



## Rosetta Stone Inc. – Supplemental Information Third Quarter 2019

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Rosetta Stone has prepared the following supplemental information regarding the results for the third quarter ended September 30, 2019, to provide shareholders and analysts more detail to help understand and analyze our results in conjunction with our earnings release, conference call and supplemental earnings slides. **This supplemental information will not be read on the conference call.**

The conference call will begin at 5:00 p.m. ET on Wednesday, November 6, 2019, and will include brief opening comments followed by questions and answers. Investors may dial into the live conference call using 1-201-689-8470 (toll/international) or 1-877-407-9039 (toll-free). A live webcast will also be available in the investor relations section of the Company's website at <http://investors.rosettastone.com>. A replay will be made available soon after the live conference call is completed and will remain available until 11:59 p.m. ET on Wednesday, November 13, 2019. Investors may dial into the replay using 1-412-317-6671 and passcode 13695547.

Please see the section “Definition of Non-GAAP Financial Measures” at the end of this document for an explanation of what our non-GAAP financial measures are and how they are computed.



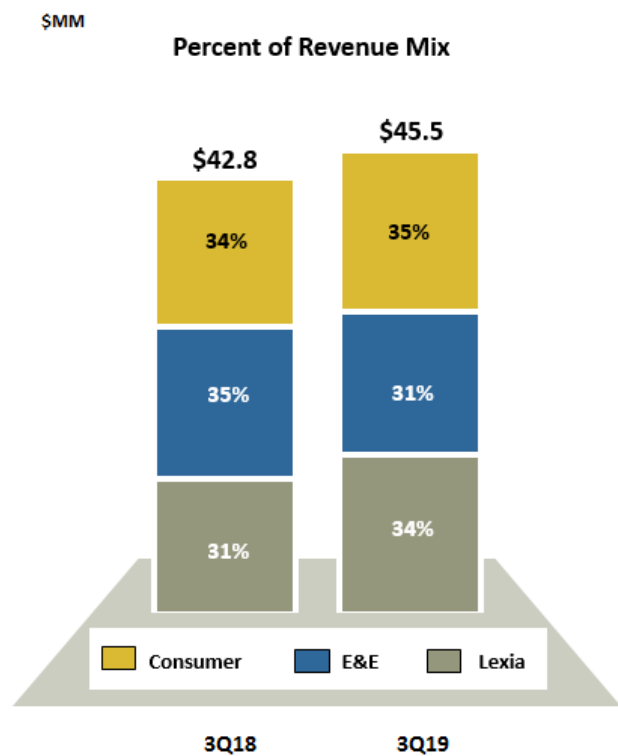
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### Q3 2019 Revenue

Total revenue in third quarter 2019 grew \$2.7 million or 6% to \$45.5 million, compared to \$42.8 million in third quarter 2018.

- The Literacy segment had a strong quarter with revenue increasing \$2.4 million (18%) year-over-year, reflecting consistently strong retention and renewal rates of 88% and 102%, respectively, in Q3. Bookings increased year-over-year to \$41.0 million, up 21%.
- Consumer Language segment revenue increased by \$1.3 million (9%) year over year, reflecting stable bookings and the benefit of previously deferred subscription revenue. Consumer Language bookings totaled \$16.3 million in Q3 2019, a slight increase over prior year Q3.
- Education and Enterprise (“E&E”) Language segment revenue declined \$0.9 million (6%) year-over-year due to lower bookings levels in 2018 and in the first half of this year. E&E Language bookings increased \$6.7 million (38%) year-over-year due to the \$7.4 million custom content Native American deal closed in early Q3 2019.





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### Q3 2019 Net Loss

The Company reported a Q3 2019 net loss of \$2.9 million, or \$(0.12) per diluted share, compared to a net loss of \$6.5 million, or \$(0.28) per diluted share, in the year-ago period. The year-over-year improvement was driven by higher revenues and lower variable incentive compensation expense based on reduced funding expectations, partially offset by increased professional fees and increased sales and marketing expense during our peak selling season.

