Rosetta Stone Inc.
Fourth Quarter 2009 Conference Call
February 25, 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 fourth quarter 2009 earnings conference call. 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 first 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, stock-based compensation, IPO related compensation expense and fees associated with a canceled secondary stock offering. We will also provide total sales bookings, which is sales irrespective of any deferred revenue; operating EBITDA, which is adjusted EBITDA plus deferred revenue; adjusted EBITDA, which excludes stock-based compensation, IPO related expense and fees associated with a canceled secondary stock offering. These measures are not in accordance with, nor an alternative for GAAP and may be different from the 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 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 extremely pleased to report our fourth quarter results, including record revenues and earnings that highlight the underlying strength of the Rosetta Stone brand and the continued demand for our innovative language-learning solutions.

Our strong performance was driven by success in all of our markets. Our Consumer business delivered excellent results on the back of record demand, including unit volume that was 13% above the fourth quarter of last year. And while US Consumer channels turned in a solid performance, we experienced dramatic growth internationally, and we now believe that we have reached an important inflection point in this aspect of the business. Our US Institutional business also continued its trend of robust growth. Our fourth quarter results helped us achieve record Adjusted EBITDA for the year of $48.7 million, which is a 34% increase over last year and record free cash flow of $32.7 million, which is a 189% increase on last year. We ended the year with more than $95 million of cash on hand with no debt.

As we look forward and begin a new year, we're taking advantage of our positive momentum and making investments that will extend our industry leadership and drive future growth. In particular, in the second half of the year, we plan to launch significant product platform innovations to dramatically improve the Rosetta Stone experience, as well as allow us to better address more segments in the language learning market. We will also continue to scale our capabilities internationally, as we see these markets contributing a growing proportion of our revenues going forward. We anticipate that International will represent approximately 13% to 15% of our total revenue in 2010, up from 8% in 2009.

Before telling you more about these product and international initiatives, allow me to first go through the highlights of the fourth quarter and full-year 2009.

For the fourth quarter, total global revenue was $78.3 million, representing 18% growth over last year. This was Rosetta Stone's highest quarterly revenue ever, $11 million more than the record results reported in the third quarter. Full-year revenue was $252.3 million, representing a 20% increase over 2008.

We saw record earnings growth as our fourth quarter non-GAAP EPS increased 85% year on year to $0.61 per share. Our full-year 2009 non-GAAP EPS was $1.38, which represents a 39% increase over 2008.

Adjusted EBITDA for the quarter grew more than 80% to $21.4 million, as compared to $11.6 million in the fourth quarter of 2008. Our full-year 2009 Adjusted EBITDA was $48.7 million, a 34% increase over 2008.

As I mentioned earlier, we generated record free cash flow in the quarter of $23.6 million, which was 714% higher than the $2.9 million of free cash flow we generated in Q4 2008. For the full year, we generated free cash flow of $32.7 million, which was 189% higher than the $11.3 million of free cash flow we generated during 2008.

Going behind these numbers, our global Consumer business delivered strong revenue growth, without significant increases in sales and marketing expenses. Fourth quarter revenues in Consumer were $65.1 million, a 16% increase over the fourth quarter of 2008, on the back of sales of 190,000 units -- a 13% increase -- besting our previous highest quarter. Sales on our website and through our call centers reflected enthusiastic demand, stimulated by our leading brand position and an integrated seasonal campaign. In the retail environment, including our own kiosks and our retail partners, we also achieved solid results, driven by strong year-on-year sell-through rates at our expanded 2,500 points of retail distribution at Barnes and Noble, Borders and Apple Stores.

While we grew the number of kiosk locations significantly during the first nine months of 2009, we closed 30 underperforming locations in the US, after the holiday season -- as we had said we would do in our third quarter report. And we ended the year with 201 US locations and a total of 242 kiosk locations worldwide. This end of year closing of kiosks is consistent with our practice in prior years, which involves evaluating our kiosks and pruning those that are not meeting expectations. Indeed, the kiosk program is a key competitive advantage for Rosetta Stone, as it serves as a 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 remain enthusiastic and committed to this channel.

