Q3 EARNINGS PREPARED REMARKS

Jason Terry - Safe Harbor

Thank you. Good afternoon everyone. Welcome to Rosetta Stone's third quarter 2019 earnings conference call. Speaking on the call today will be John Hass, Chairman and CEO, along with Nick Gaehde and Matt Hulett, Co-Presidents of Rosetta Stone. Additionally, Tom Pierno, the company's Chief Financial Officer will be available during the Q&A portion of today's call.

We have posted to the Investor Relations section of our website at rosettastone.com, both the earnings release and a slide presentation which accompanies today's call. We've also posted supplemental information and analysis on our website.

I want to remind everyone that as always, there will be elements in today's presentation which are forward looking and are based on our best view of the world and our business as we see them today. 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 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. The full definition, GAAP comparison, and a reconciliation of those measures are available in the aforementioned presentation and press release.

I will now turn the call over to John.

John Hass - Opening

Thank you and welcome everyone.

We have a lot to cover so please turn to **slide 2.**

Slide 2 - Rosetta Stone is a Global Leader in Digital Education

We have shared this slide with you a few times in the past. Let me be clear as to why this background is critical to our future. We have the experience and expertise to be the leader in helping people build the communication skills necessary to improve their lives. Whether it is a child learning to read in a classroom or an adult learning a second language in retirement, we build equity and deliver positive societal change.

Please turn to **slide 3** for a review of our consolidated results.

Slide 3 - Consolidated Results

Consolidated bookings in the third quarter grew 21% to $81.5 million with contributions from every segment of the business. This is the largest year-over-year increase in organic bookings in the history of the company and is indicative of what we are capable of doing during the seasonally important third quarter. But it is not all we are capable of. We expected more and will talk today about what it will take to deliver that.

Consolidated revenues grew 6% in the quarter to $45.5 million, our largest quarter-over-quarter dollar increase in 2019.

Importantly, with over $80 million in bookings and $45 million in revenues, we added $36 million to deferred revenue in the quarter.

Net income in Q3 was a loss of $2.9 million, an improvement of $3.6 million over the same period in 2018. This was driven by higher revenues and lower variable incentive compensation expense, partially offset by increased sales and marketing expense during our peak selling season.

Adjusted EBITDA in the quarter improved to $2.5 million, versus a loss of $700 thousand in 2018.

We ended the quarter with $36.2 million of cash and no debt. A $25 million increase in our net cash position since the end of Q2 on $29 million of operating cash flow and $4 million of cap ex. When we utilized our seasonal borrowing facility we said it would be repaid by the end of the year. We are pleased that we repaid the line fully in Q3 and we will not use it again this year.

Let's move to the performance of our business units beginning with Literacy on **slide 4** and I will turn the call over to Nick.

Slide 4 - Literacy Segment Results

Thank you John and good afternoon everyone.

Literacy bookings in the third quarter were a record $41 million, an increase of 21% versus the third quarter of 2018. To put this in context, this represents more than 85% of the total bookings we recorded in all of 2017 and more than double the full year Lexia joined the Rosetta Stone family. But as John said, we expected more in Q3.

Revenue in Q3 in the Literacy segment was a record $15.6 million, an increase of 18**%** over Q3 2018. Literacy segment contribution more than doubled from $1 million to $2.1 million relative to Q3 last year.

The key to bookings and revenue growth in Q3 was continued improvement in new sales performance through our core distribution channels, along with strong dollar-based renewal rates. I will unpack each of these in a moment, but first let me talk about the timing of bookings this year, as it continues to evolve.

The third quarter is the season in which school budgets are released and it is critical to our growth. This year, however, we expect full year bookings growth to be positively impacted by bookings in both Q3 and Q4. In fact, based on business to date and our current pipeline we expect bookings in Q4 to be approximately 30% higher than in Q4 last year. Why are we seeing more bookings growth in Q4 this year than in past years?

First, we heard from many districts that the Federal funding that supports schools with large low-income populations, was released later this year than last, causing many schools to delay both new and renewal purchases. Secondly, as our business has grown, the volume of open deals at the end of the third quarter has grown as well. Many of these spilled into Q4 and are closing now.

Overall, I am pleased with the growth in our core markets and distribution channels. We continue to penetrate our existing districts, as well as the 60% of the market where we currently don't have a presence.