### Annualized Recurring Revenue

#### Q3 2019 ARR Performance Metrics

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	<u>Q3 2019</u>	<u>Q3 2018</u>
Literacy	\$55.5MM	\$47.8MM
E&E Language	\$54.4MM	\$53.2MM

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Annualized Recurring Revenue – or “ARR” – which is computed using the annualized value of subscriptions at the end of the period, separate from services like training and implementation. ARR is a performance metric used to assess the health and trajectory of our E&E Language and Literacy segments, which we believe cuts through the differences in the types of licenses and deal sizes in our businesses and aids in understanding our segment results. We present ARR as a statistical measure rather than a non-GAAP financial measure. ARR should be viewed independently of revenue and deferred revenue – as ARR is a performance metric and is not intended to be combined with either of these items.

ARR for the Literacy segment at September 30, 2019, was up \$7.7 million (16%) year-over-year to \$55.5 million. Growth in this business continues to be driven by strong retention and renewal rates and new bookings from its direct salesforce. E&E Language segment ARR was up \$1.2 million (2%) year-over-year to \$54.4 million.



### **Q3 2019 Segment Contribution**

Literacy segment contribution was \$2.1 million (or 13% of segment revenue), compared to \$1.0 million (or 8% of segment revenue) in the year-ago period. This improvement was due to higher revenue, partially offset by higher expenses in cost of goods sold (up 15% to \$2.5 million), sales and marketing (up 11% to \$8.1 million), and research and development (up 8% to \$2.4 million) as the Company continues to make investments to support Lexia's long-term growth.

**One note of clarification about the segment contribution data for the E&E Language segment, the Consumer Language segment and the two Language segments combined. Language Research & Development (R&D) expense is a shared service cost that is not allocated to either Language segment, but is included in combined Language – therefore, it is the combined Language view that is comparable to the Lexia segment contribution.**

The combined Language segments contribution was \$6.8 million (23% of the total combined Language segment revenue), an improvement compared to the prior year period which was \$5.1 million (17% of the total combined Language segment revenue).

The E&E Language segment contribution margin **before shared Language R&D expense** was \$5.7 million (or 40% of segment revenue), which was flat compared to the year-ago period. This performance was primarily driven by a decline in revenue, offset by a decrease in sales and marketing expense (down 12%) driven by lower headcount and reduced media spend.

Consumer Language segment contribution margin **before shared Language R&D expense** was \$4.1 million (or 26% of segment revenue), which was up \$0.8 million from



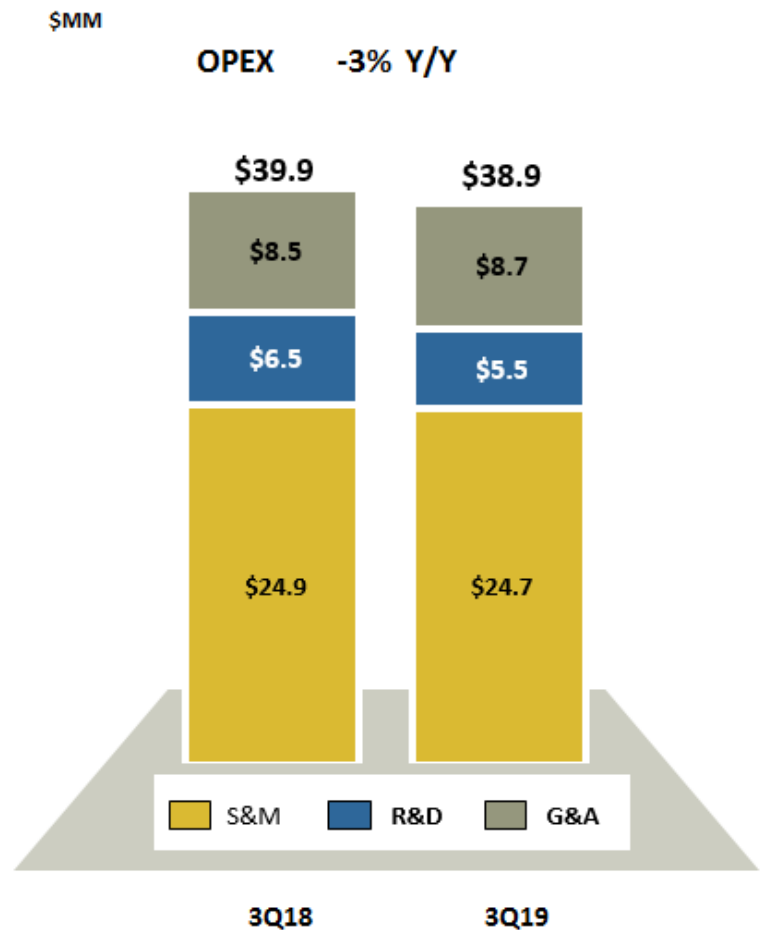
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\$3.3 million (or 23% of segment revenue) in the year-ago period. The increase was primarily related to higher revenue.