Our Institutional business had another strong quarter as Institutional revenue was $13.2 million, representing 29% year-over-year growth. While there was growth across all of our verticals, we saw particular strength in our Corporate business, due to strong upgrade renewals and our increased focus on key activity metrics. In the fourth quarter, 58% of our total Institutional revenue was from online subscriptions, as compared to 42% for the same period last year. We believe that an increasing percentage of our sales in this channel will be based on annual subscriptions as we move to migrate more institutional customers to an online platform where there is opportunity for recurring revenue.

Notable new customers were added during the fourth quarter, including Avnet and the US Attorney's Office, while we also renewed and expanded our relationships with existing customers such as Pitney Bowes, the US Air Force, and the University of Denver.

Our International business achieved significant growth during the quarter. International revenue grew 76% over the third quarter of 2009 and more than 160% from the fourth quarter of 2008. International accounted for 11% of our revenue in the fourth quarter, up from 5% last year.

We are growing our brand recognition rapidly and have developed several scalable, profitable commercial channels in the UK, Japan, and Korea. Based on our sales and marketing success in several markets and our superior technology-enabled solutions, we are very confident that we will continue to grow market share worldwide.

Our strong finish to 2009 gives us a good foundation for attacking the opportunities before us in 2010. This year, we intend to focus on two key areas of investment to extend our industry leadership and drive future growth:

1. We plan to launch significant product platform innovations that will have greater appeal, with a wider range of price points and more targeted to differing language-learning aspirations.

2. We will continue to scale our capabilities internationally, as we see these markets contributing a growing proportion of our revenues going forward.

Allow me to take a moment and describe in more detail these two principal initiatives, starting with our planned platform innovation.

Product Platform Innovation

In order to broaden our offering and make our customers have even greater language learning success, we will be releasing in late Q3, a new version of our core offering called Rosetta Stone® Version 4 TOTALe™. It will combine the best of our locally installed software solution with our TOTALe related online socialization features. We'll also introduce a new iPhone/iPod Touch playable Speech practicing companion as an ancillary part of this exciting new offering. Version 4 TOTALe is an integrated technology enabled immersion experience that is built on our successful experience with TOTALe online over the past 7 months. Version 4 TOTALe will be sold in Level increments in all our channels in the US and will replace Version 3 as it is rolled out. And at only a slight premium to the current Version 3 software, Version 4 TOTALe will represent an even more compelling value and we expect it to be highly disruptive in the industry.

Clearly, by having had TOTALe online in the market since its release in August 2009, we have been able to observe how users engage with the expanded features and services. And we have been able to validate the efficacy of the approach. TOTALe learners have higher satisfaction and better outcomes than current Version 3 software learners despite TOTALe online currently having a much higher price point.

As a complete solution, Version 4 TOTALe will enable customers to learn with our award winning Dynamic Immersion based software, which they will be able to access in perpetuity, while also getting duration based access to online conversation coaching and peer to peer language learning games. Customers will also have the benefit of reinforcing their language learning on the go, either with audio companion activities on their iPod or some Speech activities on their iPhone or iPod Touch. The full experience is powerful and success filled.

In conjunction with the overall Version 4 TOTALe launch, we are also planning to release an introductory offering (much smaller than a Level 1) at a sub-$180 price point, in order to enable a new segment of learners to experience Version 4 TOTALe.

We will share with you the specific price points for Version 4 TOTALe as we get closer to launch in the second half of the year, but we expect these significantly enhanced offerings to be priced only slightly above our current Version 3 products, making them affordable for the consumer.

No doubt, this new offering will result in higher Costs of Sales as we provide new and more extensive services. However, we believe that we will be able to capture revenue growth that more than makes up for this increase in costs.

In addition to the general value of delivering more language learning success for our customers, we believe that there will be 5 long term economic benefits for us,

1. We expect to capture some more value up front from customers as they appreciate the increased benefits that Version 4 TOTALe comprises.

