Fourth Quarter and Full Year 2019 Earnings Call

Prepared Remarks

Jason Terry - Safe Harbor

Thank you. Good afternoon everyone. Welcome to Rosetta Stone's fourth quarter and 2019 earnings conference call. Speaking on the call today will be John Hass, Chairman and CEO, and 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 - CEO

Good afternoon and thank you for joining the call. We have a lot to talk about so please turn to **slide 3** and I will begin by walking you through an overview of our consolidated fourth quarter and year end results.

Slide 3 - 2019 Summary Year End and Fourth Quarter Results

2019 was a year of significant progress across all of Rosetta Stone confirming that the efforts to restructure our business are behind us. 2019 was the first year since before 2014 in which each of our segments grew producing consolidated bookings growth of 9%. Our Literacy segment led the way, driven in particular by increasing contributions from PowerUp, but for the first time in many years both Language segments also contributed to growth. I would point in particular to the very strong fourth quarter performance of Consumer Language which saw bookings grow by 14% over Q4 2018.

On a consolidated basis, fourth quarter and full year revenue grew by 5% over the same period in 2018. This growth helped drive improvement in both Adjusted EBITDA and net income for the full year. Net income for the quarter was a loss of $6.5 million, compared to a loss of $4.4 million in the same period in 2018, and for the full year net income was a loss of $13.0 million compared to a loss of $21.5 million in 2018.

Adjusted EBITDA for the quarter was negative $0.9 million compared to positive $0.7 million in the same period in 2018, and for the full year it was $6.9 million compared to $0.2 million in 2018. We ended the year with a cash balance of $43 million and no debt.

2019 was a very good and important year for us. Please turn to **slide 4**.

Slide 4 - Investment Thesis Today

Now with a great set of SaaS-solutions producing terrific outcomes for learners, meaningful growth opportunities in both our K-12 and Language businesses, and a strong balance sheet, we are excited to move forward and begin to realize the benefits of the investments we have been making in the business. Benefits that in products like PowerUp, and our soon to be released K-6 english learning solution, are either just beginning to realize their potential or have not yet even been released. It's this latent opportunity, as well as the opportunity we see in other assets, like the Rosetta Stone brand, that get us excited about the future.

Before we go further I would like you to know that, after seeking input from our shareholders, we have decided to recommend in this year's proxy an amendment to our charter that will allow us to eliminate our current classified board structure. We believe that the stability afforded by a classified board served us well as a relatively new public company, but as we have matured and built a strong, shareholder focused board, we believe it is no longer necessary.

I also need to let you know that we have decided to postpone our Investor Day, previously scheduled for April 15th. There is much we want to share with you and we want to do that in person. We have heard from many that that might not be possible right now so we are looking to move Investor Day to this summer. I also need the team right now focused on everything that is happening in the business and with our customers. We will get back to you with a date as soon as we can reasonably do so.

Now let's take a closer look at the performance of each of the businesses, beginning with Lexia. And for that I will hand the microphone over to Nick.

Nick Gaehde – Co-President

Thanks John. Please turn to **slide 5**.

Slide 5 - Literacy Financial Overview

In our Literacy segment, revenue in the quarter was $17.1 million, an increase of 18% over the same period in 2018. For the full year revenue increased to $62.6 million, or 19% higher than 2018. Bookings were $10.8 million in the fourth quarter, an increase of 11% over the same period in 2018, while full year bookings were $68.4 million, an increase of 17% from 2018.

While new customer bookings grew on both an absolute and percentage basis in 2019, we did not achieve the expectations we originally set for ourselves. In a moment I will talk about why, and what we are doing to better realize the opportunity we have.

Please turn to **slide 6**.

Slide 6 - Strong Renewal Rates + New Business = ARR Growth

Annual recurring revenue, or ARR, grew 17%, consistent with bookings growth. ARR is driven by our ability to maintain and grow the dollars we receive from existing customers and by new sales.