Lifetime Value (“LTV”) added was \$13.1 million in Q3 2019, a decrease of \$2.3 million from the year-ago period. Note that Consumer LTV per unit in Q3 2019 was \$156 compared to \$183 in Q3 2018, but was more stable sequentially, compared to \$154 LTV per unit sold in Q2 2019. The year-over-year decline reflects a lower initial selling price.

### Q3 2019 Operating Expenses

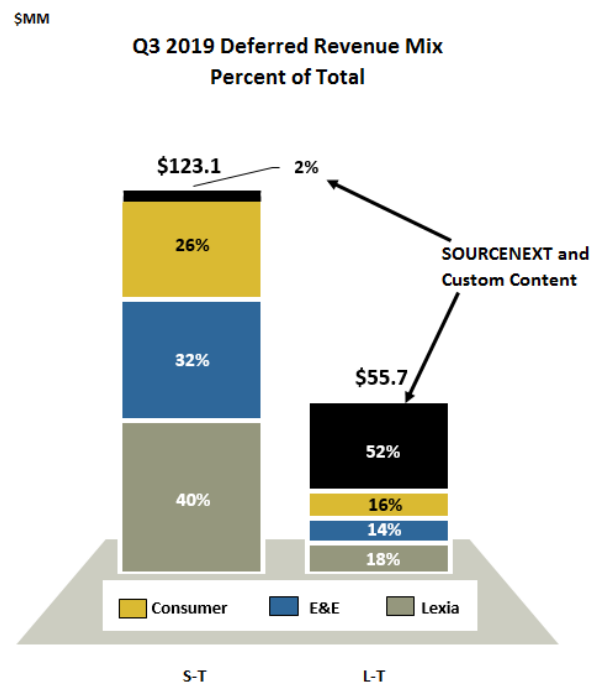
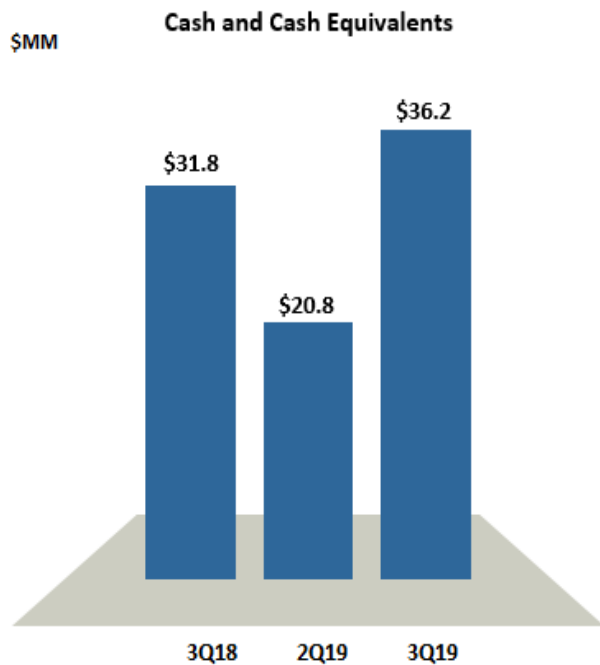
Total operating expenses decreased \$1.0 million (3%) year-over-year to \$38.9 million in the third quarter 2019 driven by lower variable incentive compensation expense based on reduced funding expectations.





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### Q3 2019 Selected Balance Sheet Data

Deferred revenue totaled \$178.8 million at September 30, 2019, up sequentially from \$142.8 million at June 30, 2019 and up from \$162.9 million at December 31, 2018. Of the September 30, 2019 total deferred revenue balance, \$123.1 million (or approximately 69%), was short-term and will be recognized as revenue over the next 12 months.