2. We also anticipate realizing increased customer lifetime value, with pro-active, service oriented customer relationships post-sale.

3. We believe that Version 4 TOTALe will help us win over more of those who today choose to attend brick-and-mortar classrooms – as they demand social interaction in their language training – and such services will now be available online with Version 4 TOTALe.

4. Over time, we believe self-directed learners will come to expect learning solutions to include a high-quality, live-coaching component – and our early adoption of such services will give us an important competitive advantage.

5. We expect that as customers have more language learning success, they will tell their friends and their recommendations will turn into unit growth over time.

As such, we expect Version 4 TOTALe to be accretive to our economic profitability, even as we provide outstanding service to our customers and provide a more effective learning solution.

Perhaps, I should note that the extension and expansion of the lifetime value of our customer relationships will not happen overnight. But still, 2010 will mark our decisive move towards this preferred customer oriented paradigm.

While we believe that the introduction of Version 4 TOTALe will increase Rosetta Stone's profitability and strengthen our overall business over time, there are accounting implications to be considered, as well as some one-time charges that will particularly affect the second and third quarters of this year, as we make this transition to more compelling products and a more value-creating business model. Brian will discuss these accounting considerations shortly.

Ultimately, this offering transition will move us further towards changing how people learn languages and will attract more people to engage with the brand, and accordingly, we will reinforce the company's position and long-term prospects.

As I mentioned, in addition to launching Version 4 TOTALe in the second half, we are also developing a stand-alone iPhone/iPod Touch application to be released in the second half of this year that will appeal to an emerging part of the market and provide travelers with a sub-2 hour learning experience in a new language.

This iPhone/iPod Touch application, which we refer to as: "Rosetta Stone Mini," will carry a much lower price point than even our prospective Version 4 TOTALe introductory offering. It will create new market opportunity for us by targeting business travelers and tourists that are just looking to know a few words and expressions in a language. Importantly, it will provide a low cost opportunity to engage with the Rosetta Stone brand and try the Dynamic Immersion method and have some real learning success, even if it is limited in scope. Our hope is that many of these users will experience and recognize the superior Dynamic Immersion method and come to represent a fertile opportunity for subsequent Version 4 TOTALe selling efforts.

To showcase our new offerings and provide more color around the economic opportunity that we think that they represent, we will be hosting an Analyst Day in the Spring.

Continuing to Scale our Capabilities Internationally
In addition to broadening our product portfolio and re-configuring our customer relationship management to drive a broader array of solutions through our growing platform, we will accelerate Rosetta Stone's international expansion in 2010. Building on the successful momentum established over the past six months, we plan to significantly expand our operations in Japan, Korea, Germany and the UK. We expect to continue to expand kiosks and in-store demonstration, and to grow and optimize our advertising, even as we prepare for the launch of new offerings, including an English speaking skill remediation offering that we plan to make available in 2011.

We believe that our International business will come to represent approximately 13 to 15% of our total revenue in 2010, up from 8% in 2009 and 5% in 2008. This sets us on course to achieve our target of having 30 to 50% of our business outside the US by 2014.

While we expect top-line growth internationally to be very strong in 2010, it is important to note that we intend to reinvest all international profits back into scaling our international operations this year. As Brian will discuss, this will affect our aggregate sales and marketing expenses as a percentage of total global sales. We believe that the benefits from investing in our international distribution and marketing system will yield significant returns in 2011 and beyond.

In summary, we're extremely pleased with our record performance in the fourth quarter and full-year 2009. As we begin 2010, we believe our prospects have never been better: International is growing rapidly; our institutional sales remain robust; and, our US consumer business is producing solid results. We're launching a significant product platform innovation in the second half of the year, and we're scaling our capabilities internationally.

By continuing to disrupt our industry and creating new value for language learners, we believe we will position the company for long term success and accordingly create shareholder value.

With that I'll turn the call over to Brian to discuss the accounting considerations related to the new offering, as well as our first quarter and 2010 guidance.

Brian Helman – Chief Financial Officer
Thank you, Tom.