As we have discussed previously, retention rates, which for us are unit based, and don't reflect the size of the account, trended down during 2019 primarily due to churn over the last couple of years in smaller accounts, including, the large number of accounts that have been coming off of grandfathered pricing leftover from when Lexia transitioned from perpetual to subscription sales. We want to do a better, more efficient job of managing these smaller accounts, but now that we better understand the underlying reason, this is not a trend that concerns us.

In 2019, dollar-based renewals continued to be strong and consistent with prior years. That said, we expected more from our renewal pool during the year as we introduced price increases that were targeted to whole-school licenses and certain annual service and implementation plans. While in many cases the price increases were accepted by our customers, more often than we had expected, schools or districts managed their expenses by shifting to lower priced service packages that maintained their prior price point. This had the benefit of improving the margin on those bookings for us, as we were delivering fewer in-person services for the same dollar amount, but it did not increase bookings as much as planned if the services had been maintained and the price increase passed through.

Please turn to **slide 7** and I will talk about our expanding portfolio of solutions that will help drive growth.

Slide 7 - Literacy Customer Expansion

The first is the clear success of PowerUp. Remember, it was just a short time ago that we had only one literacy curriculum product. In 2018, we talked to you as we introduced PowerUp about how we expected it, along with Core5, allows us to serve critical literacy needs from kindergarten through high school, and would fundamentally broaden our dialogue with school districts and deepen our impact.

And you can see the effect of PowerUp's introduction on this slide. Since the launch of PowerUp in January of 2018, it has driven a rapid expansion in the number of customers using more than one product.

PowerUp is also driving standalone sales, and in many cases is the first product we introduce into a school system that is using one of our competitors' solutions in their elementary school buildings. It is an effective wedge that will allow us to move down into elementary school buildings over time, especially as we demonstrate its effectiveness.

By the end of last month, PowerUp was being used in over 6,000 school buildings both on a standalone basis and in combination with Core5. This is a 70% increase over February of 2018 and indicative of the largely unmet need we saw in the marketplace to help the broad population of struggling readers, and their teachers, in middle schools and high schools. And now we are beginning to see compelling evidence that our ability to develop highly effective K-12 products that produce positive changes for students and their schools is not limited to Core5. Please turn to **slide 8**.

Slide 8 - PowerUp: Demonstration of Efficacy

In January, our first study looking at the effectiveness of PowerUp, received an ESSA rating of Strong, which is the highest rating under the guidelines of ESSA, the Federal Government's "Every Student Succeeds Act" and is very difficult to achieve. In fact, given the effects seen in the study, PowerUp is now listed on the website of Evidence for ESSA, the organization that provides clear and authoritative information on programs that meet the ESSA evidence standards, as '*the most effective secondary literacy intervention'*, among the programs listed.

This is a special distinction earned by a product barely two years from its launch. We always believed PowerUp would be able to help the two-thirds of older students that are struggling to read that it was built for, but to have independent validation as '*the most effective secondary literacy intervention'* is something we are very proud of.

With Core5 and PowerUp we now have two successful, validated products that are highly complementary. This puts us in a much stronger position as a company than when we were a one product company, even one product as good as Core5. And now we have a great opportunity to make it three. Please turn to **slide 9**.

Slide 9 - Rosetta Stone English - In Beta Now

As the success of Core5 and PowerUp demonstrate, we are very good at identifying large areas of underserved need in K-12 and building products that meet these critical needs by delivering adaptive, personalized solutions that benefit students, while providing their teachers the data and information they require, all in a way that accelerates learning.

Helping emergent bilingual learners achieve language proficiency in English is the next area we are focused on. As a reminder, this is the fastest-growing K-12 student population in the US, currently around 10% of students, but expected to grow to 25% by 2025. We believe there is an opportunity to dramatically improve instruction for these English as a second language learners in the United States, and potentially around the world.