Excluding SOURCENEXT and non-core custom content, short-term deferred revenue at September 30, 2019 was approximately 82% of total deferred revenue.

The chart above depicts the Q3 2019 deferred revenue balance by the segment components, with separate disclosure of the SOURCENEXT and non-core custom content components within the Consumer Language and E&E Language segments, respectively. Note that the vast majority of the cash received to date from our 2017 long-

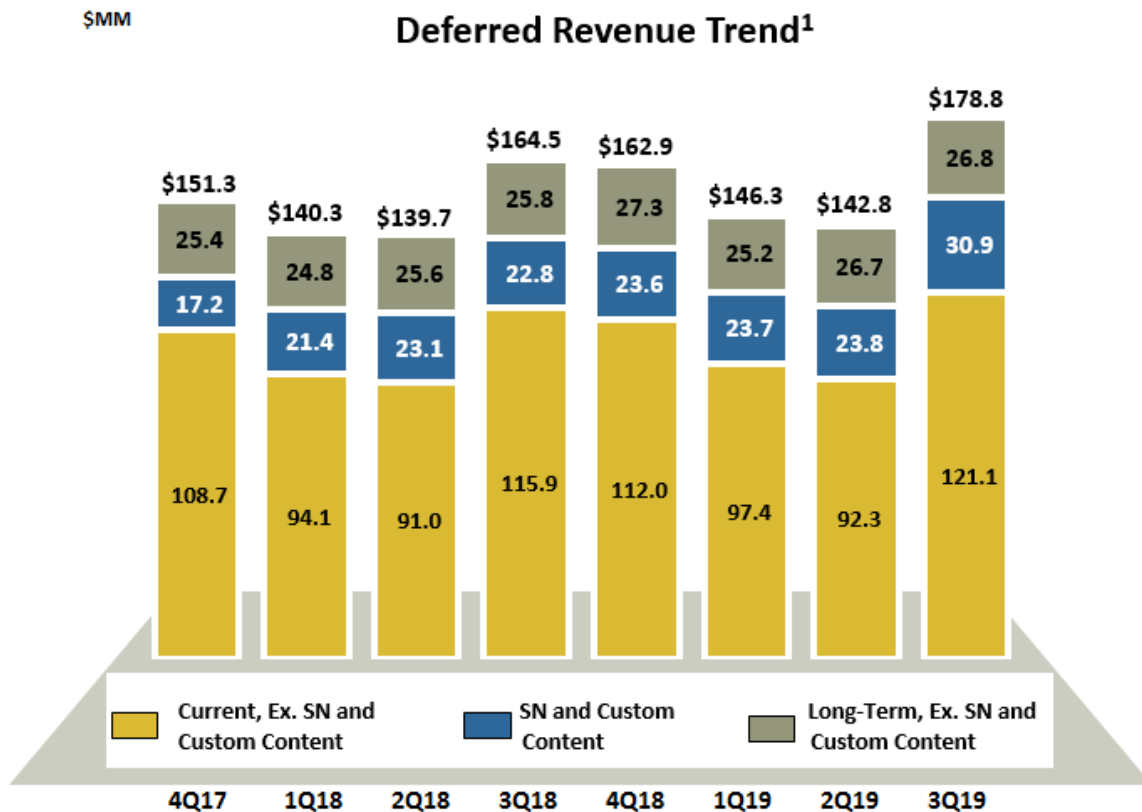


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term royalty agreement with SOURCENEXT was recorded as deferred revenue, with nearly all of that classified as noncurrent to be recognized over 20 years.

The following chart depicts the 8-quarter trend in deferred revenue, with the separation of short-term, long-term and the amounts that were attributable to the SOURCENEXT transaction and non-core custom content transactions.



<sup>1</sup> The vast majority of SOURCENEXT deferred revenue is long-term and is being recognized as revenue over 20 years.

As of September 30, 2019, the Company had \$36.2 million of cash and cash equivalents and no debt outstanding. During the third quarter, we repaid \$9.9 million of short-term borrowings that were previously borrowed under the Company’s seasonal revolving credit facility. The ending cash balance was up approximately \$4.4 million compared to the year-ago period, and up \$15.4 million sequentially from June 30, 2019.