As Tom mentioned, we generated record revenue of $78.3 million during the fourth quarter. Consumer revenue grew by 16%, driven by a 13% increase in unit volume as a result of solid demand from US consumers and rapidly accelerating international growth. Our aggregate average sales price per unit increased by 3% during the quarter, however, we grew our ASPU by 7% in our direct channels, which was offset by increased volume through our indirect retail channels. Our institutional business also continued its strong growth trend as revenue grew by 29%.

We generated record earnings during the quarter as non-GAAP net income for the fourth quarter was $0.61 per share, an 85% increase from the prior year. GAAP net income for the fourth quarter was $0.58 per share, a 100% increase from 2008.

Adjusted EBITDA for the fourth quarter was $21.4 million, up 84% from the prior year. Our 27% Adjusted EBITDA margin for the quarter represents the highest quarterly margin in the company's history and a 10-percentage-point improvement over the fourth quarter of last year.

Turning to our balance sheet, we ended the quarter with $95.2 million in cash and cash equivalents as we generated record cash flow in 2009, with $41.2 million in cash flow from operations and $32.7 million in free cash flow.

Gross margins for the quarter were 86.9%, which is up approximately half a percentage point from the fourth quarter of last quarter.

Sales and marketing expenses were $31.9 million for the quarter, or 41% of revenue, which is approximately 1.4 percentage points lower than the fourth quarter of the prior year. This represents the greatest amount of sales and marketing leverage that we have ever achieved in our history.

Research and development expenses were $5.2 million for the quarter, which represents a 2% increase over the prior year.

General & administrative expenses for the quarter were $12.2 million, which represents an 8% reduction from the prior year.

In terms of our results for the full year, total revenue was $252.3 million, up 20% from last year. Non-GAAP net income was $1.38 per share, which represents a 39% increase over 2008. GAAP net income for full year 2009 was $0.67 per share, which includes the $18.8 million, or $0.60 per share, charge associated with the IPO related stock grant. Our Adjusted EBITDA for the year was $48.7 million, which is up 34% from the previous year.

Despite the global economic challenges and our significant investments in product, international expansion and infrastructure, we grew our Adjusted EBITDA margin to 19% in 2009, up from 17% in 2008.

Our effective tax rate for 2009 was 35%.

Rosetta Stone Version 4 TOTALe Development and Launch -- Investments and Accounting Impact

Before I discuss our guidance for the first quarter and full-year 2010, I wanted to take a few minutes to review the investments and accounting impact related to the development and planned launch of Rosetta Stone Version 4 TOTALe.

As Tom mentioned, our Version 4 TOTALe solution will combine a perpetual license for Rosetta Course, our traditional language learning software application, with a time-based subscription to our on-line services, RosettaStudio and RosettaWorld. As a result, we will defer a portion of each TOTALe sale related to the online services component of the bundled solution. The deferred amount will be recognized as service revenue over the subscription term.

Although, as Tom noted, we have not finalized the price points for the bundled solutions, we expect to defer between 20 to 25% of the total sales price. We expect that subscription terms will range from 1 to 15 months depending on the numbers of level included in the set, and the average term will be approximately 9 months.

Finally, the majority of our Version 3 standalone perpetual license products will no longer be offered upon the release of Version 4 TOTALe.

In order to facilitate the launch of Version 4 TOTALe across all of our US sales channels, we are introducing new packaging as well as investing in a broad marketing campaign to drive significant consumer awareness. As a result, we expect to incur approximately $4.5 million in additional costs related to market launch activities, of which we anticipate that approximately 40% will be incurred in the second quarter, with the balance to be incurred in the third quarter of this year. We also expect to incur approximately $3.0 million in obsolescence charges related to our Version 3 inventory, which is expected to be recorded in the second quarter.

In addition, the enrollment in our online services will grow dramatically upon the release of Version 4 TOTALe. As such, we plan to expand our staff of conversational coaches and customer support employees. We anticipate that our total gross margins will be approximately 83% to 84% of revenue once we are live with this offering. We plan to begin expanding the staff several months prior to release.

