country, don't have our products yet. But when you look at the footprint we have, the relationships we have in districts today, we have the ability to expand within our current customer base. We have the ability to come into a district, work with them, show them the data about how their students are performing using our program and then expand to the rest of the district, the rest of the schools in that district. The schools and students in those districts represent 41% of the schools nationwide and 46% of the students. Clearly, a lot of room to expand in the districts where we already have relationships.

Our mission is to continue to reach as many students and schools as possible, to drive the kind of literacy performance we know is possible through the research we've done. We're focused on that mission. We're focused on a formula that we call efficacy times scale equals impact. But we also don't forget about the individual needs of students that we work with. Let me share with you what that experience looks like through the eyes of one of our students.

Luka:

Hi, my name is Luka (phon). I love Lexia. I have completed level 1, level 2, level 3, level 4 and I'm well on my way at level 5. Lexia has improvement my reading skills. At the beginning of the year, I was reading at very low levels. Now, I'm reading up to fifth grade books and I'm in third grade. Thanks, Lexia.

Nick Gaehde:

Clearly, we are building more than literacy skills, we are building confidence, and we are building opportunity. I'd like to now ask Dr. Liz Brooke, our Chief Learning Officer, who'll talk about the power of Adapted and Blended Learning, to join me. As Chief Learning Officer for Lexia, Liz sets the educational vision, develops the pedagogical approach for the Company, and she establishes the research and efficacy strategy for our products. Prior to joining Lexia in 2010, Liz worked as the Director of Intervention for the Florida Center for Reading Research. She also served as a speech and language pathologist at Mass General Hospital and public school settings, and before that, began her career in the classroom as a first grade teacher and student. Welcome, Liz.

Liz Brooke:

Thank you, Nick. Good morning, everyone, and that's really what it's all about, right? Hearing from the students and meeting them where they are, and accelerating their learning and making them confident in their skills. How do we do that? Through Personalized Adaptive Blended Learning. Now, John gave you a great analogy this morning with tennis, I'm going to give you a little bit more of the official definition and dive a little deeper into the research and how we do it in Core5.

Michael Horn, who you will hear from shortly, and his colleagues, provided this three-part definition. I'm going to go over it briefly here because you'll hear from the expert himself later, but it's really three components. There is an online component where the students, or the learners, if they're adults, have a choice of pace, path and time. It increases motivation when they're in control of where they're going. The second piece in this model, we're talking about a school model, so I'll use a teacher, that a teacher needs to do some in-person teaching. Now, the last step of this definition is really critical and that is about the data. The data connects the online with the offline. As John used his example, that wall would actually adapt and adjust based on how he was hitting the ball, and then his tennis pro would know exactly what to focus on. In Core5, we have assessment without testing. This is our patented technology where we predict future performance and we prescribe instructional intensity. Let's take a look at the Core5 Blended Learning model.

When you think about that three-part definition that I just shared with you, you see three parts in this model. That's not by accident. You have in the upper right-hand corner there, that's the online portion where the students have their own selection, they select which activities they're going to work on, they go into their own path. On the left hand side here, you see the targeted instructional resources that we provide for that teacher. But again, that critical piece in the middle is through MyLexia which Nick explained, as our data dashboard, is going to give the teacher exactly what skills the student is struggling with online, and then we're not only going to do that, but we're going to provide them with the resources they need to deliver that lesson. When we think about this—and you also see those arrows, this is an ongoing process. You're constantly learning, we're constantly adapting that pathway for you, and in this room, we would probably have over 50 different profiles that we need to adapt to.

How do we use the technology and the data to help a classroom teacher address all the needs of his or her students? Well, let's take a look at how we do that in our online software. The students come into this first step here, the standard step, and that is basically saying, "Can you do this grade level skill?" If you can do that grade level skill to 90% or 100% mastery, we're going to move you on. We don't want to waste your time with something you can already do. What we will do is provide you with some offline materials where you can practice. Think about that as extra hitting against the wall so that you get really good at that form. If they can't do that, automatically, the software is going to branch them down to guided practice, and we're going to provide something called scaffolding. Now when you think about scaffolding on a building, it's really there to support the building as it's being built, right? The same thing is true in terms of teaching someone to read.

In this case, this is a multiple meanings activity, we're taking away some of the choices or maybe explaining the directions again for them, and if they still can't do that activity online, we're going to branch them one more time and we're actually going to give them explicit instruction on what is the multiple meaning word, that words can actually have two meanings. You see there we take away the background, the distractions. If they continue to struggle, we're going to provide a lesson. We're going to alert the teacher that this student is struggling and he or she needs to step in to give additional instructions. This is where the tennis pro analogy would come in, in this case, multiple meanings, but for example, it could be a serve that the pro is going to spend that precious half hour instead of working on something you already know how to do.

Let's see what that looks like in the data. This is where the classroom teacher lands. There's a lot of numbers here. If you have time to dive into the data, which some teachers do, but if you don't, if you only have two to three minutes, you're going to quick come in here and check out that red square at the top. This is my to-do list as a teacher. We all know that teachers are trying to do a lot of things. We need to help them be really targeted and time efficient. The first piece here tells me how many students need more time on the computer. Because as I mentioned with our assessment without testing, we're not only going to predict future performance but we're going to prescribe that instructional use on the computer. The second tab is who's struggling and needs more time with me, the teacher? Okay, and I'll talk about

that in a minute. The third tab tells me who has those practice activities where they can build up their automaticity, become more automatic with that skill. Finally, most importantly, who has a certificate to celebrate success? Because we want to make sure that we're celebrating success for these students.

Let's look at the tab if I wanted to see who needs more time with me, the teacher. What you'll see here, it's probably hard to see here in the room, but the top two students are both struggling on beginning sounds. I know I can pull those two students and I can give them a quick lesson on beginning sounds. The bottom three are struggling on spatial concepts and prepositional phrases. The best part is I don't have to say, okay, what do I know about teaching spatial concepts or what word list am I going to do for beginning sounds? All I do is click on the name of the lesson, and then up pops the PDF right there, no hunting around and I can deliver that lesson. Again, thinking about that circular integrated model, the three steps of the blending model, it's a really powerful piece when you have the right data at the right time.

You might be saying, "But do you have any research specifically about this approach where the teacher is engaged and you're using that blended model?" Well, the answer is yes. We actually have—it's one of the largest studies looking at both teacher engagement and a blended learning model. We looked at over 760 schools, and what this was looking at was three months before a contest that was designed to engage teachers and then three months during the contest. What did we find out? Well, that when teachers have the right data, the right time, they're more likely to be engaged. How does that translate to the students? When teachers are engaged, more students are meeting those usage targets. What does meeting those usage targets mean? It means that they're five times more likely than their peers to reach the end-of-year grade level benchmark. What do those benchmarks in Core5 mean? It means that when they reach that benchmark, they're more likely to be successful on those outside measures. Like the state assessments, on the NEP assessments like Nick talked about, the Nations report cards. It's not only progress in Core5 and that's why schools are seeing the results, not just in Core5 but on outside measures.

Now this is a lot of research and statistics and numbers. Let's hear from teachers and students themselves. This is a large urban districts in Massachusetts, and they're going to share with you how they use Lexia and the data in their school.

Female Speaker:

My children absolutely love Lexia, and the more and more they practice, the stronger their brain gets. They see my enthusiasm for the program. "It's time for Lexia," and they're all excited and who's going to beat their level today or who's going to unlock the second-half? The students are really motivated and they want to do it.

Male Speaker:

Most students get excited about the program, knowing that they have varied assignments or different challenges awaiting them. Any time you take today's learners and allow them to use a computer program that is exciting to use, and more importantly, gauges many different types of reading skills, works well to get the children prepared.

Female Speaker:

I started to use it like a lot, I was a little obsessive there.

Female Speaker:

With Lexia, (inaudible).

Female Speaker:

When I've been using the data this year, it's been motivating them to try harder. It hasn't been negatively affecting them at all. It's making them try harder and harder to get where they need to go.

Male Speaker:

One time, I went down on a reading test by 5 points, but then I did more Lexia at home and then I went up by 35 points.

Female Speaker:

I think this year I've seen a difference with sharing the data with them. We, as a kindergarten team, started implementing these motivational things in our classroom to show and share with each other where the kids are, what level they are in Lexia.

Male Speaker:

It makes it very clear to them where their weaknesses are and where their strengths are.

Female Speaker:

It's just fun with all the different places you could go within education levels.

Female Speaker:

Level seven, second half, two more badges to go to level eight.

Female Speaker:

The kids are actually making the connections that it's not just a separate program. What they're using in Lexia and what they're practicing and the skills that they're gaining is used in multiple facets in their life, actually, that they'll see it when they're at home, they may see AR on a box of cereal, they may see the silent E and they'll learn about long and short vowel sounds. It's really a great, great program.

Male Speaker:

When a student finishes a level, there's a printable certificate that is printed and handed to the student and a large deal is made in front of the classroom.

Male Speaker:

When I get it, it says in the thing I passed it. It says great job and it says the level I passed in Lexia.

Male Speaker:

When I go home, I show my mom, so they get really excited when I pass a level.

Female Speaker:

Every Friday, I print out the certificates for the week, present it to the students as a presentation in the classroom, and I take a picture of all the students that moved or received a certificate. Then I tweet that picture on Twitter and the parents love to see it, and the kids love to see themselves in media.

Male Speaker:

When I started kindergarten, I couldn't read anything, but when I got to level seven, I could read everything.

Liz Brooke:

Again, that's what it's all about. Just like with this student who is reading fifth-grade level, even though he was a third-grader, these teachers, and you could hear, even in kindergarten, they begin to engage the students and the data. They celebrate success and all of those students from different levels, even though they potentially are in the same classroom. It really is that personalized adaptive approach.

