Rosetta Stone Inc.
Second Quarter 2010 Conference Call
August 5, 2010, 4:30 pm ET

Chris Martin – Investor Relations

Thank you, Operator. Good afternoon and thank you for joining us today for Rosetta Stone's earnings conference call for the second quarter of 2010. This afternoon's conference call is being recorded and will be available for replay on Rosetta Stone's Investor Relations homepage at investors.rosettastone.com.

With me on today's call are Tom Adams, our President and CEO, and Brian Helman, our Chief Financial Officer. Tom will open this afternoon's call with a review of the quarter's highlights and then Brian will provide financial details and guidance for the third quarter and full year 2010. We will then open the call to questions.

During this conference call and the question and answer session, we will be making projections, providing revenue and earnings guidance and other forward looking statements under the Safe Harbor provision of the Private Securities Litigation Reform Act of 1995. Such statements are based upon management's current expectations and are subject to a number of risks and uncertainties that could cause actual performance and results to differ materially from those discussed in the forward-looking statements. Important factors relating to our business, including factors that could cause actual results to differ from our forward-looking statements, are described in our filings with the SEC. These statements are made only as of today and we undertake no obligation to update or revise forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events or changes in future operating results.

A few administrative notes related to some of the metrics we will provide today. During the call, we will provide non-GAAP financial measures as additional information regarding our operating results. These non-GAAP measures exclude the amortization of acquired intangibles, and stock-based compensation. We also will provide total sales bookings, which equals total revenue plus or minus the change in deferred revenue; adjusted EBITDA, which is EBITDA less stock-based compensation and operating EBITDA, which is adjusted EBITDA plus the change in deferred revenue. These measures are neither in accordance with, nor an alternative for GAAP and may be different from other non-GAAP measures used by other companies.

Rosetta Stone believes that the presentation of these non-GAAP financial measures provides useful information regarding additional financial and business trends relating to the company's financial condition and results of operations. Reconciliation of GAAP and non-GAAP has been provided in today's earnings press release, which is available on the investor relations section of our website at investors.rosettastone.com. You can also find a copy of our earnings press release, as well as additional supplemental financial information, including a slide presentation that complements our prepared remarks under the "Most Recent Earnings Announcement" section of the investor relations homepage.

At this time, I will turn the call over to Tom Adams. Tom?

Tom Adams – Chief Executive Officer
Thanks, Chris, and thank you all for joining us this afternoon.

We're pleased to report that, despite a short fall in our US Consumer Sales, we delivered a strong bottom line performance in Q2 and made excellent progress in all key strategic areas of the business. We continue to develop our international presence, are delivering strong growth in our institutional markets and Version 4 TOTALe is on track for launch in Q3.

Operating EBITDA, which is our key metric for economic profitability, came in ahead of target at 10.9 million dollars, while our second quarter GAAP and non-GAAP EPS also came in significantly ahead of expectations at $0.17 and $0.21 respectively. Our aggregate sales bookings in Q2 grew to 64 million dollars, a 9% increase over last year, as our strong international and U.S. institutional growth compensated for a decline in our U.S. consumer business. Our revenues for the quarter were 60.6 million dollars, up from 56.5 million dollars last year. Our international business continued to post impressive growth as revenues grew 155%, and our institutional business generated record revenues with strength in schools, government and corporate markets.

As we have described to you previously, we're taking advantage of our strong market position to make investments that will extend our industry leadership and drive future growth. And in terms of our biggest initiative, we're delighted to announce today that VERSION 4 TOTALe is now set to launch on September 14th – in line with our target schedule. We have done extensive testing on the product, are on track with hiring conversational coaches and expect to drive interest in this innovative and exciting new offering with new messaging and enhanced marketing activity. We continue to have confidence that Version 4 TOTALe will delight customers, bring greater learner success and open up new opportunities for us to evolve our business model towards extending customer lifetime value.

Before telling you more about our international expansion and our product initiatives, including VERSION 4 TOTALe, allow me first to go through in more detail the highlights of the second quarter 2010.

Consumer revenue was 43.7 million dollars, a 2% increase from a year ago. Although total unit volumes decreased by 6%, primarily as a result of decreased U.S. advertising, we still grew our overall consumer revenue as a result of a 123% increase in International units and an 8% increase in our average selling price per unit.