Over the last 12 to 18 months we invested in staff and marketing initiatives (along with product and services) to "open up" these targeted locations.

We have been selective and focused in our approach, aware that while success can yield six or seven figure contracts, the time to gain acceptance and win programs - as well as overcome entrenched competition - is significant.

That said, we have made solid progress in places like New York City, Arizona and Virginia. Texas has proven to be more challenging and although we have had district wins in that market, and have grown new business in that state by over 40% this year, overall closed business has been less than we had hoped. Many districts in Texas have focused their initial adoptions on filling traditional core print-based literacy curriculum needs and have deferred the selection of providers for digital blended learning solutions like ours. We are committed to the Texas opportunity and expect to see more success next year and the years following as districts address their supplemental curriculum needs. In all cases, we are confident that when we consistently demonstrate significant impact on student performance these relationships will expand over time.

Please turn to the **next slide.**

Slide 5 - Land and Expand Strategy

We have made progress growing our presence, both in districts where we did not have customers and in districts where we have been able to expand based on the strength of our partnerships and the performance gains of the students we serve. In the third quarter we saw an increase of over 35% in the number of new districts compared to the number of new districts in the third quarter of 2018. And even when we start with small initial purchases it represents a toe hold to expand in future years. There is more opportunity here.

Please turn to the **next slide.**

Slide 6 - Customer Expansion

The investments in our product portfolio enable us to expand our district penetration and also the lifetime value of our customers. This growth is achieved through multi-building and multi-product sales. With the launch of PowerUp two years ago we began to build our presence in middle and high schools. In two years we have brought this solution for nonproficient readers to over 4,000 schools.

Please turn to **slide 7.**

Slide 7 - Strong renewal rates = Higher LTV = Literacy ARR Growth

The growth in bookings in Q3 drove a 16% increase in ARR to $55.5 million. This growth was driven by an increasingly productive sales force with more solutions to offer, and is shown through continued strong renewal performance in the third quarter. Retention rates were 88% while renewal rates were 102%.

We are achieving rates in K12 which are very strong, even as our business has undergone significant growth and structural change. This speaks to the excellent value we deliver to our customers.

We conduct extensive analysis to understand the factors behind customers who don’t renew their contracts. We see fewer larger accounts that do not renew, with the majority of non-renewals occurring among smaller accounts.

That said, we are not satisfied if we lose any customers. We are confident that as we mature as an organization, we can do a better job of providing our Customer Success teams with the data they need to identify accounts that are showing early signs that they might not renew, and then re-establish customer commitment and minimize the risk of cancellation.

Please turn to **slide 8**.

Slide 8 - Literacy Bookings and Revenues

As we look to the end of 2019 and beyond, it is important to remember what we are building. The continued penetration of Core5 in elementary schools, the introduction of new products like PowerUp, and the building of a national direct sales and service team have driven bookings growth. Growth that has been compounding since 2014 at an average of 25% has almost doubled our business in three years. Now we need to do that again. Please turn to **slide 9.**

Slide 9 - Literacy Expansion Opportunity

And we can because even as we grow, we remain underpenetrated in the markets we already serve. We can triple the number of schools we are in just by fully penetrating all schools in those districts where we already have a presence. To make a difference in even more lives we are going to make a large, targeted investment in K-12 sales and marketing and service teams that support our customers. Please turn to **slide 10**.

Slide 10 - K-12 Sales and Marketing Investment in Our Future

Over the past two years the size of our sales force has grown slowly even as we grew bookings by almost 50%. While rep productivity has gone up, it will be approximately $1.2 million this year, in hindsight it has come at the expense of opportunities to grow our business more quickly with existing and new customers; this became clear to us as we were closing the largest Q3 in Lexia's history. We have a capacity and structure issue. Not a business opportunity issue.

To rectify this and set the business up for strong, sustainable and profitable growth, we will take a number of steps. First, we are expanding the size of our field sales team. As importantly, to structurally build efficient capacity we will be focusing field reps on bigger accounts and new business opportunities while investing in our inside sales teams with the capacity and skill to grow our large volume of smaller customers. This will be a high ROI investment. Getting the right people, at the right level, focused on the right accounts.

This is a step change investment that we will not need to repeat in the near future, but is warranted given the scale of the opportunity in front of us. Please turn to **slide 11**.

Slide 11 - K-12 Opportunity - World Class Products with Great Efficacy

We are confident in this investment because we have the solutions fundamental to the success in K-12.