I believe our special guest has arrived. New York traffic. But I'm going to ask Michael Horn to come up and join me. As John said, Michael is the Co-Founder of the Christensen Institute. He's also the Chief Strategy Officer of Entangled Solutions, which offers innovation services for higher education, and he is the author and co-author of many, many books and white papers, including the bestseller on Amazon that you have in your bags, *Blended*. We are going to hear from the expert himself, Michael Horn.

Well, thank you so much for joining us this morning, Michael. You really are an expert in the blended learning field and we've been talking here this morning, especially around K-12 and blended learning. As technology has risen in use in education, there really seems to be two camps of thought in terms of, one, that people feel like technology can replace the teacher and really solve all the problems that teachers haven't been able to, and then there's the camp that says technology is always going to be inferior and it really is never going to be able to do what a human can do. Where do you fall in those camps of thought?

Michael Horn:

Yes. Well, first of all, thanks so much for having me here. I would say this classic false dichotomy of where you have canceled both sides, as you accurately described. What I think the other industries have realized over time, in terms of K-12 education and then higher education, is that you can't do a system that's all virtual and all just AI, making decisions and programming kids like they're robots. You can't just rely on the fact that a teacher can reach all 30 students, and there's a lot of evidence for this from industry more generally.

If you look back to the advent of Deep Blue and IBM's first experiment of beating Gary Kasparov in chess, they saw that, yes, you could design a computer that can beat the world's expert in chess, right? But the real magic happened when you had complementarity, right? You took amateur chess players, who had average skill levels, you pair them with Deep Blue and the power was actually unbelievably amazing and that it can beat anyone. Even just Deep Blue in terms of chess and what I think you take away from that is there are certain things that human beings can do that computers aren't replicating and they are not likely to replicate anytime soon, if at all. The real idea, the real magic is to let machines and computers do what they can uniquely do well, to free up human beings to spend time on those things that only human beings can do well.

That's what I think we've seen, language learning spaces catching up on this, but I think K-12 and higher education, it seems, for a long time that if you can use technology to really—it turns out that practicing something 50 times sometimes is really important. Computers are a lot more patient in doing that than as a human being or teacher. By the same token, computer's not going to offer you the emotional

encouragement you needed at a certain point of learning and that social support and so forth, and having a teacher see that or say, "The reason you're not getting this is not because it's something that the computer thinks is wrong, but it's something in my intuition, my expert intuition, that I can see is going on here, and I can help you remediate that." Being able to unlock the power of both is just a much more potent combination.

Liz Brooke:

Right, and that really is the power of blended learning. Now, I know in both at the Christensen Institute, in a lot of your books, you talk about the disruptive power of blended learning. Can you talk a little bit about—because disruptive doesn't always has a positive connotation, but I think in this case it does. Can you talk a little bit about that?

Michael Horn:

Yes. I mean, disruptive innovation, I'm sure many of you are familiar with the concept. I obviously read *Disrupting Class*, Clayton Christensen, the father of disruptive innovation theory and I would say it's widely misused by people, particularly in Silicon Valley. But it basically means an innovation that comes along that is simpler, more affordable, more accessible than the products and services that dominate at the time, which are characterized by things that are complicated, expensive, deeply centralized and inaccessible.

The way I think about, in terms of blended learning and online learning more generally, is that for a long time, we've known in human history that the best learning experience you could possibly provide is an extraordinarily small group or a one-on-one learning experience, a tutor-like experience. The problem is, a tutor-like experience that can personalize and so forth for exactly your needs, whether those are knowledge based or social and emotional and so forth, is just out of reach for most of us. We just can't afford enough tutors to possibly extend that to every single child in this country or any learner, period. The wealthy have access to it but most of us haven't. What blended learning or online learning does is allow us to have the power of a tutor for every single child. That's pretty exciting and from my standpoint, it started as this pure online learning play.

I think a lot of people thought it would be purely technology and that, then very quickly what we realized is human beings are really important. By the way, in the case of K-12 students specifically, the video you just shared shows this, having a safe place to go with nurturing adults is really, really important. As blended learning has been improving itself, or rather, every disruptive innovation, the other feature is that it starts out as primitive and the market leaders dismiss it as not very good and it will never amount to anything. But what they don't count on is that disruptive innovations improve predictably and reliably year-over-year-over-year. I think blended learning is the way online learning has been improving itself. It's realized it has to snap in human and brick-and-mortar components to be able to solve where the majority, in the case of K-12, the majority of K-12 learners always will be, in my opinion, in schooling environments and we're seeing it in higher education, quite frankly, right now too.

Companies are partnering with places like WeWork to be able to give access to purely virtual learners in the past and give them access to these community-based human touch environments and I think that's the bigger a-ha, is that online learning is great. But actually, it doesn't do everything and the way to improve it is to snap in these human and brick-and-mortar components.

Liz Brooke:

Great, thank you. When we're thinking about outcomes, because we've talked a lot about the research and the outcomes that we've driven with Core5 and with our other products.

Michael Horn:

Yes.

Liz Brooke:

When you think about outcomes specifically for blended learning, what examples do you have already and what examples do you feel like it can drive in the future?

Michael Horn:

There's two ways to do it, right? One is to look at the extensive research and the power of personalization already and so, we already have lots of research dating back to Benjamin Bloom studies about power of a tutor where he basically said, "You can improve learner two standard deviations within their peer group." I think most of the research suggests that's an exaggeration now, that more somewhere between 0.7 and the standard deviation is the power of tutoring and then there has been extensive research that showed cognitive tutors in the form of machines can produce almost as good as those results as well. That's a good theory basis for the belief behind blended learning.

On top of that, you have this notion of mastery-based or competency-based learning. Basically, the sense that students shouldn't move on just because it's a new day, they should move on as they actually demonstrate progress and learn and that's what Lexia does. It's that as you master concepts, you make progress through the software, not an arbitrary date of the calendar. There's extensive research, John Hattie's research, shows that mastery-based learning has something like nearly 0.6 of an effect size in terms of standard deviation. Yet another powerful thing. Then you're starting to see proof points in action.

You already showed some of the research on Lexia's, so I won't go over that, but I think that's actually a pretty big part of this case, so I don't want to look past it. But there's also been Department of Education studies at this point that have shown, actually, online learning performs similarly to face-to-face learning and the best of all worlds is blended learning. There was a meta-analysis that they released probably eight years ago, at this point. They've done one of the most robust studies that the Department of Education did. They've looked at math intervention that was blended learning and got phenomenal results that can really close a lot of the achievement gaps through blended learning. We've had RAN (phon) studies that the Gates Foundation was funded that haven't been conclusive, but they've shown really promising parts of blended learning and then I guess the last thing I'd say is, the individual proof points that I've seen are extraordinarily compelling. I always go back to the school that opened up in Los Angeles, California in 2010 and its budget cuts, they can only afford four teachers instead of five, were forced to go to a blended learning design. That meant larger class sizes; 30 to one instead of 20 to one as they had planned. They implemented this blended learning design and because the blended learning enabled them to have small group construction with the teacher, it unleashed huge growth and they could use the data, right?

Liz Brooke:

Yes.

Michael Horn:

To inform what the teacher did with each of those groups and she could change the groups constantly. What was fascinating about it was the school, serving over 90% free and reduced lunch students, which is the margin of poverty in this country for education, and 98% or 99% racial minorities, at that time,

California scored its schools on a zero to 1,000 scale, the academic performance index, and if you got an 800, you were just knocking it out of the pack. The school got a 991, which I think it was the third best elementary school in the State with that sort of a population. It's pretty powerful. Now, the caveat is, just because you're doing blended learning doesn't mean it's good.

Liz Brooke:

Right.

Michael Horn:

The software, the content, really does matter and the instructional practice of how you orchestrate that, the teacher orchestrates, that is really important too. Blended learning isn't inherently good, but when you put those things together, the impact can be much more significant than anything we've ever seen in the school environment.

Liz Brooke:

Yes, and that's so exciting. A lot of those words, standard deviation, effect size and all of that, but those students that Michael is talking about are historically what we see on the NATE scores, are flat lining, and so to have them move chunks like with the LEAP study like where Nick said they moved 11 percentile points, that is the power and again, I think the key is that the right data, connected with the instructional practices and the adaptive online portion as well.

Michael Horn:

Yes.

Liz Brooke:

One final question for you this morning. We've been talking, again, this morning about really focusing on the success we've seen with blended learning in the classroom. John mentioned in his keynote about classroom to the cloud. What do you see? Do you see blended learning being able to be successful on the cloud? If so, what components need to be in place to see that success?

Michael Horn:

Yes, so the answer is yes, I do. I think the big a-ha, right, is if you can wrap your hands around the entire experience. We've seen this in lots of industries, when there is a new nascent technology and service. The key is to be able to integrate across the different interfaces. Meaning, to be able to control the software experience and the human experience and allow those to trade off each other in a dynamic fashion. To knit those experiences together in a very integrated, thoughtful, intentional way, I think it can be pretty transformational because you can use the data, right, to say, when is the technology going to produce the outsized gains and when is introducing a human component to this going to help unlock learning for the students.

Just really quickly in my simple conception of this, language learning software I think is great particularly for a novice learner because there's no fear of embarrassment when you're practicing. You can make all the mispronunciations and as you know, my wife is Korean and I tried to impress her by learning Korean and it didn't go well when she heard me because she was laughing at me. But when I was able to practice with software, it's non-judgemental, it's just, hey, this is what you need to work on. That was actually pretty important for me to be able to make some progress.