### **Non-GAAP Financial Measures**

The reconciliation of the GAAP metrics to the non-GAAP financial measures can be found at the end of this document. Adjusted EBITDA was \$2.5 million, compared to an Adjusted EBITDA loss of \$0.7 million in the year-ago period.

Net cash provided by operating activities was \$29.1 million, compared to net cash provided by operating activities of \$14.5 million in Q3 2018. Capital expenditures, which primarily relate to capitalized labor on product and IT projects, totaled \$4.0 million, an increase from \$3.6 million in Q3 2018. Lexia drove the majority of the increase in capital expenditures year-over-year, reflecting investments to support long-term growth. Free cash flow was \$25.1 million, compared to \$10.9 million in the year-ago period.

### **Financial Outlook - Full Year 2019**

With respect to the full year 2019 guidance that we communicated in conjunction with our second quarter conference call, we are lowering our year end revenue guidance by 3%, or \$5.0 million to \$182.0 million, or \$1.0 million lower for Literacy and \$2.0 million lower for each of the Language segments, due to slightly lower expected bookings. Consolidated bookings before SourceNext and revenue are expected to grow 9% and 5%, respectively, this year. Broken down for the mix among the three segments are as follows:

Literacy revenue is now expected to be approximately \$62.0 million, on bookings of approximately \$71.0 million (up 21% versus 2018).

E&E Language revenue is now expected to be approximately \$56.5 million on bookings of \$61.0 million. As mentioned in prior quarters, E&E bookings are now expected to





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come in later in the year than planned, and consequently contribute less to 2019 revenues, or in the case of non-core custom content contracts have no impact on revenue this year.

Consumer revenue is now expected to be approximately \$63.5 million on bookings of approximately \$65.0 million, up 3% versus 2018 after excluding SourceNext (\$0.5 million in 2019 and \$4.5 million in 2018) and approximately \$0.3 million from Fit Brain bookings in 2018 that will not be repeated as that product has been decommissioned. We also now expect Consumer subscribers to grow approximately 16% in 2019, to approximately 560,000 subscribers at the end of 2019 compared to 483,000 at the end of 2018.

For the full year 2019, our outlook for net loss remains unchanged at approximately \$15.0 million, a 30% or \$6.5 million year-over-year improvement, as the reduced guided revenue for the year is expected to be more than offset by lower expenses while also taking into account investment in new products. We further expect full year 2019 gross margin, R&D and G&A margin percentages to approximate the corresponding 9-months actual percentages, with sales and marketing margin percentage slightly higher than the year-to-date percentages.

Our outlook for Adjusted EBITDA also remains unchanged at approximately \$6.0 million as the change in revenue outlook is expected to be more than offset by lower expenses. This compares to breakeven in the full year 2018.

Capital expenditures are now expected to be \$18.0 million, down from our prior guidance of \$20.0 million. We continue to expect to end 2019 with no debt and ending cash of approximately \$42.0 million.

Looking to 2020, in addition to the outlook provided in our Q3 earnings slides and commentary in our Q3 prepared remarks, we expect consolidated 2020 gross margin



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percentage and net loss to be roughly flat to our current guidance for 2019 (nearly 80% gross margin percentage and approximately \$15 million net loss).

## Definitions – Statistical Measures

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- Annualized recurring revenue (or “ARR”) is computed using the annualized value of active subscription arrangements at the end of the period. ARR is a performance metric used to assess the health and trajectory of our E&E Language and Literacy segments, which we believe aids investors in understanding our segment results. We present ARR as a statistical measure rather than a non-GAAP financial measure. ARR should be viewed independently of revenue and deferred revenue, as ARR is a performance metric and is not intended to be combined with either of these items.
- North America Consumer DTC and Global App Sales LTV per Unit - The Lifetime Value per unit, or LTV per unit, is an operating metric calculated as the combined value of customers' initial purchases plus an estimate of future renewals based on the median renewal rates observed for recent renewals of similar products. The per unit metric is expressed as the weighted average LTV per unit of all products sold during a given period.
- LTV Added is the LTV per unit multiplied by total new unit sales net of returns.
- North America Consumer DTC and Global App Sales CAC - The Customer Acquisition Cost, or CAC, is an operating metric calculated as the sum of Consumer GAAP sales and marketing expenses in a period plus affiliate commission expenses that are classified as cost of goods sold, adjusted to reflect the lifetime app store commissions incurred on the initial app sale plus an estimate of app commission expenses on future renewals.
- CAC per Unit is CAC divided by total new unit sales net of returns for North America DTC and Global App sales.
- The LTV-to-CAC ratio is calculated as LTV per Unit divided by CAC per Unit.
- Net LTV Added is calculated as LTV Added minus CAC.
- Retention is a customer-based metric based on whether a customer was retained from a prior period to the current period. Renewal is an annualized dollar-based metric (of the dollars available to renew) and includes upsells.
- Prior period amounts have been restated to be comparable to the current period methodology. In addition, prior period LTV, CAC Net LTV, retention and renewal metrics presented for a given period may change over time as the most current experience for that period is used to update the calculations of those operating metrics.