We also expect that R&D expenses for 2010 will increase throughout the year as we expand our development teams to support our Version 4 TOTALe release along with our other key development initiatives.

Finally, as Tom mentioned, the revenue growth in our international businesses is accelerating as a result of greater marketing investments and returns. We are planning to reinvest our excess international marketing returns in order to continue expanding our market share within both Europe and Asia. Although we are expecting our US sales and marketing returns to be consistent with 2009, we anticipate that our overall sales and marketing expenses as a percentage of revenue will increase in 2010 as we accelerate our international penetration and defer a portion of our US consumer sales upon the release of Version 4 TOTALe.

First Quarter and Full-Year 2010 Guidance

I would now like to review our guidance for the first quarter and full-year 2010.

Since a material portion of our sales are expected to be deferred once Version 4 TOTALe is introduced, we believe that Adjusted EBITDA will no longer represent a meaningful performance metric for the company as it does not fully reflect the cash economics of our business. As a result, we are introducing a few new metrics to provide more relevant measures of our financial performance. We will now be providing guidance on sales bookings and Operating EBITDA, which represents Adjusted EBITDA plus the change in deferred revenue.

We expect full year 2010 revenue in the range of $286 million to $299 million, with sales bookings of between $310 million to $325 million. We anticipate that international will represent approximately 13% to 15% of revenue in 2010. We expect Operating EBITDA for the year to be between $58.0 million and $65.0 million.

While, as I said, Adjusted EBITDA will no longer be a relevant performance metric going forward, we are providing our expected Adjusted EBITDA for 2010 as point of reference for the full year only. Our estimates of Adjusted EBITDA and earnings per share are based upon our current expectations of Version 4 TOTALe pricing, subscription terms and revenue deferrals.

As such, we expect Adjusted EBITDA of between $34 million to $39 million and non-GAAP diluted net income in the range of $0.90 to $1.00 per share. We expect GAAP diluted net income of $0.78 to $0.88 per share. These amounts include approximately $6.0 million, or $0.18 per share, in litigation expenses related to our previously disclosed lawsuit seeking to prevent Google from infringing upon Rosetta Stone's trademarks. The trial has been scheduled for May, and as you would normally expect, our litigation expenses are accelerating in preparation for the trial.

For the year, we are using 21.5 million weighted-average shares outstanding. Finally, we expect that our effective tax rate for 2010 will be between 35% and 38%. Our effective tax rate may vary on a quarterly and annual basis depending on the international contribution to taxable income.

Looking at the first quarter of 2010, we expect revenue in the range of $58 million to $60 million, with sales bookings of approximately the same amount. We expect Operating EBITDA for the first quarter to be between $3.1 million and $3.6 million. Non-GAAP diluted net income is expected to be in the range of $0.07 to $0.09 per share. We expect GAAP net income of $0.04 to $0.06 per share. These amounts include approximately $4.0 million, or $0.12 per share, in expenses related to the legal action against Google. For the quarter, we are using 21.2 million weighted-average shares outstanding.

As a reminder, you can find additional, detailed information related to the accounting impact, including the deferral of sales, on the slide presentation that we have posted on our investor relations website. And, as we have in the past, we have also posted a supplemental information worksheet on our website.

With that, we will turn it over to the operator to begin the Q&A session. Operator?

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Tom Adams – Chief Executive Officer – Closing remarks
Allow me to thank everyone again for joining today's call.

As we've said, we're very pleased to report these record results and are excited about the prospects for the company both here and abroad in 2010. We're clearly moving towards being a truly global technology leader in the very large language learning market.

This year should be great for our customers as we roll out new offerings in both institutional and individual settings and take the learning experience to another level – one where we are delivering an unparalleled, technology-enabled immersion experience.

To Rosetta Stone employees listening to today's call: Thank you for your tremendous work in 2009. I am very proud of the progress we all achieved in the past year, driven by the overriding goal of serving customers exceptionally, which, in turn, creates shareholder value.

And with that, let me wish everyone a pleasant day. Thank you for your interest.

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