By the same token, the software is not going to give you the encouragement and the social emotional support that you need so keep going in your journey and understand the intrinsic and extrinsic motivation and so forth. Being able to bring in the human element, also for, frankly, languages for conversation. The computer might do a very expected thing over time; it's not going to have a dynamic conversation in the way humans will do with all the imperfections that that implies. Being able to actually port it into the real world and have those interactions I think is really important as well. You can imagine the human being helping with social emotional aspects, the real life application aspects, but also the academic pieces of the software is just not going to pick up for whatever reason and so, being able to have that alongside of the great adaptive software with great content that is an incredibly active learning experience and using the data to knit those two things together, I think is incredibly compelling and for all those who are having the fights right now, we're just software, we're just humans? The combination goes back to the complementary principal. I think it can blow language learning out of the water.

Liz Brooke:

Yes, great. Well, we're happy to hear you say that because we agree and that's a great transition about conversations because we're going to now switch to give you a little sneak peak of our product that we're designing for our K-12 EL Learners. But I want to thank Michael very much for his expertise and conversation this morning, we really appreciate you being here.

Michael Horn:

Thanks for having me.

Nick Gaehde:

Thank you, Michael and Liz, for terrific conversation about the power of adapted blended learning. What I'd like to do now is switch gears a little bit and as Liz said, give you a glimpse into the future and something that we're very excited about. When you think about the power of adapted blended learning and you think about the experience we've had building these products and working with schools across the country, we see an opportunity to serve a broader need and that broader need is working with emerging bilinguals, or English language learners. It's the fastest-growing population in the country when it comes to K-12 enrollment.

In, I think it was 2014—no, 2016, about 9% of the student population were English language learners. National Center for Educational Statistics predicting that by the year 2025, that's going to be 25% of the population, so you can see how quickly that market and that student population is growing. It's a market that we actually serve today, a market that we serve in our language business, with our suite of products that help students acquire those language skills they need to be part of their community and they need to be able to function in the school system. We also serve those students in our literacy business, helping them build the foundational reading skills they need to be successful. It's a place that we believe we can make a difference. How big is the opportunity to bring the adapted blended learning solution to these students? When you look at the industry today, or in the 2013-2014 school years, about \$3 billion of total spending and it's predicted to grow at about a 9% compound annual growth rate so that by 2020-2021, it will be about a \$5.6 billion spend.

Now, that's still primarily being serviced by print providers. But digital products are starting to emerge and what we've seen in K-12, is that once teachers and school system see the power of digital products and especially blended learning products, they move very quickly, that market emerges very quickly. It's a market that is ripe for disruption.

Why do we believe we have an advantage in this market? First of all, as I said, it's a market we already serve. We have deep relationships with school systems that are eager to continue to work with us and are also eager for a more comprehensive solution, a solution that can drive student performance. It's a market that today is being served by a large number of print providers, very fragmented, so that moderate buyer power and moderate supplier power exists. Again, giving us an opportunity to come in and be a leader in this space.

What are some of the perspectives that both the buyers, the users, and learners bring? First of all, when you think about a district, when you think about a district that's considering what they need to do to move those students forward, they're thinking about the diverse needs of this population and the diversity in that population. They're thinking about how they bring that curriculum to address the needs of English language learners and integrate it with the rest of their English language arts curriculum. They're thinking about what kind of products they can actually support in the school system, how they can integrate it into their technology offerings. At the classroom level, teachers are thinking about, "How do I understand the needs of those English language learners? How do I get the data I need to inform instruction and to move those students forward?"

I'd like to ask Liz to come back up and share the learner perspective.

Liz Brooke:

Thanks, Nick. I think when you think about this population, think about the learner's needs, there are a few pieces, and Michael touched upon one of them. That is a safe environment for them to learn. They're coming in at different age levels, different language proficiencies. They want something that is engaging, that's going to meet them at their needs. Then, it's going to give them that support, and allow them to monitor their own progress and grow, and be with their peers, that relatedness to their peers. It's really powerful when you think about the needs of the classroom and the teacher trying to meet all of those diverse needs, but thinking about that individual student, and where he or she needs to go on their path of learning.

Nick Gaehde:

We're going to give you a glimpse now, a view into our plans for K-6 adaptive blended learning solutions for emerging bilinguals. Just this past year, we brought in two visionaries who are already working on EL learning methodologies and pedagogy. We built a team around them to execute on this vision. Currently, this new program is being developed with expertise from across the country, across the Company, expertise in language and expertise in literacy and assets, both technology and content from all of our businesses. We're going to share a glimpse into that product right now.

Liz Brooke:

Just before we do, I want to give you four guiding principles, because, again, we were thinking about this from the learner perspective in terms of that culturally responsive pedagogy and teaching. We used four main guiding principles. One is that we were going to acknowledge and celebrate content and cultures. We're not only going to include content and cultures around English, but around the top languages outside of English spoken in the U.S. The second piece is that we're going to celebrate their heritage language as an asset. We're going to talk about these learners as emerging bilinguals. They're not starting with a deficit. They are starting with an asset of first language. The third piece was that connection to home and encouraging the home language, still spoken, but how to weave in the English as well. Then, fourth and final, which is really crucial in today's learning and especially with language learning, is a growth mindset in terms of acknowledging that this is going to be challenging, but supporting them in their errors, and supporting them to try again until they succeed and provide that

scaffolding, but that's all really official language. I'm going to let Sofia and Marcus tell you about it in a much more exciting and engaging way.

Sofia:

Hey, Marcus. Have you heard Rosetta Stone are making a new program for EL students?

Marcus:

Oh, no. EL? What does EL mean?

Sofia:

EL stands for English Learners. It's a brand new program designed for students from kindergarten right through to the sixth grade, regardless of their English ability.

Marcus:

Really? How are they going to help so many different kids with just one program?

Sofia:

By using some clever science called personalized, adaptive, and blended learning, which automatically adjusts the program to an individual student's needs.

Marcus:

Wow, Sofia, that sounds pretty neat.

Sofia:

It sure is. Another thing that makes it even more special is that this program is all about conversations.

Marcus:

Conversations?

Sofia:

Exactly. Rosetta Stone are busy creating a series of virtual characters that the students can interact with.

Marcus:

You mean like us? Are we going to be in the program?

Sofia:

Sure. They might be like us or like some of the characters you saw on the slide. But what I do know is that the characters will be representing kids from all around the world.

Marcus:

That's such a great idea. It will be so much fun to learn along with someone that looks and talks like me, a virtual friend that helps me with my learning.

Sofia:

I know, right? As well as familiar looking characters, there'll be some super cool features to track student progress. It's really going to boost their confidence and help them engage more with their schoolwork and their classroom friends.

Marcus:

Aw, that's really great, Sofia. Well, if the characters won't look like us, why are we here?

Sofia:

We're here to show how awesome the Rosetta Stone animation engineers are handling advanced 3D graphics and how it can easily render realistic talking characters.

Marcus:

Sweet. Hey, Sofia, you said it was going to be blended learning. What does that mean?

Sofia:

Oh, blended means it'll have an online part that the students use and an offline part that the teacher delivers, but both parts are connected with some cool data.

Marcus:

How does that help the kids?

Sofia:

Well, the teachers will know exactly where the students are struggling in the online part. Then, Rosetta Stone is going to provide the teacher's with some great resources like lesson plans, so they'll know how to fix up any skill gaps, either one-on-one or with a small group of students.

Marcus:

Wow. This sounds like one wickedly powerful program. Can we use it yet?

Sofia:

No, not just yet. Making something this amazing takes time and a bunch of super talented people. (Inaudible) which must fit in with state standards. Then, the virtual characters will need to learn to listen to the kids using the Rosetta Stone speech recognition engine. Then, it needs to be tested with real students and teachers and then it needs to be—

Marcus:

Okay, okay. But when can I see it?

Sofia:

Well, I've heard it's going to be ready for schools around summer 2020.

Marcus:

Okay. That sounds cool. What's the name of this amazing program, Sofia?

Sofia:

Patience, Marcus. You'll just have to wait and see.

Marcus:

Okay. But it won't be easy.

Nick Gaehde:

Thank you, Sophia and Marcus. Hopefully, you can see why we are so excited about what we're working on. What makes this possible is a combination of our own animation engine and our speech recognition technology. These are both significant assets to the Company. Unlike any other animation engine—I'm going to leave it there for a minute. Unlike any other animation engine, this animation engine was designed specifically for the needs of literacy and language learning. It was specifically designed for K-12 schools. When you think about a lot of animation engines, they're designed for the gaming world and high-end devices. With this animation engine allows us to do is deliver that kind of engagement through low-end devices and low-bandwidth environments that you see in schools today. It's a real game changer in educational technology and schools.

What you also saw was an example of real-time lip-syncing, which is really important, just ask a speech language pathologist for students who are learning to speak and learning to read. This is an investment that is incremental to the guidance that we provided before, but an investment we believe has enormous potential, given the size of the market, the growth of the market, and the expertise that we bring to it. I hope you can see the significance of what we're working on and what a game changer it is in schools.

As John said earlier today, given where we are, given the momentum we have, and given the investments we're making, we can be much more. We gave you a glimpse into what we're working on to meet the needs of English language learners. John talked about the ability for us as a Company to bring together the expertise of language and literacy under K-12. Today in K-12, we have literacy business that's growing about 25% a year. We have a full literacy suite of products that we talked about this morning, and about 45 salespeople who are working across the country with schools and school districts. On the language side, we have a suite of products to help English language learners and students who are learning world languages. We have about 25 salespeople with deep relationships in those schools and long tenure with the Company.

Our vision is that by 2020, we can bring world-class literacy and language together and build a suite of products, not only to address literacy skills but emerging language skills, with 75 highly productive salespeople and a world-class customer success team. Then when we combined literacy and EL with the high-retention rates we've seen, we're so well positioned to be a leader in this industry, to truly be the experts in literacy and language education for K-12. I'd like to now stop and ask Liz to come up, and see if we have questions. I know we've covered a lot this morning. Yes?