## Definitions – Non-GAAP Financial Measures

- Bookings represents executed contracts received by the Company that are either recorded immediately as revenue or deferred revenue. Therefore, bookings is an operational metric and in any one period is equal to revenue plus the change in deferred revenue.
- Adjusted EBITDA is GAAP net income/loss plus interest income and expense, other income/expense, income tax benefit/expense, impairment, lease abandonment and termination, depreciation, amortization, stock-based compensation, restructuring, and strategy and cost-reduction related consulting expenses. In addition, Adjusted EBITDA excludes "Other" items related to non-restructuring wind down and severance costs, and transaction and other costs associated with mergers and acquisitions, as well as all adjustments related to recording the non-cash tax valuation allowance for deferred tax assets. Adjusted EBITDA for prior periods has been revised to conform to current definition
- Free cash flow is cash flow from operating activities minus cash used in purchases of property and equipment.
- Segment contribution is calculated as segment revenue less expenses directly incurred by or allocated to the segment. Direct segment expenses include costs and expenses that are directly incurred by or allocated to the segment and include materials costs, service costs, customer care and coaching costs, sales and marketing expenses, and bad debt expense. In addition to the previously referenced expenses, the Literacy segment includes direct research and development expenses and Combined Language includes shared research and development expenses, costs of revenue, sales and marketing, and general and administrative expenses applicable to the Consumer Language and E&E Language segments. Prior periods have been reclassified to reflect our current segment presentation and definition of segment contribution.

## Adjusted EBITDA and Free Cash Flow

	Amounts (\$000)							
	Quarterly				FY18	Quarterly		
	1Q18	2Q18	3Q18	4Q18		1Q19	2Q19	3Q19
GAAP net loss	\$ (6,402)	\$ (4,158)	\$ (6,489)	\$ (4,424)	\$ (21,473)	\$ (544)	\$ (2,807)	\$ (2,917)
Total other non-operating expense (income), net	286	59	(40)	(260)	45	(769)	(429)	146
Income tax expense (benefit)	461	454	588	306	1,809	(170)	175	(93)
Depreciation and amortization	3,610	3,479	3,802	3,725	14,616	3,529	3,457	3,938
Stock-based compensation	583	1,353	1,452	1,087	4,475	1,220	1,356	1,412
Restructuring expenses	31	(23)	(8)	(3)	(3)	-	-	-
Other EBITDA adjustments	141	261	27	252	681	53	269	(22)
Adjusted EBITDA	<u>\$ (1,290)</u>	<u>\$ 1,425</u>	<u>\$ (668)</u>	<u>\$ 683</u>	<u>\$ 150</u>	<u>\$ 3,319</u>	<u>\$ 2,021</u>	<u>\$ 2,464</u>

	Amounts (\$000)							
	Quarterly				FY18	Quarterly		
	1Q18	2Q18	3Q18	4Q18		1Q19	2Q19	3Q19
Net cash (used in)/provided by operating activities	\$ (418)	\$ (14,316)	\$ 14,471	\$ 10,706	\$ 10,443	\$ (6,567)	\$ (14,847)	\$ 29,072
Purchases of property and equipment	(3,948)	(4,188)	(3,564)	(5,189)	(16,889)	(4,714)	(4,995)	(4,011)
Free Cash Flow	<u>\$ (4,366)</u>	<u>\$ (18,504)</u>	<u>\$ 10,907</u>	<u>\$ 5,517</u>	<u>\$ (6,446)</u>	<u>\$ (11,281)</u>	<u>\$ (19,842)</u>	<u>\$ 25,061</u>