A portfolio of world-class Literacy products and soon a new product to serve the needs of English Language learners. No other company has the deep experience and expertise to serve the needs of all students and to be the leader in Literacy and Language education.

Next **slide please.**

Slide 12 - K-12 Opportunity - Huge Need and the Scale to Serve It

And these products address a big market with great societal need. A need that is unfortunately highlighted in the recent release of the federal government's NAEP scores, also called the Nation's Report Card. The 2019 scores for reading show an alarming decline in student proficiency where the average eighth-grade reading score declined in more than half of the states compared with the average score in fourth-grade reading declining in 17 states. The good news is that this crisis is getting national attention. Most importantly, we know from our 36 years of experience and deep portfolio of research that we can be a powerful force to change these trends and provide students with the opportunity to succeed not only in school, but in life.

For an update on the performance of our Language business let me turn the call over to Matt.

Slide 13 - Language Business Results

Thanks Nick.

Bookings in our Language segments totaled $40.5 million in Q3 with Enterprise and Education bookings growing $6.7 million, or 38% over Q3 last year driven by the $7.4 million long-term custom content deal we announced in early August, while Consumer segment bookings were flat on a year-over-year basis.

Total revenues for the Language segments were $29.9 million in Q3, an increase of 1% over the same period last year. Within this, Consumer revenues were $15.8 million, an increase of 9% from Q3 2018, while E&E revenues (as opposed to bookings) were $14.1 million, a decrease of 6% from Q3 2018.

Consumer Language revenues were negatively impacted in the quarter by a higher mix of long-term subscriptions than in the same period last year. These sales are attractive from an LTV perspective but have the effect of lowering in-period revenues as the bookings are deferred over a longer period of time.

In our E&E segment, I would call out the improved performance of our Enterprise business, outside of custom, globally. These bookings grew 5% in Q3, versus the same quarter last year, even as we transitioned existing customers to our new solution. Next **slide please**.

Slide 14 - Rosetta Stone Enterprise

We formally announced the introduction of our new product to serve business customers - Rosetta Stone Enterprise - earlier in Q3. This is the successor to Catalyst made possible by the consolidation of our technology stacks that we discussed on the last call. It introduced notable functionality like proprietary, standards-aligned Assessment Tests, unlimited access to live online tutoring sessions from highly trained tutors who are native speakers, and over seven thousand hours of beginning to advanced content. Corporate customers now have the most robust cross-platform learning product in the market.

Lastly, it is important to note that we have completed the majority of our migration and de-flashing work across our Language platforms. We are excited to unburden the R&D team to build on what is already the best-in-class consumer and enterprise language learning solutions. Please turn to the next slide and I will walk through Consumer Language performance.

Slide 15 - Consumer Performance

As expected, Consumer in Q3 returned to more traditional metrics and more profitable unit economics as results were not impacted by the brand marketing test expenses that affected second quarter results. Average initial sales price per unit increased to $102 on the strength of a greater proportion of long term unit sales. LTV to CAC was 1.7x.

To be clear, this means our margin per unit after all incurred and expected future marketing costs was over 40%. Couple this with the fact that the payback period is very short, immediate in the case of our long-term subs, and you can see why this business is attractive.

While the Consumer business has stabilized on a bookings and revenue basis year-over-year, increased competition in our traditional performance marketing channels has increased the cost for paid media. You can see that compression of customer acquisition efficiency in our per unit economics.

We have the best product in the market as evidenced by our high NPS and app store rating. Our unrivaled 97% brand awareness is a rare competitive advantage that we have not yet built on as we transformed product and pricing. We are evaluating our spend, which has largely been focused on shorter payback cycles to include more longer-term payback marketing cycles in 2020.

Please turn to **slide 16**.

Slide 16 - Language Opportunity - And the Assets to Address It

What gives us confidence that this is the right strategy? We have the assets necessary for success. We have consumer and enterprise products that are the best in the marketplace. That was not true in either case just a few years ago. And we have the tools to do more. As we leave platform consolidation behind us we will accelerate innovation and take advantage of everything from our software to our decade of experience delivering virtual online tutoring on a global basis.   And supporting all of this is the best brand in the United States and one of only a few that could begin to extend globally.

I will now turn the call back to John.