Male speaker:

Who is providing that kind of product today?

Nick Gaehde:

Who is providing that kind of product today? That kind of product in K-12 schools, I'm pretty confident in saying nobody. Nobody with the kind of engagement you saw, with the kind of animation engagement for low-end devices and speech recognition technology.

Male Speaker:

Then, just where do they get the funding from? What is it? The same buckets of dollars that you're getting today?

Nick Gaehde:

There are specific funding sources for EL funding in school districts. Some of that is coming from the federal landscape, and some of it's coming from state and local. We are tapping into that funding today, both in our language business and our literacy business.

Male Speaker:

Can you size what this investment is?

Nick Gaehde:

We are not giving guidance at this point on specific investments at that level, Steve.

Male Speaker:

How quickly do you think this scales up and gets introduced in 2020? Do you think you have leverage now in selling multiple products that could give this a faster start than Core5, for example, had?

Nick Gaehde:

I do. I think there are two things that are going to allow us to drive momentum in 2020. One, as I said before, is the fact that we already have relationships with these schools and school districts, both from the language side and on the literacy side and we have customers using our current Language products. If we see an opportunity to transition those customers to the new products, we also know with our 75 salespeople across the country and with the capabilities we now have working at the district level, that we can drive that kind of momentum much faster than we did, for instance, with Core5. We're seeing that this year with PowerUp and the kind of quick growth we've seen in just the first six months.

Male Speaker:

Okay. If you could clarify a couple of things I heard this morning, I heard two different numbers in how many schools you serve. How many schools does the literacy business itself serve today?

Nick Gaehde:

In the U.S., we serve over 13,000 schools. We've got another approximately 3,000 schools outside of the U.S.

Male Speaker:

What do you think it takes to get that to close to half the market?

Nick Gaehde:

As I shared with you, when we looked at the market penetration in terms of the footprint we already have, if we simply worked with the customers that we currently have, the district level customers, that's about 46% of population and about 41% of schools. If those schools simply purchased an unlimited site license and a basic set of services, that's about \$287,000 a year in contract—\$287 million a year in annual contract value. That's just within our current customer base. Other questions? Yes?

Male Speaker:

I guess it's a question regarding the product's ability to sort of sell itself once it's established within a district. It would seem almost as if a school has to have it if they're underperforming other schools. Could you comment on that?

Nick Gaehde:

Sure. One of the most powerful advertising mechanisms in K-12 is actually the peer effect; teachers talking to teachers, principals talking to principals. The power of that is enormous, but what we add to it is the ability to point to data in the school that we're working with, to point to the kind of performance gains those students are making in that district, and then to bring it to the district level, and to spread it out throughout the district.

Male Speaker:

Is there a timeframe that they use, and do you have a sense of the timeframe when that usually starts to occur in a district?

Nick Gaehde:

It happens anywhere from three months to six months. What's been really fantastic to see is the power of our research department and partnering with our sales teams. Within a very short window of time, we can provide data on how students are actually performing compared to their peers. Liz, I don't know whether you want to add to that?

Liz Brooke:

Sure. Again, you saw some of that data where Nick showed the students who were at risk made two-years gain in a full year. We have similar results in just 12 weeks. If they're meeting those usage targets, at least half of the time, they are going to see significant gains in grade level of material, and the power of the district level folks seeing their own students, not some national sample but their very own students, making that progress, it's easy to implement for teachers. That data is really powerful, and it can happen within as short of a time as 12 weeks.

Male Speaker:

Thank you very much.

Nick Gaehde:

Steve?

Steve:

(Inaudible) where you with (inaudible) what does it take you to move (inaudible)?

Nick Gaehde:

Sure. Utah isn't the first state level relationship we've had. A number of years ago, we were also working at the state level in Kansas. What we see is the ability to point to the kinds of results that we're seeing in Utah and bring that to other states. Sometimes those are governor's initiatives, and sometimes those are Department of Education initiatives. Given the evidence we have of being able to drive student performance and to do it at the kind of scale we see in Utah, I think it's making a lot of other states and big districts to take a very close look. What I also talked about was increasing our capacity on the sales side to work at that level. We now have that strategic sales team in place who are focused on those larger opportunities and focused on responding to RFPs across the country. Increasingly, we are seeing, especially at large districts and state levels, that a lot of that business is being driven through RFPs. Again, we've built that capacity over the last two years, and I think are now ready to continue to accelerate that kind of high level business.

Male Speaker:

I understand the product won't be ready for schools until 2020. Will the product be sold with the Lexia name or will it be Rosetta Stone name? Question one; and then question two, maybe you addressed this, but when do you intend to combine the two K-12 sales forces?

Nick Gaehde:

Let me tackle two questions there. One is about what name will that product carry. We haven't made that decision yet. If you think about it, the Rosetta brand is such a strong brand, as we've all talked about, one of the most recognizable brands regardless of industry. The Lexia brand is also very, very powerful in K-12 school. We have some work to do to step back and think about naming of the product and the branding of the product, but we certainly have some fantastic assets and awareness to work with. In terms of the sales force, initially, the product will be represented by our current language team. They are the ones who have relationships with those customers who are currently buying our suite of language products. Then, over time, we will see. I think there's a real opportunity to bring and leverage those two teams, and how we exactly structure those to maximize sales efficiency, we will see. Yes?

Male Speaker:

Yes, wanting to know more about of the sales process. Could you please talk more about the sales process? Is the product sold at the district level and then adopted at the school level or sold at the school level? When you think about moving from 45 to 75, what's your general assessment of what is full critical mass for the sales force to achieve maximum coverage across the country?

Nick Gaehde:

Sure. We sell both at the school level and the district level. I believe that will continue to be our model of bottom-up and top-down selling. It's important to work at the school level to create that buy-in. But it's also, as we know, important from a mission standpoint and a business standpoint, to be working at the

district level. We've seen, in this industry, products fail when they're just sold at the district level and pushed down to the school. You have to have that commitment in school buildings. Our current model, which is selling top-down and bottom-up, I believe is the most powerful. When we think about the size of the sales team, I think back to a study that Parthenon Group did a number of years ago, that talked about national coverage, and they actually talked about being able to cover the country required with a sales force of about 80 people. I think we're right in that range of having the sales team we need to be able to cover the country well. Other questions. Yes?

Male Speaker:

I'm just curious. A lot of the school districts have magnet schools that they're moving forward, and they're supposed to be state of the art. I'm wondering if there have some elements of what you're doing to enhance the learning curve or you just focus on general districts where there's a lot of poor performance. I don't know what the reasons are for the poor performance (inaudible) so I'm trying to understand if that's where your focus is. Do you work with the teachers? Because a lot of them are well paid and the numbers aren't good for the students. I'm trying to understand (inaudible).

Nick Gaehde:

Great question. We talk a lot about public schools in the presentation this morning. Certainly, that is the biggest part of the market. It's also where we have the biggest impact. You think about large urban districts where the literacy proficiency levels are very low. We know we can have the biggest impact there. We know we can help students drive really significant performance gains. But we also work in a lot of charter schools, parochial schools, magnet schools. You asked about in terms of teacher capability is absolutely a challenge, I think, for us to continue to drive performance improvements. I'll ask Liz to comment on that.

Liz Brooke:

Yes. You may have seen in the New York Times last week, the article about, "Teachers don't know how to teach reading", and Nick mentioned, I was a first grade teacher and I was one of those teachers who didn't know how to teach reading. We are constantly working with teachers, providing them with the education and the training as part of our services. Nick mentioned how we wrapped around implementation services. It's critical to make sure teachers understand the why of the program, not just how it works. That's something, at Lexia, we're very focused on because teachers are doing a phenomenal job and they need the tools, including the foundation of how to teach reading, and that's what we provide as part of our services, not only product training, but some of that foundation in how to teach reading.

Nick Gaehde:

In fact, we just launched an online service called Lexia Academy that gives teachers, administrators the ability to, as Liz said, not just understand how to implement the product well, but how to interpret data and how to weave the curriculum into their general ELA curriculum. We believe that kind of online support for teachers, administrators is critical for us to continue to drive the business forward and to make sure that we are actually having an impact in schools.

Liz Brooke:

I think we're up on time, we're getting told. I think it's time for break. It's a 15-minute break, John, is that correct?

John Hass:

Absolutely.

Liz Brooke:

Okay. We will see you all back here around 10:20. Thank you very much.

John Hass:

Okay, we're going to go ahead and get started again. I think we'll have a few more people trickle back in, but we want to keep you on schedule. I'm going to introduce Matt Hulett. Matt is the President of our language businesses. Matt has been with us just over a year now, and during that time, as I think you'll see, he's dramatically transformed our products and the way we go to market. You're going to see some really neat innovation coming up this morning. With that, let me turn it over to Matt.

Matt Hulett:

Thanks, John. Appreciate it. "The limits of my language are the limits of my world." This is one of my favorite quotes about language learning. Language has the ability to create common understanding, to connect us, and in many cases, allow us to achieve our dreams. It's been an exciting, fun and challenging first year for me at Rosetta Stone. Hopefully you leave today with a clear understanding where the business is today and where we're going to take it in the future.

In the beginning of 2018, I really set forth three goals for the business of language. This team is focused on three things and these three themes will actually permeate through today's presentation. One is stabilize the business, two utilize our existing assets, and utilize those existing assets for the third component, growth. Those are the three themes today, but let's break it down.