## Revenue and Bookings

	Amounts (\$000)								
	Quarterly					FY18	Quarterly		
	1Q18	2Q18	3Q18	4Q18	1Q19		2Q19	3Q19	
<b>Revenue</b>									
Literacy	\$ 12,384	\$ 12,695	\$ 13,215	\$ 14,472	\$ 52,766	\$ 14,806	\$ 15,101	\$ 15,587	
E&E Language									
Enterprise	8,983	8,538	8,421	8,019	33,961	8,021	7,871	7,819	
North America K-12	6,453	6,818	6,569	6,575	26,415	6,422	6,631	6,255	
Total E&E Language	15,436	15,356	14,990	14,594	60,376	14,443	14,502	14,074	
Consumer Language	14,988	15,451	14,545	15,508	60,492	15,362	16,339	15,795	
Total Language	30,424	30,807	29,535	30,102	120,868	29,805	30,841	29,869	
<b>Total Revenue</b>	<u>\$ 42,808</u>	<u>\$ 43,502</u>	<u>\$ 42,750</u>	<u>\$ 44,574</u>	<u>\$ 173,634</u>	<u>\$ 44,611</u>	<u>\$ 45,942</u>	<u>\$ 45,456</u>	
<b>Bookings</b>									
Literacy	\$ 4,524	\$ 10,325	\$ 33,980	\$ 9,799	\$ 58,628	\$ 4,511	\$ 12,089	\$ 40,984	
E&E Language									
Enterprise	5,498	9,921	7,621	10,928	33,968	5,622	7,421	15,397	
North America K-12	2,486	7,952	9,901	4,969	25,308	2,020	7,938	8,798	
Total E&E Language	7,984	17,873	17,522	15,897	59,276	7,642	15,359	24,195	
Consumer Language	19,906	14,752	16,055	17,238	67,951	15,827	15,071	16,278	
Less: Adjustment for SOURCENEXT	4,486	-	-	-	4,486	-	499	-	
Subtotal for Consumer, before SOURCENEXT	15,420	14,752	16,055	17,238	63,465	15,827	14,572	16,278	
Subtotal for Language, before SOURCENEXT	23,404	32,625	33,577	33,135	122,741	23,469	29,931	40,473	
<b>Total Bookings, before SOURCENEXT</b>	<u>\$ 27,928</u>	<u>\$ 42,950</u>	<u>\$ 67,557</u>	<u>\$ 42,934</u>	<u>\$ 181,369</u>	<u>\$ 27,980</u>	<u>\$ 42,020</u>	<u>\$ 81,457</u>	