Thanks Matt. Let me now turn to guidance for this year and an initial look at 2020. Please turn to **slide 17.**

Slide 17 - 2019 FY Guidance

We began 2019 with goals of growing bookings and revenues, improving adjusted EBITDA and becoming cash flow positive, all while investing in the future. We will accomplish each of these, but our bookings growth has not been as strong as we expected for the reasons we discussed. We now expect bookings of approximately $71 million in Literacy, or 21% growth over 2018. This is strong growth but leaves us short of our expectations.

We expect total bookings of $126 million in Language and consolidated bookings of $197 million, 9% higher than in 2018.

Because of lower expected bookings we are lowering our year end revenue guidance to $182 million. This is $1 million lower for Literacy and $2 million for each of the Language segments. Consolidated revenue is expected to grow 5% this year.

We see upside to our prior guidance for net income and adjusted EBITDA as we continue to manage expenses, but we are maintaining our estimate of a loss of $15 million and adjusted EBITDA of $6 million Both adjusted EBITDA and net income would be higher but for the fact that more of our R&D costs than expected are being expensed rather than capitalized. Cap ex is now expected to be $18 million, down from our prior guidance of $20 million.

Finally, we continue to expect to end the year with $42 million in cash and no debt.

All of this is a start to the improved longer-term performance we expect.

And we want to make sure that performance is sustainable and backed by the plans and investments required to build intrinsic value. I also don't want guidance to be an impediment to our decision making or your confidence.

Please turn to **slide 18.**

Slide 18 – Outlook / Current Trends

Given the lower starting point and the more competitive operating environment in U.S. Consumer, we are revising our prior outlook for next year. We are providing this preliminary outlook today, and will finalize guidance as part of our year-end call in March.

Our outlook for 2020 has the following features. Accelerating growth in Literacy and relatively flat expenses across most of the company, with the up-front investment in K-12 sales and marketing and implementation services Nick outlined, being the major exception.

Let me start with a walk through of our preliminary view of bookings and revenue.

We expect Literacy bookings to grow 25% to 30% up from 21% this year.

Because almost all K-12 bookings growth occurs in the second half, revenue will grow more slowly. We expect Literacy revenue in 2020 in a range of $75 to $78 million, or 21% to 26% higher than this year.

This is lower than our prior outlook, in part because of a lower starting point, but our confidence in delivering these goals is high.

Growth will be driven by continued penetration of Core5 with increasing contribution from PowerUp. Our K-5 EL solution will add to growth in 2020 but we want to be conservative about its launch and may do things to enable its long-term penetration and maximize its intrinsic value such as using unpaid or partially-paid pilots.

In Consumer Language, given the current competitive unit cost dynamic we want to be more conservative in forecasting our U.S. business. At the same time, we intend to thoughtfully invest in our brand and building top of funnel traffic and recognition of the new Rosetta Stone.

Outside of the U.S., we have referred to our work in Korea as having higher risk. We remain excited about the opportunity for blended language learning there and Asia broadly, but to de-risk the outlook, have eliminated these revenues in our 2020 outlook.

We expect slightly higher Consumer Language revenue of $64 to $66 million in 2020.

In E&E Language we expect revenues to be down slightly as growth in Enterprise is more than offset by a decline in Education Language as part of this business moves to the Literacy segment.

Total Language revenues are expected to be approximately $117 to $121 million in 2020. This is the largest change to the topline relative to our prior 2020 outlook.

On a consolidated basis this produces revenues in 2020 of approximately $192 to $199 million, or 9% growth on the high end, on total bookings of $210 to $218 million.

Moving to investments and profitability, we expect to again hold G&A relatively flat in 2020.

Total R&D, including cap ex, is also expected to be flat next year with the benefits of completing our platform consolidation in Language offsetting a small increase at Lexia.

Sales and marketing as a percentage of revenues will grow in 2020 as we invest in our K-12 infrastructure to sustain growth for the next few years. Since joining Rosetta Stone six years ago, the Lexia team has had an almost unblemished record of meeting its goals, compounding growth at 25% a year. This year we had consistently high expectations but found that as we expanded, our ability to grow new business while serving the needs of thousands of existing customers exceeded the capacity of our current structure. To address this we are adding capacity by accelerating changes to make greater use of inside sales teams to more efficiently target existing customers with smaller renewals, in order to expand the capacity of our field team to target larger customers and new opportunities.