One is, we've really focused on stabilization around two core businesses in the language group, that's the consumer business and our corporate business in the E&E segment. Those are the two areas that we've really decided to try to provide emphasis on, and you've heard that earlier today from John and Tom. In particular, the Consumer business has done a rapid transition from a business model primarily relying on CD perpetual sales, to now finally 100% pure web consumer business, as well as a mobile subscription business. Both businesses are now up and running, fully SaaS. In fact, I, earlier in the year, mentioned that we're going to move to mobile and make it mobile awesome. Today, you will hear from Greg Spils about some of the new innovations that we're doing in the mobile space.

Second is utilizing our assets. We have phenomenal assets at Rosetta Stone. Most companies would kill to have assets like this. We have the speech recognition technology that's world class, that's designed specifically for language learning. We have assets that includes 7,000 hours of content that range from beginner to advance content. We have an assessment technology that we use in our corporate business that can be utilized for serious English language learners around the world. Finally, we have a tutoring capability that we haven't really talked a lot about yet publicly, but we will today, in terms of how we think about growth.

Lastly, growth. We're going to focus and recast the business today, and you'll hear from Jerry Huang about a new effort that we're doing and have been investing in for the last year, to focus on a larger piece of the language learning space. We're going to go after the \$52 billion offline learning space and you'll be seeing a new technology that we'll be announcing and launching next month in the test market, that will have a new approach to digital language learning that takes the best of expert online instruction via human being, and expert content, all in one package. You will hear today those three themes, and I'm

excited for you to meet the team. Lastly, I couldn't have done this without the team. I came aboard at Rosetta Stone with a fantastic team, but I have also brought together some new faces that provide brand, go-to-market and product experience.

Let's first set the table, this market's large. As I mentioned previously, it's a \$52 billion market; 1.5 billion people in this market are learning English, it's the largest language that's being learned and taught within that \$52 billion. Yet by any measure that you will find, the proficiency and efficacy of these learners in terms of learning English is extremely low, it's extremely painful for them. There is no one solution that has enabled them to be proficient at English, especially speaking. If you think about it, outside English-speaking countries, speaking English is not a nice to have, it's a must-have. If you think about it, a corporate learner has to think about knowing English to communicate clearly, and that is a skill that keeps that person from their current state to the corner office. Conversely, a young child learning English has to learn English to potentially transform their lives. It's not a nice to have, it's a must-have.

Why is it that there's nothing out there that's seemingly providing the efficacy that learners want? Well, there's two camps; there's the offline players that have been around for forever, they're out-of-date, expensive, not particularly convenient. Then, you have the digital players that primarily provide either one of two things, you have digital content players that have new ways of teaching, that are all e-learning based, or conversely you have the mobile tutoring players in this space. They've taken the modality of classrooms, but actually just ported it to the web and the mobile environment, they haven't provided world-class content. It's a very bicameral way to view the world. In essence, this is some of the problem why learners around the world today are not really proficient in English.

That's great and all, in terms of overall market trends, but here's some actual data from actual learners. At Rosetta Stone, we love to talk to customers, because we have thousands of customers around the world. We asked, in one of our studies this year, what are some of the problems around English language learning? We contacted learners from China, Brazil, and Korea and we asked them this question. Shockingly, 80%-plus of these learners are actually using other products and other services outside of Rosetta Stone. This ranged from other digital products, physical flashcards, offline schools, offline tutoring; in fact, 50% of those customers were using offline tutoring. They are cobbling together these solutions as part of a learning stack. It was a lot of difficulty for them to complete that stack. Two-thirds of those customers, surprisingly, actually had claimed that they're intermediate to advanced learners, which shocked us because they were actually using a product, our consumer mobile product, for beginners.

There's major desperation, a major need for these customers to have a one-stack solution, a one-stop solution that solves all their needs, and we're going to be showing you some of that today. The digital language learning space, and we've shown this chart last year in the investor presentation, is a relatively good growth market, is about 12% of the overall market for language learning. But we're recasting ourselves into a much broader light. The \$52 billion offline language learning market is about two-thirds made up of offline classrooms and offline tutoring. We see there's a huge opportunity to shrink this market. Marc Andreessen, and Michael, I'm sorry for mentioning Silicon Valley in this presentation, Marc Andreessen was very famous for saying "software is eating the world," and that has not really approached EdTech yet. But we think it's going to happen very, very quickly.

In language learning, just like you saw today in the presentation from our literacy group, language really does start with human teachers, it's the milk in the back of the store, to use a fairly reasonable analogy, it's the staple that most learners come into the learning process. They go to see a teacher or a tutor first, and as they move to the back of the store, they fill their cart on the way out with lots of different products, like I showed you previously. We think there's a huge opportunity to actually combine the best of personalized instruction with world-class content, and this is something that you will be seeing from us today.

We're not the only ones that think this space is great, I'm sure those of you that are watching or in the audience know that there's a lot of money flowing into EdTech right now. (Inaudible) IQ estimates about \$6 billion of venture capital will be flowing into this market this year, it's a lot. Offline players are primarily playing defense, they're protecting their P&Ls, protecting their business models. The new players obviously trying to disintermediate the old folks, and trying to come at them with new innovations, different types of pricing models, but no one's really approached the space trying to think about how both worlds can be combined. This is a theme that you've heard today in terms of adaptive blended learning. We think, and we'll show you, and we believe, that there's a product coming, because we're making it, that includes expert instruction, software and a data layer in the middle that allows the learner to get the best of personalized adaptive learning. We'll be talking about today, and Jerry Juan will be showing you that.

First off, let's talk about the assets that we have as a Company. As I mentioned earlier, I couldn't have asked for more interesting business to take over that has so many assets in our toolbox. First off, I'd like to talk about our speech recognition technology. When we talk about speech recognition, most folks think this is one of those technologies that's on your phone or in a smart device in your house. Our speech recognition technology is very different than those, it's designed for language specific reasons. This won't be something that you remember when you go home, but I think it's really cool because I tend to geek out. We take digital instructions. In other words, I'm speaking into a digital device, I digitize in a wave form, I put it through a machine learning algorithm, I decide in real-time, how does that map to phonemes, the actually building blocks of language, and then we provide the learner with input about how you spoke against your target language. It's amazing. We're the only company in the space that has its own speech recognition technology.

We have 7,000 hours of advanced content to beginning content across all those different (inaudible) levels. No one has this kind of treasure trove of content. We have tutors that provide expert instruction and primarily, we focus that capability in our corporate business, where corporations absolutely want to have a standardization in terms of a language which is typically English. A little-known fact is Rosetta Stone actually introduced tutoring for the first-time digitally and a pioneer of this in 2009. We know how to do tutoring, but we've been primarily focused on our corporate business. We'll be parlaying that core capability in our consumer business very, very soon.

John mentioned our iconic brand. Our brand is what Google is to search; it is the iconic brand and we actually have not invested in it in many, many years and we will do so in the future. It's 3x to 4x more aware in terms of brand awareness, more impactful than our nearest competitor. We haven't invested in it in three to four years. This is in North America, and our brand has extremely high awareness outside North America. This is something that we're going to leverage as we start building a more global brand to expand internationally.

Tom mentioned earlier about E&E. We're disappointed in our results overall this year, and we talked about two forms of our business; strategic and non-strategic in terms of E&E. The strategic pieces of our business are actually doing quite nicely. Our corporate business is something that we're investing in and we're closing larger multinational corporations. Most of our business to date has been focused on small and mid-sized companies. We think the growth to MNCs is a great move for us, and we continue to see progress there. Our nonstrategic forms of our business are particularly difficult to forecast. In particular, Tom mentioned custom content, which is actually an effort that is very, very core to the mission of the Company to save indigenous native American languages and other languages. But those businesses are high dollar and very hard to predict. We won't be including those in guidance moving forward.

Our other business that's on the decline is our affiliate business, which is a channel that takes our core language software, uses a third-party to distribute that software onto intranets. That's a business that's been on declined since we primarily moved to a direct sales channel. That's another element of that nonstrategic business. The flip side of the E&E is it's allowed us to figure out how to do five-nines of

reliability with some of the most demanding customers in the world. That has enabled us to really focus on key success and proficiency around teaching language to the most demanding customers around the world. To date, we've really thought about the language business from a product and platform perspective as two businesses. In fact, they were actually run from a product perspective differently.

However, sometimes I wear wingtips and sometimes I wear flip-flops. Today, I'm fortunately wearing wingtips. Our consumer business and our corporate business have very similar connective tissue. That connective tissue is, we teach serious language learners, and they particularly are adults. Those use cases are actually very similar. In our consumer business, you'll see some new consumer functionality that we're about to roll out, that is really delightful, that will enable E&E customers to actually have a great experience. The catalyst business that we built, with our catalyst product that is world-class, with high NPS, has a lot of components that we'll be extending to our consumer business, including content and tutoring. We think the combination of these things provides a great bootstrap for adjacency and expansion into international markets.

Oh, have we progressed. It was only several years ago that we had about 750,000 CDs out there. Anyone remember the airport kiosks CDs, remember those? Those are gone. We were going to have a CD crushing party, but that wasn't environmentally sound. But we progressed, and we are now on web and mobile. I want to mention web and mobile both. We took an old business model, migrated it, stabilized it in two channels. We learned how to do web and mobile at the same time. Ask my wife, I barely know how to walk and chew gum at the same time. We did one old business model to another in two channels. That has actually been pretty successful. We've had 447,000 subscribers this last quarter. We've added 30,000 net new subscribers. As Tom mentioned, primarily, a lot of that growth has been our short-term subscribers. There were some earlier questions about how we think about pricing and optimization. I think we're in the early innings for that. We've just learned how to do a lot of different optimization, as I mentioned earlier. In the beginning of this year in January, we only had one SKU as a perpetual download for \$199. Now we have a lot of different ways to monetize our product, lots of different ways to think about packaging and pricing.