## Reconciliation of Revenue and Bookings

	Amounts (\$000)							
	1Q18	2Q18	3Q18	4Q18	FY18	1Q19	2Q19	3Q19
<b>Reconciliation of Revenue to Bookings</b>								
Literacy								
Segment revenue	\$ 12,384	\$ 12,695	\$ 13,215	\$ 14,472	\$ 52,766	\$ 14,806	\$ 15,101	\$ 15,587
Segment change in deferred revenue	(7,860)	(2,370)	20,765	(4,673)	5,862	(10,295)	(3,012)	25,397
Bookings	<u>\$ 4,524</u>	<u>\$ 10,325</u>	<u>\$ 33,980</u>	<u>\$ 9,799</u>	<u>\$ 58,628</u>	<u>\$ 4,511</u>	<u>\$ 12,089</u>	<u>\$ 40,984</u>
E&E Language								
Segment revenue	\$ 15,436	\$ 15,356	\$ 14,990	\$ 14,594	\$ 60,376	\$ 14,443	\$ 14,502	\$ 14,074
Segment change in deferred revenue	(7,452)	2,517	2,532	1,303	(1,100)	(6,801)	857	10,121
Bookings	<u>\$ 7,984</u>	<u>\$ 17,873</u>	<u>\$ 17,522</u>	<u>\$ 15,897</u>	<u>\$ 59,276</u>	<u>\$ 7,642</u>	<u>\$ 15,359</u>	<u>\$ 24,195</u>
Consumer Language								
Segment revenue	\$ 14,988	\$ 15,451	\$ 14,545	\$ 15,508	\$ 60,492	\$ 15,362	\$ 16,339	\$ 15,795
Segment change in deferred revenue	4,918	(699)	1,510	1,730	7,459	465	(1,268)	483
Adjustment for SOURCENEXT	(4,486)	-	-	-	(4,486)	-	(499)	-
Bookings, before SOURCENEXT	<u>\$ 15,420</u>	<u>\$ 14,752</u>	<u>\$ 16,055</u>	<u>\$ 17,238</u>	<u>\$ 63,465</u>	<u>\$ 15,827</u>	<u>\$ 14,572</u>	<u>\$ 16,278</u>
<b>Total revenue</b>	<b>\$ 42,808</b>	<b>\$ 43,502</b>	<b>\$ 42,750</b>	<b>\$ 44,574</b>	<b>\$ 173,634</b>	<b>\$ 44,611</b>	<b>\$ 45,942</b>	<b>\$ 45,456</b>
Change in deferred revenue	(10,394)	(552)	24,807	(1,640)	12,221	(16,631)	(3,423)	36,001
Adjustment for SOURCENEXT	(4,486)	-	-	-	(4,486)	-	(499)	-
<b>Total bookings, before SOURCENEXT</b>	<b><u>\$ 27,928</u></b>	<b><u>\$ 42,950</u></b>	<b><u>\$ 67,557</u></b>	<b><u>\$ 42,934</u></b>	<b><u>\$ 181,369</u></b>	<b><u>\$ 27,980</u></b>	<b><u>\$ 42,020</u></b>	<b><u>\$ 81,457</u></b>

## Segment Contribution

	Amounts (\$000)								
	1Q18	Quarterly			4Q18	FY18	1Q19	Quarterly	
		2Q18	3Q18				2Q19	3Q19	
<b>Revenue:</b>									
Literacy segment	\$ 12,384	\$ 12,695	\$ 13,215	\$ 14,472	\$ 52,766	\$ 14,806	\$ 15,101	\$ 15,587	
E&E Language segment	15,436	15,356	14,990	14,594	60,376	14,443	14,502	14,074	
Consumer Language segment	14,988	15,451	14,545	15,508	60,492	15,362	16,339	15,795	
Shared services	-	-	-	-	-	-	-	-	-
Combined Language	30,424	30,807	29,535	30,102	120,868	29,805	30,841	29,869	
<b>Total revenue</b>	<b>\$ 42,808</b>	<b>\$ 43,502</b>	<b>\$ 42,750</b>	<b>\$ 44,574</b>	<b>\$ 173,634</b>	<b>\$ 44,611</b>	<b>\$ 45,942</b>	<b>\$ 45,456</b>	
<b>Segment contribution</b>									
Literacy segment	\$ 1,872	\$ 1,823	\$ 1,025	\$ 2,453	\$ 7,173	\$ 3,013	\$ 2,371	\$ 2,087	
E&E Language segment	5,890	5,663	5,666	5,633	22,852	6,107	5,848	5,679	
Consumer Language segment	2,085	4,550	3,301	2,835	12,771	4,548	3,649	4,093	
Shared services	(4,156)	(4,074)	(3,907)	(4,016)	(16,153)	(3,680)	(3,387)	(3,003)	
Combined Language	3,819	6,139	5,060	4,452	19,470	6,975	6,110	6,769	
<b>Total segment contribution</b>	<b>\$ 5,691</b>	<b>\$ 7,962</b>	<b>\$ 6,085</b>	<b>\$ 6,905</b>	<b>\$ 26,643</b>	<b>\$ 9,988</b>	<b>\$ 8,481</b>	<b>\$ 8,856</b>	
<b>Segment contribution margin percentage:</b>									
Literacy segment	15%	14%	8%	17%	14%	20%	16%	13%	
E&E Language segment	38%	37%	38%	39%	38%	42%	40%	40%	
Consumer Language segment	14%	29%	23%	18%	21%	30%	22%	26%	
Combined Language	13%	20%	17%	15%	16%	23%	20%	23%	