Our Direct to Consumer business felt the impact of the pull back in US advertising spending most significantly, though kiosks and retail partners were also affected. We continued to prune our kiosk locations even as we benefitted from an expanded retail footprint and solid year on year sales store performance in channels such as Barnes and Noble. We began the quarter with 240 kiosks worldwide. During the quarter we opened 23 new kiosk locations and closed 18 locations. All of the kiosk closures were based in the US and as such we ended the quarter with 186 kiosks in the US and 245 worldwide. While the kiosk channel acts as an excellent marketing vehicle as well as a point of sale -- providing us with an opportunity to demonstrate our difference to prospects and promote our brand, we will continue to drive greater optimization of our kiosk returns. During this quarter, we reached agreements with Staples and Best Buy to roll out Version 4 TOTALe in stores in the US in the fourth quarter, giving us broader reach and positioning within these important consumer environments.

Our revenue and bookings shortfall was primarily related to extreme pricing dynamics in the American scatter TV advertising market in the second quarter. We cut back on marketing spend and thus generated 63% fewer impressions from TV in the US than in the second quarter a year ago. The impact of this reduction in spend was felt in all channels, but especially on our own website and our call centers where media spend and impressions are the key driver of sales. In this context, unit volume in our US consumer market was 15.8% lower than last year, while our aggregate US media spend was 27% lower than the same period in 2009.

As we have explained previously, we strive to maximize our net marketing contribution, which is derived by taking revenues and deducting Cost of Sales and Sales and Marketing expenses. We practice a disciplined approach to media buying, adjusting our media spend based on discreet media prices and relative expected returns, which are based on historical tracked response rates. The reduction in our advertising spend was thus a conscious business decision taken in light of adverse market conditions, in which spots traded at nearly twice the prices seen last year.

While the tightness in the media market was challenging, we did manage to generate higher response rates from the spots that we did run, with more calls per spot than in the same period last year. As a result, we believe that there continues to be strong underlying demand for our language learning solutions in the U.S. and that improvements in the TV scatter market at some point in the future should allow us to scale our spend and drive an increase in Consumer sales revenue.

In light of our difficulties in the media market in Q2, it is worth taking a step back and noting that historically, our experience has been that TV prices and availability move within a relatively stable range and that this has historically made our top line performance relatively predictable. In this way, while the Q1 scatter TV advertising market was already tight by historical standards, Q2 represented an extreme tightening from a historical perspective. Indeed, we believe that the tightness in the TV media markets in Q2 was the climaxing of increased scatter market activity by buyers that prior to the recession had been most active in the upfront market. This surge of scatter market activity, which was a direct result of a weak 2010 upfront market, created an extremely competitive and historically expensive “seller’s” market.

We understand that most general advertisers were very active in the upfront market for 2011 following their experience in the scatter market during Q2. According to third-party experts, this should reduce pressure on the scatter market next year. However, while already more stable, we expect the scatter market for TV advertising to remain tight and expensive for the balance of 2010. More normal market conditions will only return next year.

Accordingly, we are taking a much more conservative approach in updating our guidance for the second half of 2010. Brian will discuss our financial outlook in a moment.

It is important for us to manage our media spend with discipline to ensure that marketing efforts generate positive returns. Let me tell you of the several steps we are taking to reduce our exposure to the US TV scatter market over the coming months and years.

In the short term, we have engaged a new media buyer to find smarter ways of buying TV media, with increased transparency and collaboration, and we have developed exciting new TV, print, radio and outdoor advertising creative that we think will drive increased interest in our new value proposition. We are also making improvements to our call center management and our website navigation and content to improve our marketing efficiency. We believe that many of these initiatives will have a positive return even while the media markets remain tight during the balance of 2010.

Furthermore, over the long run, we expect that our current strategy, which is focused on international and institutions, and subscription revenue, will reduce our exposure to the U.S. media market volatility as the advertising driven parts of our U.S. business come to represent a smaller proportion of our revenues. In this way, our progress in all our major initiatives promises to deliver more predictability over time through diversification and longer, more stable customer relationships.

I will now turn to our institutional business which delivered record results in Q2.

Institutional revenue of 17 million dollars represented an increase of 25% over last year and was 28% of our total Q2 revenues, compared to 24% last year. These record results were driven by an expanded sales team delivering higher productivity per rep than the same period last year. Significantly, our institutional sales efforts internationally delivered 100% year on year growth, on the back of solid activity in Europe and a new contract with the Australian Department of Defense Organization which plans to use Rosetta Stone's language learning solution for all active military and civilian employees.