Our mobile business, in terms of a customer perspective, has been doing quite nicely. We've been getting a lot of awards, which is great. We've been getting a lot of kudos in terms of our App Store rating, and a lot of good response from it, which is fantastic. But instead of just being insular and just looking at our own business, we decided to actually ask some of our friends in the industry to help accelerate our learnings and growth. We've talked to Google, and they've been very helpful with us to design some help in terms of design sprints in UIX, UI, and UX optimizations. We talked to Apple, and you're going to be seeing an augmented reality demo, something that we worked with them on with our AR kit release in the new iOS 12. Lastly, we're working with Samsung for new custom content and feature optimizations for their Made For Samsung App Store, which will be available globally. We've done a lot of work in our mobile business to optimize it. But instead of me showing you more slides, there's a saying that we have in our group, instead of talking, let's roll out real software to real people. Without further ado, I'd like to introduce Greg Spils, who was at Shazam, he ran the Rhapsody business, the division of RealNetworks, as well as Amazon and Microsoft. Ladies and gentlemen, Greg Spils.

Greg Spils:

Thanks, Matt. Mobile is not just a great new distribution channel for Rosetta Stone. Mobile technologies allow Rosetta Stone to take our proven language learning methodology, what we call dynamic immersion, and bring it to new levels. We immerse our learners 100% into their new language. We use our images and our videos to teach them vocabulary and grammar. Learners enter the Rosetta Stone world of Spanish, or French, or English, or any of the other 20-plus languages that we offer. But what if instead of learners entering the Rosetta Stone world, Rosetta Stone entered the learners' world?

In September of this year, Apple announced their new iOS 12. In the new operating system, they introduced object recognition technology integrated. Object recognition technology allows you to use your phone in the video mode and scan real-world items around you. Two of our software developers took this new technology and made a small demo. When the phone recognizes an item, they displayed it in a learner's new language. We showed this to our contacts at Apple, and they loved it. They liked it so much, they, within two weeks, had sent one of their technologists to our Boulder office where the demo was made to support us in innovating on this new technology.

Now, just a couple of months after the release, before the end of the year, we'll be releasing our new feature called Seek and Speak. Seek and Speak is a way that we enter the learner's world. Here's how it works. We have lists of vocabulary categories that we offer the learner to choose from. For instance, the learner could choose the produce aisle. We then ask the learner, find five items that would be in a produce aisle. Now, we have hundreds in our catalog that we would recognize, but it's a nice open-ended request to the learner, just find five. The learner uses their phone to scan items that should be in the produce aisle. Once they've found five of those, we then engage the learner in vocabulary recall right then and there to make sure that they can match the image to the new vocabulary they obtained. But the learning doesn't stop there. We then take those new items and we engage the learner in conversation practice with grammar around that item. In the case of an apple, we would ask, what is this? What color is this? Do you like eating apples? We're just getting started. We see building out a comprehensive catalog of items where learners can obtain new vocabulary and grammar anywhere, anytime, in the real world around them.

This technology also allows us to further personalize the learning experience. You can imagine that once we have an image from that user of a mountain, there is no reason for us to show images of our mountains later on. We are going to use the user's images further in our curriculum. So far, the UX has been really smooth from a learner's perspective. But under this, there is a lot of technology happening. We use machine learning. It takes us hundreds, if not thousands, of images—I was to say Apple images but not the company—images of apples to tune our models so that we recognize any apple from any angle. It also uses augmented reality. That's exactly what you're seeing here, where in the camera's view, in real time, we're able to display to the user what the item is that they're seeing in their new language. Of course, that uses artificial intelligence. AI is what powers our speech recognition engine through accent.

We are really excited to get this in the hands of users very soon, so much so that we've created a short demo video to show them, it's such a dynamic feature that it's really hard to see on still slides. You'll be the first to see this today.

(Video Presentation)

Great. Seek and Speak, we can't wait to get into customer's hands. But that's not the only thing we're doing in mobile. Very soon, we'll be launching Translations. Translations will use the mobile long press on a word or an image when a user isn't quite understanding what the item is or the word means in the new language. On top of Translations, we're building flashcards. These are like physical flashcards, where a user will be able to learn new vocabulary by flipping through them. Just like physical flashcards, the user will be able to pull out cards and create a separate pile to learn on their own, to learn ongoing.

Lastly, around grammar and vocabulary, we're creating grammar guides. Similar to translations, a user will be able to dig into the mechanics of grammar when they're not sure, from context, fully what to do with their grammar. We also have Your Plan. Your Plan is like workout apps or training apps where the learner tells us their goal in the future. Then, that allows us to set up a schedule and a duration with the user where we can leverage mobile notifications to keep them on task and help them reach their goals. We're very excited with what mobile platforms offer us and we can't wait to leverage all these new technologies to continue to make the best language learning products in the world. Thanks.

Matt Hulett:

I hope you get a sense that there is a lot going on at Rosetta Stone. This probably looks a lot different than what you've seen in the past. I also like to note, and this is an impromptu remark, that if you're a product professional, you can always not wear a sports coat to an investor day. You can always get away with a sweater.

We're getting ready for growth, so we've been focused hard at the lab working on growth strategies, optimization of the current business, and stabilizing things. But as the earlier question indicated, majority of the language business is focused on North America. We have a small presence in EMEA, but, oh boy, are we focused on the wrong market. Geographically, North America is the smallest market, growing the slowest. By 2020, the estimates are that 60% will be in LATAM, APAC, and the Middle East. We have not focused on those markets to date, and we will. We will because, going back to my earlier analogy, the milk of the back of the store, outside United States, our products are perceived very, very differently and are under a different lens. A serious language learner that's trying to be more proficient in speaking needs expert instruction, needs tutoring. There's examples of this in each geographic area of folks doing this with myriad degrees of success. We think there's an opportunity for us to bring that together, like I mentioned before. Our tutoring capability has been scrutinized by the best multinational corporations on the planet. We have native English speaking tutors from an American brand delivering English services around the world. It's extremely attractive for customers. It's extremely attractive for customers that have heard of the Rosetta Stone brand and know and trust it.

Everyone's heard of smartphones. They're a big deal. There's 2.5 billion smartphones in the world. Each smartphone has the ability to be a virtual classroom and we're about to show you one. We're about to show you one that we're going to launch in a test market next month. Here's how it works. Small first, it gives you access real-time or on-demand to tutors around the world, 7/24, 365 days out of the year, and enables the concept of content and tutoring, coupled together with data and personalization in the middle. I think it's super cool. In the future, you'll be able to actually have a virtual classroom like you'll be able to order an Uber today. Again, with the theme of showing you some of the themes and real software, I'd like to introduce Jerry Huang who just joined us from iTutor, who's the COO of iTutor, one of the fastest growing edtech companies in China. Ladies and gentlemen, our Head of International Strategy, Jerry Huang.

Jerry Huang:

Thank you, Matt. Really excited to be here and really excited to show you some new initiatives that we've got going on at Rosetta Stone. As Matt mentioned, there's about a 1.5 billion learners of the English language learning out there. This is the driver for worldwide English; our new initiative to reach those learners around the world. Now, we talked a little bit about how we're going—and I'll show you in a little bit, how we're going to blend the e-learning content with live instruction. We all probably know in this room and around the world that online tutoring is a hot business right now, it's a hot trend. Most of those organizations have a model where they're—is it getting darker? Did I do something? We know most of those organization's models are about selling large packages through heavy marketing and sales techniques. Our goal and our hope is to disrupt that type of model through being a very product-centric delivery. We want learners to enjoy and love our product and transact and purchase through the software.

This has two advantages. First advantage: it gives us a platform to really expand internationally to all countries around the world. The second advantage is it gives a great value to the learner. We talked about earlier, that, a lot of times, tutoring is inaccessible to learners around the world. By providing a great value, focusing on great product, it really does allow us to enter these global markets and reach a larger base of learners. But enough about that. Let's jump into product.

As we mentioned, the worldwide English initiative brings another dimension of immersive learning, blending our world-class e-learning content with live tutoring. Now, studies have shown that around the world, learners are learning English. They've learned it since they were children, all the way through adulthood and they still struggle with speaking confidently, engaging confidently. Worldwide English initiative really gives them an environment to practice with a live instructor, or if you're struggling with a lesson, with some content, if you need extra help, or you just need a coach to guide you through what the best steps to learn a language, you can do that now. You can extend your learning with our worldwide English initiative. Lesson plans, content is the cornerstone of successful live tutoring. Worldwide English initiative provides learners with fresh new topics every week. We give them new topics that cover things like business English, current events, leisure, travel, arts, culture, things that really will engage and interest them, on top of the fact that they can learn English. Also included with the content isn't just during session, it's all the stuff between sessions, before sessions, and after sessions. I can practice my vocabulary, I can use our speech recognition, practice pronunciation before I go into a session, so I can maximize my time with the tutor. This is an entirely blended environment that takes all of those facets and really maximizes their learning time.

When we mean anytime, we really mean anytime; 24/7, 365 days a year. We are a global company. Find the time slot that works for you, for your schedule. Normally, when you're working with a tutor, that tutor has a certain availability. I'm available Monday, Wednesday, Friday, from five to seven PM. But wait a minute, why do I as a learner have to change my life, my schedule, to you? With our worldwide English initiative project, you pick a time slot. You pick the tutor. Do you have a favorite tutor that you like? Pick him or her, or try a new one out based on their profile and our tutoring. We haven't talked a lot about that, but we've been doing this for a long time. Our professionally trained tutors have years of experience teaching learners all over the world. Our interface really allows for that intimate and engaging connection. Face-to-face really allows the learner and tutor to engage, and the tutors can provide immediate feedback and correction while guiding them. On top of that, we have a live chat. This live chat allows us to take the content that they use to live chat. For example, practicing new vocabulary words or trying grammar. That live chat can then be saved for after class, so they can continue to practice.