Our solution for K-6 emergent bilinguals will be called Rosetta Stone English, leveraging the power of our brand to drive awareness and confidence in a language development solution. Rosetta Stone English will break new ground in a part of the marketplace that is still largely print based and unable to adequately meet the needs of these learners.

Rosetta Stone English entered its beta period in early February. This is a broad program spanning over 30 schools, across eight key states including California, Florida, Texas and North Carolina, and reaching approximately 2,000 students. So far the feedback is very promising.

With this expanding portfolio of products we are also focused on ensuring the sales force is structured and supported to achieve our growth targets. Please turn to **slide 10**.

Slide 10 - Literacy Expansion Opportunity

New Literacy bookings, despite growing more than it did in the prior three years, in both absolute and percentage terms, did not meet our expectations. While we operate in a competitive marketplace, we don't believe this is an opportunity problem.

As mentioned on our third quarter call, we booked lower than expected new sales in two areas - Texas and large, or what we refer to as National Accounts. These continue to be important and exciting opportunities and we believe we have the right positioning to drive growth in the market as it develops further, as in the case of Texas, and as our relationships mature and expand, as in the case of our National Accounts. In fact, the secondary school portion of the Texas literacy adoption, where PowerUp is a great fit, begins this year.

But as shown on this slide, we expect the majority of our opportunity to continue to come from focusing on the districts we are already in and where we can demonstrate positive outcomes. The opportunity represented here is huge, but we need to adjust how we were going after it. Please turn to **slide 11**.

Slide 11 - K12 Sales and Marketing - Investing in Growth

Historically, in large part to focus on upsell opportunities with current customers, regional sales managers have managed a team that included both account executives, those field based sales reps that are working face-to-face in districts and generally focused on larger accounts, and account managers, who are more like an inside sales team and generally focused on smaller accounts.

As we have grown, the volume of lower opportunity customers has built up under our sales teams, decreasing the time available for regional sales managers and their account executives to prospect for new business and drive larger expansions. In fact, we will manage approximately 4,600 renewals in our direct business this year.

To address this and realize more of our growth potential, we have accelerated the evolution of our Literacy sales and marketing organization to significantly increase its capacity for new business and high value expansions and renewals, while more efficiently managing our large volume of smaller accounts with more limited expansion potential.

Earlier this year we moved account managers out from under our regional sales managers and placed that team under two newly created regional inside sales managers. This account manager group, which we are also growing, is now entirely focused on the large volume of smaller opportunity customers.

Critically, these reassignments of smaller account responsibilities to an inside sales team, is allowing our field-based, regional sales managers to work more closely with their account executives and for all of them to focus more productively on larger new opportunities and strategic renewals. We are also increasing the size of our field sales teams.

And, finally, to improve the efficiency of all sales professionals, we are more than doubling our Account Specialist team. This team supports the transactional elements of the process so the sales team can focus on reaching out to new customers and strengthening existing customer relationships.

These steps, taken together, have significantly increased our capacity to drive the engagement and focus necessary to manage renewals while also growing new business more rapidly. This is an important investment that will reduce earnings in 2020, but with that in place, it should allow us to scale faster and efficiently.

Let's turn now to our Language businesses and I will hand it off to Matt.

Matt Hulett – Co-President

Slide 12 - 2019 E&E Financial Overview

Thank you Nick.

Moving to **slide 12**, we had a solid fourth quarter in both our Consumer and Enterprise and Education language businesses, concluding the first year of growth since before 2014.

In the fourth quarter, excluding custom content, Enterprise bookings were $10.7 million, versus $9.3 million in the same period in 2018. The growth in Enterprise was more than offset by the year-over-year decrease in custom content within the period and lower K-12 Language bookings, resulting in total E&E bookings of $14.9 million, down $1 million from the same prior-year quarter. For the year, however, total bookings in E&E were $2.8 million higher than in the prior year, driven by the large custom content deal in Q3 and improved performance in our corporate vertical.