Across our markets, we saw increased transaction volume and average order value, as customers such as Microsoft and NASA renewed and significantly expanded their commitments. In Education, we saw a 24% increase in sales person productivity on a bookings basis, as our subscription oriented sales efforts of last year brought extensive renewal activity and average order value was increased significantly. In our government markets, we renewed our contract with DHS Immigration and Customs Enforcement, which not only increased the size of their annual contract, but also extended it to a five year commitment. Our corporate business also saw positive development as both transaction volume and average order value grew and new adoptions came in from Apple, Univision and Brinks.

Importantly, institutions are increasingly becoming subscription based relationships, and approximately 60% of our bookings in the quarter being online subscriptions, which compares favorably to last year's 46%. We expect to grow subscriptions as a percentage of our overall revenue mix over the long term.

As I indicated last quarter, we continue to make great strides with large organizations as our solutions are being viewed as a core learning platform within a growing number of institutions. We continue to add new sales representatives and are targeting getting larger contracts over time from existing and new customers. Response to TOTALe online at several sites has been very positive and we're expecting to see several large new adoptions of this augmented solution from institutions.

Our International business also performed very well in the second quarter. We achieved 155% revenue growth, making international 14% of total revenue, compared to 6% last year. We experienced very rapid year-over-year growth in all of our international markets; however, Japan's performance was the strongest.

In Japan, we are experiencing tremendous uptake in our products, as we expand our advertising and store in store retail footprint. In the second quarter, several new kiosks were opened in Camera Stores. Two of these locations are already among the top three locations in our Japan kiosk program. Meanwhile, we have already started beta testing our TOTALe solution and are excited by the positive user response in Japan. We expect to launch Version 4 TOTALe in this large language learning market early next year.

In Korea, although there was some anticipated seasonal softness after the Lunar New Year, we saw a strong pick-up in TV shopping activity at the end of the quarter and this lead to a strong second quarter finish. We ran several department store kiosk tests in this market with encouraging results.

Similar performance improvements were seen in our European operations. In Germany we successfully opened our new office in Munich and launched our first kiosk there too, while in the U.K. we signed significant new retail agreements with PC World that will lead to roll out of our offering in Q3 in more than 150 stores throughout the UK. We continue to be excited by the level of activity in our London and Munich offices, while this experimentation is nurturing a healthy marketing ecosystem.

In addition to the strong top line growth performance, our international teams delivered better than expected profitability. Although this was a positive result, we will continue to focus our international efforts on building more scalable distribution and advertising, as previously indicated, rather than optimizing profitability on a short term basis. We expect to thus reinvest international profits back into this business over the balance of 2010 in order to create more long-term growth potential.

As previously indicated, our target has been to grow our international business to be 30 to 50% of our total revenues by 2014 as markets beyond the US represent over 90% of worldwide spend on language learning products and services. As such, global expansion represents our biggest long term growth opportunity and it is important that we provide adequate resources and focus to it. In this regard, we plan to bring stronger leadership to our overall international effort, by bringing on a Senior Vice President of International Sales. We believe adding this role is a natural progression at this juncture in our international expansion efforts.

Turning now to Version 4 TOTALe, we're pleased to report that preparations for launch are continuing to proceed according to plan.

As we embarked on our Version 4 TOTALe transition effort earlier this year, we settled on 3 important goals.

Our first goal was that Version 4 TOTALe should be an offering that customers love even more than Version 3.

Towards this end, I am pleased to report that our products are already being assembled and we do not now see any significant risks to launch in terms of product readiness. Over the past several months, we have focused on making the overall navigation in a hybrid environment successful for the learner, while extensive beta testing has sought to eliminate technical issues. We have done extensive testing of the TOTALe platform as an online offering over the past 12 months. All our tests suggest that the offering represents a significantly more attractive way to learn a language. Student performance is also better while socialization opportunities support student's desire to develop conversational proficiency.

Our second goal was that our service teams, including coaches, should be scaled and trained to cope with a significant increase in demand for socialization services.

We have developed rigorous recruitment and selection processes and are already delivering training, even as our back end systems are developed to provide new tools and optics that will enable performance of quality conversational coaching, on-demand technical support and customer management. While we are still in the early stages of our scaling of these functions, we are encouraged by the quality of the preparations and excited to see these teams help customers enjoy conversational success.

Our third goal was that our marketing and sales preparations should communicate the compelling value that Version 4 TOTALe represents, generating excitement, without unnecessary complication of our messaging.