Before and after classes, they can keep on going. It doesn't stop within that session alone. After session, one, they can watch their recordings, so they can practice. They can try something. If you've ever taken a live tutoring class in language, you do 20 minutes. After that, your head is all, it's like it went through a blender, you forgot, exactly. By watching your recordings, it allows you to remember some key things. On top of that, we have a study guide that allows them to practice after classes. The tutors provide feedback. They'll provide ratings so learners can see how they progress from session to session, but also the tutors can provide direct feedback. They can say, "Hey, good work on the lesson today. Really want you to work on this pronunciation. Here's some extra words you should practice," so that they can continue their learning experience even outside of class. Our worldwide English initiative really provides learners this new environment that combines and blends content with live instruction, as well as practice between sessions. It's really a full education ecosystem that really maximizes learners time. Now, I would love to give you a glimpse into our beta launch of our product. We'll show a quick video clip that is first released here, fresh, hot off the presses.

Female Speaker:

Around the world, more than one and a half billion people learn English as a foreign language. Yet, while they spend years learning, many continue to struggle with the ability to speak confidently in real-world settings. That's why we created Rosetta Stone Worldwide English. Rosetta Stone takes its world-class platform of e-learning and adds a new dimension of immersive learning. Learners around the world can practice with live professionally trained tutors in U.S. anytime, anywhere, and on any device. Our highly trained and experienced language tutors provided immediate feedback and correction, while guiding

learners through Rosetta Stone's e-learning content. Our mobile interface is a highly-engaging environment for learner and tutor using face-to-face interaction and live chat.

Female Speaker:

When you listen to a podcast or read an article, do you listen or read for the gist? Or, do you listen for all the details?

Male Speaker:

I try to do both. I listen to details, and I read in detail, so that I can understand.

Female Speaker:

After every session, learners have access to their prior session details. They can see feedback from the tutor, and monitor their progress from session to session. They can rewatch any of the past lessons, review the lesson plans, vocabulary, and their online study notes that were captured during the live chats. Rosetta Stone builds upon its world-class learning platform, combining e-learning content and interaction with live tutors, to help learners maximize their time and help them reach their goals.

Jerry Huang:

There you go, guys. Thank you.

Male Speaker:

Thanks, Jerry. To recap, I'm going to open this up for questions. Hopefully everyone got a sense of those three themes: stabilize our core businesses, consumer and our corporate business in E&E; utilizing our assets, the bootstrap growth and adjacent season two international expansion with a primary focus on blending expert instruction with software content. I can't be more thrilled with this next phase, the language division. In fact, when I was doing my prep this morning, I noticed that the acronyms are a lot more compelling if you actually invert it and call it gas. We definitely want to be hitting the gas into 2019 versus talking about stabilization. Without further ado, we'll open up for questions, and Jerry and Greg can join me up here without getting blinded by the lights. That'd be great.

Male Speaker:

Traditionally, one of the things Rosetta always talked about was, it was a fully immersive product. You didn't believe in flashcards, yet I hear you talking about flashcards today. Is this driven by consumer feedback, or have you found that something was missing in your product that flashcards can add?

Male Speaker:

Yes. I'll start and then I'll have Greg finish because we've debated this. It's a massive debate. We don't have time to cover all the inside baseball on that. But, as you know, we do have academics in the experts in the field of language learning. Pedagogically, we actually are pretty diverse. For consumers, we do believe that for beginning level, language learning, that immersive is the best approach, and flashcards are a nice refresher for folks that need more explicit types of learning. For the advanced learners, immersion isn't the only way to teach, and we don't do it that way for advanced and intermediate learners. With the flashcards feedback, although we've been dogged on this within I don't know how many years, the App Store feedback and all the feedback we got was massive in that, people love the immersive

approach, but they felt like they needed a little bit of a, for the lack of a better word, cheat, from time-to-time outside of that process. Greg, you want to fill that in?

Gregg:

Yes, you mostly covered it. I would just add that the nuance was the long press on mobile. The flashcards and translations and grammar guides are really secondary to the immersive experience. Yes, we definitely have received some learners that prefer to know the answer and don't necessarily want to continue through an immersive experience until they can triangulate on what a word or what grammar meant. Again, we're keeping it as secondary and auxiliary to the immersive experience.

Male Speaker:

All right. Two questions on Worldwide English. What market are you trying first, and what's the pricing approach? Is this going to be—am I going to pay ad hoc per tutoring session, or do I subscribe separately to tutoring?

Male Speaker:

Yes. We haven't announced the country, but it's somewhere in the APAC region. Pricing and packaging, we're doing testing right now. We'll more than likely do both. We're testing right now. One thing that's interesting though is what Jerry mentioned, it's a hardcore principle of ours, is majority of the companies that are in this space do a lot of upfront purchasing of packages upfront, a lot of upfront bundling. What we want to do is add a lot of flexibility from the consumer purchasing experience, so that's not a core part of it. Our goal is not to be a tutoring company, our goal is to be a blended learning company, so that's how we think about the business. It's a mixture of software and service, so more to come on that. But the good news is we're launching testing and learning now.

Male Speaker:

Where are those competitors typically priced today?

Jerry Huang:

If you look around the market, depending on which regions, you can get anywhere from, probably on the low-end, maybe \$10 a class all the way to \$50 a class. It's pretty wide variety, again, depends on their models and what they're trying to achieve.

Male Speaker:

Any other questions?

Male Speaker:

Are you going to try this country for—you're going to basically launch in, looks like December, in an APAC region? How much testing and data would you like to see before you expand into any other countries?

Male Speaker:

That's a great question. Several months, with a more global rollout available everywhere and a date TBD. I think we'll let data drive that decision. But one of the things that John Hass and I have an internal debate on is, what's going to be bigger, our target country or more of a global horizontal approach. For instance,

on a personal situation, our kids are learning foreign languages, and we don't have access really, easily to great language tutoring, and so this app would open that up. The idea is broaden this to a global base of consumers once we hit the target use-case. We think EMEA could be interesting, maybe North America as well. Everyone will have access to it, in-line with their current immersive experience, but there will also be another track if you're an advanced language learner.

Male Speaker:

What kind of infrastructure will be required to expand it to other countries, is this mainly online or do you have to have infrastructure in country?

Male Speaker:

We don't have to have infrastructure in country, and I think that's maybe the new thing that's changed in the last five years is, we don't have to have in infrastructure in country. We actually understand a lot about video relays, and we understand a lot about latency and network sockets and things like that. We also have a person on our team that grew a business from zero to 10,000 tutors in Jerry, who knows how to scale the human side of the supply side of this equation. That's the other side that we were missing in the past, is not understanding that level of scale. We feel like we have a good distribution of people now in this Company that can answer those questions.

Male Speaker:

This question is for Jerry. What type of margin is traditionally—you said the tutoring sessions between \$10 and \$50 per session? What type of margin does the Company keep on that type of transaction, per session?

Jerry Huang:

I've never been able to see all of that. Most of these tutoring companies are private companies, so that data is not really accessible. My assumption is based on knowing what's out there, that the margin is going to vary just like the price points. Again, it depends on which country, what kind of learners they're targeting. I foresee a wide variety. I think the key for us is, like I said, like Matt is called out, that we're not trying to emulate those kind tutoring companies, and we really want to make it accessible to learners around the world. We want to make sure we have that blended learning experience for them.

Male Speaker:

Just one more if I could. Are you going to sell the tutoring in a package, not à-la-carte per session? Would you sell a package of \$2,500 or \$1,000 or \$500, or is it just à-la-carte?

Male Speaker:

We're still working on it. But there will more than likely be some bundling as well as on demand. What we don't want to do, and I'll stress this again, is we don't want to be tutoring company. We don't want to rely on customers not using the tutoring. However, they want to use it, they'll be able to use it. We think that, overall, the economics of that space, hopefully we'd be the most cost effective, long-term because we're using technology to make a lot of the tutoring part of the software, in addition to human expert help. Again, I think the way you view this is a little bit like add-on services to a core software subscription versus a tutoring company first with software included, that's how we think about the economics. The goal is to make it very easy for consumers to buy. We don't want to trick people into buying software and service. We don't want to force people to buy too much. Yes?

Male Speaker:

Maybe you could elaborate a little bit more on your Seek and Speak app, and if it's going to be incorporated into your current product or it's going to be a separate product, what's your pricing and how that all works?

Male Speaker:

Maybe I'll start and you finish? Everything will be incorporated into one app including the WWE, the World Wide English initiative, which we haven't named the feature yet, and the idea is to keep it under one app because we really want to boot strap the language brand that we have in Rosetta Stone. One app with additional functionality that you can unlock. In terms of the feature itself, do you want to take that, Greg?

Male Speaker:

Yes. Seek and Speak is going to be included in our core app learn languages. There's not going to be extra charge. Again, it will help personalize the app itself for learners.

Male Speaker:

Any questions? Great. Looks like no other questions. One? Couple more.

Male Speaker:

(Inaudible).

Male Speaker:

Okay.

Male Speaker:

You talked about you got rid of the kiosk full of dusty boxes of software, and you're leveraging the App Store. But now that you've stabilized the business, do you feel it's appropriate to start to spend some marketing money and how and where would you spend that if you wanted to try to accelerate the business by spending money?

Male Speaker:

Yes. That's a great question. The answer is yes. We're definitely going to be spending more in brand. I don't have a good sense of exactly how and when. But we did bring on Christina Kozlov who I worked with years ago at Expedia, who also did a lot of brand work at Zillow, and she's a fantastic talent who will be helping us think through that. One of the things, just a quick anecdote. I was at my doctors the other day and he said, "Boy, I love your radio ads, Matt," and I was like, "Yes, we haven't done one in years." He was like, "No, they're fantastic." I said, "Well, how would you use the product?" He mentioned the CD and he put it in his car, and I'm like, I can't believe doc, A, you have a CD player in your car. God love you. B, we do have digital products. He's like, that's amazing. I do think that a level of awareness in our brand in terms of what we offer, in terms of new digital products, is at an all-time low. The good news is the relevancy may be low but the level of respect for the brand is really high, so we think the level of effort to reinvigorate the brand is definitely in the world of doable. Yes, we're definitely going to spend some time thinking about brand and reinvigorating it. It's a great question. There's a question over here?