During the quarter the corporate team closed another seven figure contract. This global deal for a European-based company was the third million dollar or greater enterprise contract signed in the last two years. We continue to see additional expansion opportunities in our large pool of Global-1000 accounts who currently have a low dollar value relationship with us.   Please turn to **slide 13**.

Slide 13 - 2019 Consumer Financial Overview

Consumer had a very strong fourth quarter with bookings growth of $2.5 million, or 14%, over the fourth quarter of 2018 driven by Rosetta Stone app sales. Bookings also increased due to the sale of lifetime subscriptions in the Web channel, but because those sales are recognized as revenue over 24-months, they did not have a significant impact on revenue in Q4 2019. Revenues in the quarter were $15.8 million, an increase of 2% over the same period in 2018.

For the full year, Consumer Language revenue was $63.3 million versus $60.5 million in 2018, while bookings, before SourceNext in the year increased by 5% to $66.4 million. As John said before, this is the first year that Consumer bookings and revenue have grown since 2014.

Total contribution from the Language businesses, after the shared costs of R&D and IT, was $3.3 million in the fourth quarter, and $23.1 million for the full year.

Slide 14 - Consumer Performance

Turning to **slide 14**, the strong fourth quarter performance in Consumer was driven in part by strong sales of longer term subscriptions, in particular, our Lifetime product. We are finding that the lifetime product is attractive to a distinct customer segment that wants to commit to learning a new language but is put off by finite subscription offers that are at odds with the investment in time they know will be required.

We recognize that lifetime sales eliminate the opportunity for future renewals from these customers and have priced the product accordingly to capture an LTV that is as high, or higher, than we would otherwise expect to realize over time from future renewals of shorter-term subscription products.

Sales of lifetime subscriptions drove an increase in the average initial sales price from $103 in both the third quarter of 2019 and the fourth quarter 2018, to $120 in the fourth quarter of 2019. And while net LTV was relatively flat year over year, we recognized more of that LTV upfront, maximizing its benefit to us.

Slide 15 - Evolution of Consumer Product Portfolio

Turning to **slide 15**, we see a logical bifurcation of our customer base into those looking to try language learning and who are most likely to purchase a three-month initial subscription, versus committed learners, who are more likely to buy a 24-month or lifetime subscription. Consequently, we are adjusting our offerings to create more value for each type of learner to better meet their objectives.

In February, for example, we added a significant upgrade to our long-term subscription offerings. For the first time, for all subscriptions 12 months and longer, learners have access to all of the 25 languages in our catalog with a single purchase. We call this Rosetta Stone Unlimited. Now a learner who buys a lifetime subscription will have the option to learn any language now or in the future. These lifetime subscriptions carry a typical average sales price per unit of approximately $189, versus $36 for a three month subscription, reflective of the tremendous value we are offering.

And the value we offer learners will only grow in 2020. We have a number of exciting new features that will be rolling out early this year and that we will talk about on future calls and share when we get to Investor Day. It is great to accelerate the pace of innovation in Language now that our platform consolidation and deflashing work is behind us. Please turn to **slide 16.**

Slide 16 - Leveraging the Rosetta Stone Brand

As we begin to see vitality returning to our Consumer Language business, we made the decision earlier this year to broaden our variable marketing spend to include more top of funnel, offline marketing. I have talked in the past about the enormous power of the Rosetta Stone brand. But frankly we haven't done much to actively leverage it.

Over the last five years we spent almost no money on offline brand marketing that can have a good return, but longer payback. Instead, virtually all of our media spend was focused on faster payback, performance digital marketing where a dollar invested relatively quickly produced bookings of approximately $1.80 on average.

We are now excited to resume investing in profitable long-term growth in our Language business. You will recall, we did a three city brand marketing test in 2019. We are utilizing the learnings from that test to expand and sharply focus our brand spend nationally during 2020. We do not intend to be, nor given the strength of our brand, do we need to be, a prolific offline advertiser. But we want to build a presence again that will broaden our customer reach and refresh what Rosetta Stone means in the mind of a language learner.