We are still finalizing our advertising creative, our new website and our new demo. These efforts are on track. We believe that we will successfully convey how Version 4 TOTALe represents "Our proven solution. Enriched" and that it delivers on "Your natural ability. Awakened." Our testing of these messages in focus groups and in AB split tests suggests that consumers will respond well. We expect to continue to improve and adjust our marketing over the coming weeks, but we are set for launch on September 14th and are eager to see the market response to this breakthrough offering.

As I previously mentioned, we're looking to increase the value we generate from our customers over their lifetime as a Rosetta Stone learner. We believe that Version 4 TOTALe will help drive higher lifetime customer value with its combination of desktop and on-line components, including live coaching, success agents, and on-line interactivity. This solution also offers travelers the ability to learn a language through an iPod Touch or iPhone application.

The breadth of the Version 4 TOTALe offering will allow us to capture additional new customers who otherwise only would have considered brick-and-mortar classroom alternatives. As you can imagine, we are incredibly excited about the upcoming launch of this solution and what it means to our ability to drive future revenue growth in both the U.S. and International markets.

Other product initiatives such as our iPhone/iPod touch Mini stand-alone application and our offering geared to helping academic English learners become conversational are also progressing in line with our expectations. We hope to provide more details about these exciting offering extensions over the coming quarters, as we begin to have more targeted solutions for the markets that we serve.

I want you to know that we will be hosting an Analyst Day on September 13th in New York. I strongly encourage you to attend this event, as it will be held the day before our launch of Version 4 TOTALe. It will give you a great opportunity to view our new offerings, and we will provide more color around the economic opportunity they represent. Please call Chris Martin to register for this event.

Before I turn the call over to Brian for a more in-depth review of our financial results, I did want to take this opportunity to thank him for his service to Rosetta Stone. We appreciate the many contributions he has made to our Company since joining in 2007. When he joined, we had an embryonic financial reporting and control process. He led the effort put in place strong financial reporting with an excellent team. He guided us through the IPO process. We wish him the very best as he relocates back to Florida. Our search for a new CFO is still underway, but we have made great progress. We have met with several qualified candidates and are conducting an expedited process.

In summary, we made great progress in many areas of our business in the second quarter. Our efforts to expand our International and Institutional businesses continue to be successful. And while we are concerned about the performance of our US Consumer business in the face of a challenging advertising environment, we continue to improve our marketing operations such that we will expect to emerge from the current challenges in a stronger position. Indeed, we are excited about the strong product pipeline and the upcoming Version 4 TOTALe release which along with our international efforts, will drive strong growth and improved revenue visibility over time.

I now will turn the call over to Brian who will take us through our financial results and our guidance for Q3 and full year 2010. Brian?

Brian Helman – Chief Financial Officer
Thank you, Tom.

Sales bookings, which are defined as total revenue plus the change in deferred revenue, were $64.0 million, up 9% over the prior year. Revenue was $60.6 million for the second quarter, up 7% over last year.

Consumer revenue represented 72% of total revenue, while institutional revenue represented 28%.

From a geographic perspective, US revenue was $52.1 million, down 2% from a year ago and represented 86% of total revenue. International revenue was $8.5 million, an increase of 155% from a year ago, and represented 14% of our total revenue.

Turning to cost and profitability, I will discuss our results both on a GAAP and non-GAAP basis. Please see our press release for a reconciliation of non-GAAP measures.

Gross margin was 87.5%, representing an increase of approximately 1.1 percentage points from the second quarter of last year.

Sales and marketing expenses were $29.4 million for the quarter and included approximately $1.1 million related to Version 4 TOTALe launch preparation activities. Excluding these costs, sales and marketing expenses represented 47% of revenue, which is consistent with the second quarter of last year. As Tom mentioned, during the quarter we continued to purchase television media in line with our historical return on media targets. As a result, we maintained stable advertising margins, although we did not spend as much on television advertising as expected due to the increased ad rates. Now, looking at our international business, our marketing returns continued to run well above the prior year levels. As Tom mentioned earlier, we expect to continue investing in our international marketing programs in order to expand our market share within Europe and Asia.

Research and development expenses were $6.1 million for the quarter, which represented a 20% increase from the second quarter of last year, when excluding stock compensation charges associated with our initial public offering in April 2009. During the quarter, we added development personnel and incurred additional consulting services to support the release of Version 4 TOTALe along with other key product development initiatives.

General and administrative expenses for the quarter were $12.4 million or 20% of revenue, which included approximately $1.2 million in legal fees related to our trademark infringement lawsuit against Google. Excluding Google litigation costs, G&A expenses were $11.3 million, a 15% increase from last year, when excluding stock compensation charges associated with our initial public offering last April.