Male Speaker:

Yes. Did you say that there are 1.5 billion people learning English in the world today?

Male Speaker:

Yes, sir.

Male Speaker:

How do they afford it? The per capita income on a lot of these countries is next to zero.

Male Speaker:

Well, it depends, it depends on country. As Michael mentioned, obviously, it does skew for at least personalized tutoring to higher demographic, higher sociogeographic environments, where middle class, upper middle class is affording it. In a lot of ways, it's software only. In terms of APAC, I think maybe I'll turn this question to Jerry who knows this better than anybody.

Male Speaker:

If you look at the 1.5 billion learners, and that comes from British counsel as they studied the market as a whole. You can look at it in different segments. Obviously, as I mentioned, for example, in China. They learn English as young as five. Now, with some of these other companies, are learning even younger, and they learn through their adulthood. This is very common in countries because as we support English not as a nice to have, it's a must. We're probably one of the few countries that, early-stage, doesn't mandate second language. They're learning from their schools and from an early age, and then some of the more of affluent countries are now supplementing that education, because by itself, is not sufficient, they still graduate high school. Many times, they can read and write sometimes, they can read emails or write emails and read blogposts. But when they talk to a foreigner, they just shutdown. They're not able to engage confidently. Again, more of the affluent countries, you see these companies emerging, are tapping into that. They're willing to spend more money. Because again, it's a gateway to future opportunity. On our belief is though, that it shouldn't matter, that case, we should be able to offer a blended learning experience that can reach all of those 1.5 billion learners.

Male Speaker:

Wouldn't it be a great thing, too, if we—with the onslaught of WVE as it develops, be able to more democratize language learning so it's more affordable. While not a core mission of Jerry's world, it's a core mission of Rosetta Stone, to make sure that learners around the world can do that. The idea is, long term, as you use a tutor, hopefully you're less reliant on that tutor longer term because the software does a lot of the instruction for you in addition to the mentoring from the human coach.

Male Speaker:

Great. Any other questions? Thank you very much.

John Hass:

Can you hear me okay? First of all, thank you, all, for being here. Thank you for your questions, thank you for the engagement that you've shown. A number of you were with us in May of last year when we last did

this. I suspect what you're seeing is a very different company than the one you saw then. It's a company that is product forward, and it's a company that is changing, and it's a company that will be growing, going forward. Just a reminder for people, when you do leave, you will have a box lunch that you can take with you. There is also a gift bag for you which has a copy of Michael's book *Blended*. Please make sure to pick that up.

Now, to close, I do want to share a high-level view of what this means for us financially. To start, as you might suspect, this is out of cycle with our normal budgeting and planning cycle which is going on right now, and will conclude at the end of the year. We'll share with you the full outlook in 2019 budget of our guidance for 2019 in March as we typically do. But as you heard from Tom and Nick, and Matt, many, many things have gone right this year. Literacy sales are expected to grow by about 25%. Consumer sales have stabilized and will grow in the fourth quarter, and G&A has been relatively flat, a trend that we think we can continue going forward. That said, cash flow will not be quite as strong this year as we had originally expected. We do care about that. We care about that very much for three primary reasons.

Some is due to the lower-than-expected performance in areas of the business, primarily consumer retail and some of the nonstrategic parts of E&E, which, while not traditional SaaS businesses, have added to cash flow in the past, and were expected to integrate our way this year. Some is due to areas like direct to consumer language, which have actually done really well this year, but where the mix of the business has been slightly different than we had originally expected. In this case, more short-term subs being sold, which actually improves the predictability and sustainability of the business over time. We want to sell what our customers want, and so that's fine for us. But what that means is the cash flow comes in slower. More of it comes through future renewals as opposed to upfront sales. Some of it was intentional. We decided to make investments in products like our K-6 EL product that you heard about from Nick and Liz and Worldwide English that you've just heard about from Matt and Jerry.

Now, to address the first of these issues, we will continue to do everything we can to drive sales in consumer and E&E language, especially in those strategic areas that add to AR and drive subs. That is our focus. In addition, we will make sure that the cost structure is appropriate to the business that we have, given the lower performance in some of the less strategic areas of the business. While our consumer mix going forward is moving to more short-term subs, the business is beginning to grow, and it is healthier than anytime in the last four or five years. But to be clear, stabilization in consumer is only a necessary milestone. It is not our goal. You've heard today that our goal is growth, and that's what we're going to do.

Regarding our decision to expand in the investment in our core business, when asked in the past what I would do with the expected growth in cash flow we would have going forward, I consistently said an internal investment that drove intrinsic value would be our first priority. If these were not available, we would return capital to shareholders. We look forward to doing both. I believe, though, the opportunity to expand in our K-12 business, leverage our brand and our blended learning capability to build a profitable global language business has the potential to fundamentally transform the intrinsic value of our Company over time.

Now, as a former investment banker, I know many companies believe it is easier to explain to investors why they're writing a cheque to buy a capability, to buy a business, than to explain new investments through the P&L and through the balance sheet. I used to write some of those explanations myself, actually. But our Board and our investors allowed us to take investment risk in building the literacy business even as we went through a difficult transition. I think that's working out okay. Rather than buy sales and capabilities and risk through integration, our goal is to build on our current platform, utilizing the assets developed by these two businesses, which, if you look at them on a combined basis, have over 60 years of experience building blended learning software for learners. I don't think there is another company

that can make that statement. Sixty years of building software for learners, that's a pretty impressive background.

Now, in the meantime, as the first K-6 language sales from our EL product come online in 2020, in the current literacy business, we expect the segment to be even larger and to grow even faster than it would have otherwise. In the meantime, we expect sales of literacy products to grow even faster in 2019 than they did this year. This year they'll approach 25%. We expect it to grow even faster next year. This power up and many of the other investments that you heard about from Nick come online and begin to have an even bigger impact. This should drive Literacy segment revenue growth of approximately 20%, again, next year.

Even as we test and learn new markets for our worldwide English business during 2019, we expect to produce approximately 10% consumer revenue language growth, driven almost entirely from the acceleration in our core US consumer business. If you just look at the growth in net LTV added this year, which hasn't shown up yet in revenue, that's what begins to flow through next year. We expect single-digit revenue growth in E&E.

Finally, on a consolidated basis, I would expect 2019 to be year of mid-teens revenue growth, strong growth following four years of declines. This growth should accelerate as K-12 becomes a bigger part of the Company, and as our EL product and Worldwide English come online more fully in 2020 and beyond. With the SaaS transition now behind us, we will continue to have a business with very high gross margins of approximately 80% and quickly expanding EBITDA margin, not margins, even as we leverage operating expenses and G&A.

Bottom line, no longer do we see ourselves as a company in transition. We talked about that last year. We have work to do, but we are now a growth company with improving margins and outstanding reinvestment opportunities within the business itself. You should have come this morning with a belief that our K-12 literacy business, with its outstanding products and increasingly productive sales force, and the expectation we will approach \$100 million in sales in 2020 and beyond. If you didn't believe that, I suspect you wouldn't have been here. Frankly, what you heard from Nick and Liz about our literacy business should only have reinforced that belief, but today, we are telling you we can do more. We will leverage our K-12 business to become the expert in both K-12 literacy and language, by adding a new blended learning solution for English language learners in our schools. By creating a bigger, more powerful combined K-12 group, we believe we will be able to take advantage of the K-12 segment more broadly and grow even faster than we have in the past. In other words, if you were happy with the direction of Lexia coming in today, you should be even more excited about the power of the combined business.

Now, I'm just as excited about our plans for the language business that has an even larger total addressable market than our K-12 literacy and language business does. As a baseline, we will continue to revitalize our U.S. consumer and enterprise language business as the pace of true innovation continues to accelerate, as I hope you saw today. We have work to do in some areas of E&E that contribute to cash flow. The consumer subs are growing nicely, backed by real innovation and more competitive pricing. We're winning enterprise clients that we couldn't have competed for in the past. But we can do more, and we will do more by leveraging our unique capabilities and adaptive blended learning to bring language learning solutions to customers online, and if we're successful, increasingly around the world.

As you heard today, we are already the best-in-class adaptive blended learning company in classrooms. We do that through Core5 and through PowerUp, but we believe we can extend that into English language learning as well. Going forward, as you heard from Matt and Jerry, we will introduce the same capability in the cloud by introducing a cloud-based English language learning product, which we believe can be both unique and bring us into larger faster-growing markets going forward. We will attempt to do

this in a way that limits the upfront capital commitment and allows us to expand geographically much more efficiently than our peers do. None of that is easy. It will not be straightforward, but I believe we're pretty well positioned to do this successfully.

But today was about doing more. If this is successful, could we do more? You bet. How much fun would it be to leverage our capability in K-12 or emerging capability and online blended learning with our tutors to provide an adaptive blended learning English language solution for kids? How cool would that be? There you have it. I hope you see what we see, a bold vision for a new Rosetta Stone, a Rosetta Stone with a bigger, better K-12 business, a breakout opportunity in our language business, which, if we get it right, gives us the chance to be a leader in blended language learning around world, all driving accelerating growth and increasing intrinsic value. Thank you for your time. We very much appreciate your participation. I'd like to thank the entire Rosetta Stone team who helped us get ready for today. Have a great day. Thanks.