Because top of funnel advertising builds and pays back over time, we are not expecting a positive return on media for this portion of our marketing spend in 2020. Consequently, it will lower the contribution from Consumer relative to what it would have been had we not chosen to invest in our future growth. We are taking a measured approach to this as an investment and are confident the return will build and pay off over time based on our prior experience and the recent testing we've done.

With that, please turn to **slide 17** and John will walk through our financial outlook and share a few closing comments.

Slide 17 - 2020 Full Year Guidance

John Hass - CEO

Slide 17 - 2020 Full Year Guidance

Thank you Matt.

Given everything that has happened, including the last few days, it is critical to provide context for our outlook for this year with a few thoughts about COVID-19 and its potential influence on our business in 2020 and over time.

As it regards the impact of the virus directly, our two priorities are the health and safety of our employees, and continuing to support our customers and learners during this uncertain and difficult period. For our employees, we have restricted travel and are taking precautions to promote a safe work environment, including, if necessary, temporarily closing offices, as we have in Seattle, which as you know has been ground zero here in the U.S.

For customers, all of our solutions can be used by learners, including those in K-12 and enterprise, remotely. We are working hard to ensure that we support our school and corporate customers, if they are disrupted by closures, to ensure that learning continues. We are confident we will be a great partner during what will be a challenging period for many.

As we consider the potential financial impact of this on our business, it is important to take a balanced long term view, especially as so much is not yet known. In the intermediate term, I firmly believe the disruption caused by the virus will raise awareness of the benefits of blended learning solutions like ours. Consider, for example, the advantages of an online coach for a corporate customer, versus sending an executive to a language center or bringing a tutor into your office. Or the ability of a young student to continue to learn to read at home using our software purchased by their district in the event of a school closure. These are real, tangible advantages to our solutions.

That said, we need to be cautious and balanced. In the near term, uncertainty, slowing economic growth or customer distraction, could impact parts of our business by prolonging customer decision making or even reducing learning budgets. In our K-12 business, we are confident of our ability to retain, and even expand, our relationships with existing customers given the remote learning ability we provide, but it's possible we could find it somewhat more difficult to drive new growth for a period if potential customers are focused on managing the immediate implications of the virus.

To be clear, we have not yet seen meaningful evidence of this, but we would be remiss if we weren't planning for it. This, and our desire to achieve guidance in this important year, led us to reexamine the preliminary guidance for 2020 that we shared in November, and include a more conservative range.

In 2020, we are now guiding to consolidated revenue growth of 3 to 7%, or approximately $189 to 195 million, through a combination of 12 to 14% revenue growth in Literacy on expected bookings growth of 20-25%, 4% to 7% revenue growth in Consumer on relatively flat bookings growth and a low single-digit percentage decline in revenues for E&E on a larger expected decrease in bookings.

Our outlook for strong bookings growth in Literacy is driven by expected continued high dollar renewal rates from existing customers, a third year of PowerUp, and the investment we are making to segment and more productively focus Lexia's sales and marketing organization that Nick talked about. This outlook is more tempered than before, in part because while we expect there may be good opportunity for growth with existing customers in this environment, we don't yet know what the impact, if any, from disruption and distraction related to the virus will be on new business.

Included in Literacy segment guidance is a little less than $2 million of bookings from Rosetta Stone English, all of which would come in the second half of the year after its commercial release. A good part of this in 2020 is expected to come from renewals of existing E&E segment Rosetta Stone language customers.

Literacy segment revenue expectations for 2020 are also affected by lower than originally expected bookings in 2019. And secondly, because we expect approximately 80% of total Literacy bookings and nearly all of Literacy bookings growth to occur in the second half of the year, the impact of Literacy's bookings growth this year on consolidated revenue in 2020 is diminished.