We will make these investments while modestly improving EBITDA and cash flow by holding other expenses across the company largely flat.

In total, we expect 2020 adjusted EBITDA of approximately $10 million and operating cash flow of approximately $20 to $24 million with capital expenditures of approximately $18 to $20 million.

Because of the more conservative bookings outlook this is lower than originally expected.

Putting this in context, adjusting for bookings that we received from SourceNext and custom content deals, operating cash flow in 2018 was $4 million. 2020 is expected to be an almost $20 million improvement in operating cash flow in two years. This is indicative of what we can do as our business scales.

As we look beyond 2020, we believe Lexia will grow bookings at a rate of 25% for at least the next few years. Remember we are adding a new product to the portfolio. This would produce revenue growth in the low 20% range on an ongoing basis.

Consumer and E&E Language should grow bookings and revenue at a mid to high single digit rate before the offset from the movement of K-5 EL sales to Lexia.

This outlook assumes no meaningful contribution from the opportunities we expect to have to grow in new markets in both K-12 and Consumer.

We will leverage G&A and the investments we are making today in R&D, and realize the scale benefit of the sales and marketing investment in Lexia. This will produce EBITDA and operating cash flow margins of 8% to 12% and 14% to 16%, respectively.

These are not peak margins. Operating cash flow margins should reach 18% to 20% as the business scales further.

Next, the filing of our shelf registration statement raised questions about how we think about managing capital and building value that I would like to address.

Please turn to the **next slide**.

Slide 19 - Value Creation

So how do we think about capital management and building value for shareholders?

Our goal is to maximize the intrinsic value of our business. Something we have worked hard to do over the last five years through the restructuring of our Language business and our investments in K-12.

We measure intrinsic value through the cash flow we expect to generate between now and a future period appropriate for each business or major investment. To do this we look at investment opportunities independently to draw judgements as to the appropriate period over which value should be considered.

In K-12, our ability to address large and difficult problems and grow customer accounts once won, has led us to consider investments over a long period. Big market opportunities and the compounding returns available in K-12 are the drivers of the large, multi-year investments we have made in new products like PowerUp.

Why is this important in the context of the shelf filing? First, internal investment has and will continue to be prioritized over acquisitions. We have the people and expertise necessary to build world-class literacy and language products. And we prefer to build products on our own platforms, like myLexia, and with our own technologies, many of which are patented or proprietary.

Finally, we are aware of the price of our shares in the market. Ultimately, we manage intrinsic value on a per share basis. Issuing shares for any purpose is considered in this context, especially when we are trading at a discount to the intrinsic value of the business we are building.

Consider our K-12 portfolio. Core5 is one of the most valuable solutions in education technology. It serves the largest slice of the education budget, teaching young kids to read, has achieved scale and is continuing to grow at a fast rate. Add PowerUp, which is new and only beginning to penetrate its total addressable opportunity. And then there is our forthcoming EL product. Today it is a very large investment, one of the largest in our history, with no associated bookings. But we look at the transformative product we are building, and consider that the fastest growing part of the school population consists of students learning English as a second language, and we could not be more excited. Investing in these products, while expensive, is building long term, sustainable, intrinsic value.

Does this close the door to acquisitions? It does not. We consider small tuck-in acquisitions - as Lexia was in 2013 - where we can leverage assets like our data platform, distribution and brand, and could consider something more transformational, but the bar is very high because the internal possibilities are great.

Finally, in the future there will be the opportunity to increase per share intrinsic value through the repurchase of our own stock at a discount to the value we see in our business. As we have gone through the process of rebuilding our Language business and investing to build K-12, we have not had the balance sheet capacity to repurchase shares even as the price has been attractive. As our cash flow after internal investment grows, and the seasonal low point of our cash balance increases, this capacity will increase and repurchase would become a consideration.

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Slide 20 - Investor Day

Let me end with an invitation. In March, we will hold our next Investor Day.

What should you expect to learn?

You will hear how we are changing lives and providing profound societal good.

You will see demonstrations of exciting new products including our English Language learning product. I predict it will blow you away.

You will hear how we intend to build on our foundation as the literacy expert in K-12, to be the expert in Literacy and Language.

And you will hear how we will take greater advantage of the equity in the Rosetta Stone brand in new and exciting ways.

We are excited to share our plans and look forward to seeing you in March.

With that, operator could you please open the call to questions.