Operating EBITDA for the quarter was $10.9 million, representing an operating EBITDA margin of 17%. Operating EBITDA excluding Google related litigation expenses and costs associated with our upcoming Version 4 TOTALe launch was $13.1 million, up from $12.0 million in the second quarter of last year.

Our tax rate for the quarter decreased to 25%, though we continue to anticipate a full-year tax rate of between 30% and 35%. We continue to carry a full valuation allowance on the net operating loss carry-forwards in the UK and Japan. As a result, we did not recognize any income tax expense on income from those operations, which resulted in a reduced effective tax rate in the second quarter.

Our effective tax rate may vary on a quarterly and annual basis, depending on the international contribution to taxable income. We evaluate our deferred tax assets on a quarterly basis. If we determine that it is appropriate to release some or all of the valuation allowances, we will recognize an immediate income tax benefit in that quarter, after which point we will expect a more normalized effective tax rate.

GAAP net income was $0.17 per share, compared to a GAAP net loss per share of ($0.42) in the year-ago period. Non-GAAP net income was $0.21 per share, compared to $0.25 per share in the prior year. Excluding Google-related litigation expenses and costs associated with our upcoming Version 4 TOTALe launch, non-GAAP net income was $0.27 per share.

Our second quarter earnings were ahead of our expectations. Lower media costs and the associated sales expenses represented a significant portion of our savings. However, we also realized savings related to lower consulting fees associated with increased product development efficiencies and slower than anticipated hiring in several areas. Finally, costs associated with our Google litigation and our Version 4 TOTALe launch were approximately $1.5 million less than anticipated.

Turning to our balance sheet, we ended the quarter with $99.7 million in cash and cash equivalents.

I would now like to discuss our guidance for the third quarter and full year 2010. As you know, we are preparing for the release of Version 4 TOTALe in September and, as a result, we expect to incur certain costs associated with the launch.

As we previously discussed, in the third quarter we expect to incur approximately $3 million in obsolescence charges related to our Version 3 inventory.

We also expect to incur approximately $3.0 million in the second half of the year in additional sales and marketing costs to support a broad marketing campaign to drive increased awareness for Version 4 TOTALe

As a result of our efforts to hire additional conversational coaches and customer support staff to support Version 4 TOTALe, we expect gross margin to be in the range of 84% to 85% in the fourth quarter of 2010, after we go live with the service. This range is slightly above our previous guidance of 83% to 84%.

Turning to revenue, in light of the increased tightness in the television advertising market we saw in the 2nd quarter, which we believe will continue for the balance of the year, combined with a challenging US consumer environment, we have revised our outlook. Accordingly, we expect third quarter sales bookings in the range of $72 million to $76 million and revenue in the range of $60 million to $64 million. Revenue guidance includes the deferral of approximately $3.5 million to $4.0 million in sales related to the launch of Version 4 TOTALe during the quarter. Included in this amount is approximately $2.5 million to $3.0 million related to the exchange of Version 3 to Version 4 inventory at our global retail partners. Upon the release of Version 4 TOTALe, we anticipate that we will defer approximately 15 to 20% of each product sale, related to the subscription based online services that will be delivered in future periods. This range is slightly below our previous expectation of 20% to 25%. The deferred revenue will be recognized over the subscription term, which we estimate to be 9 months, on average.

We expect operating EBITDA for the third quarter to be between $11 million and $13 million.

Non-GAAP net loss is expected to be in the range of $0.02 to $0.09 per share. We expect GAAP net loss of $0.05 to $0.12 per share. For the quarter, we are estimating 20.4 million weighted average basic shares outstanding.

On a full-year basis, we expect sales bookings between $285 million to $295 million and revenue in the range of $265 million to $275 million. We expect operating EBITDA for the year to be between $50 million and $55 million. We anticipate non GAAP diluted net income in the range of $0.77 to $0.93 per share. We expect GAAP diluted net income of $0.65 to $0.81 per share. These amounts include approximately $4.4 million, or $0.13 per share, in litigation expenses related to the legal action against Google and approximately $7.0 million, or $0.21 per share, in expenses related our Version 4 TOTALe launch. For the year, we estimate a weighted average of 21.3 million shares outstanding.

As a reminder, we have posted a slide presentation related to our second quarter results as well as additional information you might find helpful in the Investor Relations section of our website.

Finally, I would like to thank Tom for all his support over the past 3 ½ years. It has been a great pleasure working with him and the entire Rosetta Stone team and I am confident in their future successes.

I will now turn the call over to the Operator for Q&A.