Consumer revenue in 2020 is now expected to be slightly higher than we previously thought due to the strong performance in Q4 2019. We haven't changed our Consumer bookings growth rate for the year as we want to see how new products, like our Unlimited Languages offering that Matt talked about, that are off to a good start in 2020, perform over a longer period.

We continue to expect a decline in E&E bookings due to lower expected bookings from custom content projects, remember we had a custom content deal of over $7 million in 2019, and declines in our K12 language business, in part as some of its renewal business moves to the Literacy segment with the introduction of Rosetta Stone English.

Turning to profitability we now expect adjusted EBITDA of approximately $3 to $5 million and operating cash flow is expected to be $14 to $16 million. Importantly, $2 million of the reduction in both EBITDA and operating cash flow from our preliminary guidance in December is the result of moving $2 million of product development costs, that were previously expected to be capitalized, to R&D where they will be expensed. We now expect capital expenditures to be approximately $17 million, down from prior guidance of $18 - 20 million and that we will be approximately cash flow breakeven for the year.

In total, expected cash flow is a few million less than we previously anticipated, but we see an opportunity to invest behind the strong performance we are seeing in Consumer, and we want to be a little more conservative in our bookings outlook in the current environment. We have offset a portion of this with expense reduction elsewhere.

As we reflect the current uncertainty in our bookings and revenue outlook, we will also be mindful of our expenses as the year progresses. As we learn more about the environment in which we are operating, we will adjust as necessary with the goal of continuing to invest in the future while remaining approximately cash flow breakeven this year.

As we look beyond 2020 and the current disruption, we see no meaningful change to the bookings trends in our business. Continued strong growth in Lexia driven by the foundation of Core5, with growing contributions from PowerUp and the introduction of Rosetta Stone English, mid-to-high single digit growth in Consumer Language and flat bookings in E&E Language as growth in Enterprise is offset by a shrinking K-12 Language business. Please turn to **slide 18** and I will talk about Q1.

Slide 18 - Q1 Guidance

Given how close it is to the end of the quarter, we would like to share our outlook for Q1. I would remind everyone that our first quarter is very small, with approximately 15% of expected bookings for the year. This is especially the case in Literacy where bookings are expected to be relatively flat with Q1 of 2019 and represent approximately 5% of total Literacy bookings for 2020.

We continue to see strong performance in Q1 in Consumer Language, and believe this provides us a great backdrop as we begin to acquaint people with the new Rosetta Stone through incremental brand advertising.

On a consolidated basis, we expect total Q1 revenue approaching $46 million, slightly up from last year, a GAAP net loss of approximately $7 million and a little over break-even adjusted EBITDA, a decline of approximately $3 million versus the prior year.

Due to our typical first half use of cash we will again have some seasonal borrowings. As in 2019, we expect to have positive net cash at all times and intend to end the year with no debt.

As implied by our full year guidance, we expect revenue growth and operating profitability to accelerate as we move through 2020 in line with the seasonal bookings growth in our business.

Slide 19 – Wrap up

To wrap up, I am proud of the progress the team has made over the last five years, but this is an important year with priorities that include refreshing the understanding of what Rosetta Stone can be for someone looking to learn a language, focusing a larger K-12 sales team on renewing and expanding existing customers and driving new business growth and, later this summer, successfully launching Rosetta Stone English.

These are challenging times for many and our thoughts are with everyone affected, but I know our team will be there to support learners and develop stronger customer relationships built on trust, commitment and delivering great outcomes.

At the same time, there is much to be excited about. The growth and newly validated efficacy of PowerUp, the coming introduction of Rosetta Stone English - the first product that will bring together all that we do best across the company, the chance to reinvigorate the great Rosetta Stone brand and begin to invest behind Consumer again, and knowing that we will support our customers through the current Corona-virus event wherever they want or need to learn.
In the interim, we will communicate with you regularly. We will keep you updated on the progress against our priorities, and we will look forward to seeing many of you in person at Investor Day.

We would now be happy to take your questions.