Second Quarter 2016 Earnings Call

August 3, 2016

Prepared Remarks

Frank Milano:

Good afternoon and let me welcome you to the Rosetta Stone second quarter 2016 earnings conference call. I am joined today by our Chairman, President and Chief Executive Officer, John Hass, and our Chief Financial Officer, Tom Pierno. John and Tom will discuss the operations and financial results for the quarter and we will open the call to questions after our prepared remarks.

Our second quarter earnings release went out after the market close and is available on our website at www.rosettastone.com. In addition, we have posted the slide presentation that accompanies today's call to our website, which you should find helpful as we discuss the Company's results and our outlook for 2016.

In keeping with the Safe Harbor statement on Slide 2, I will remind everyone that certain statements will be made today which are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Given the uncertainties of forward-looking statements, our actual results may differ materially from anything we say in these forward-looking statements. We can give no assurance as to their accuracy. We expressly disclaim any obligation to update or revise any forward-looking statements, whether as a result of new information, future developments or otherwise, except as required by law. We also use non-GAAP numbers in our presentation. For further information on the definitions of those numbers, the GAAP comparisons, and their reconciliation to the nearest comparable GAAP numbers, as well as risks and uncertainties that could cause our actual results to differ, please read the Company's SEC filings, earnings release and presentation, including the paragraphs beginning with the words, “Caution on Forward-Looking Statements” and “Non-GAAP Financial Measures,” which are available on our website under the “Investor Relations” tab.

I will now turn the call over to John.

John Hass, Chief Executive Officer:

Thank you, Frank, and good afternoon.

I am very pleased with our continued progress across the Company in the second quarter, as demonstrated by our improved profitability even as we continue to invest to grow Lexia and build a higher-margin and more predictable language business.

In particular, I would highlight the performance of our K-12 literacy and language businesses that produced a combined second quarter record $18.6 million in bookings. I would point out that this was roughly equal in size to our Consumer business in this period. I am very happy with these businesses and the momentum we are seeing in both.

Our efforts to revamp the go-to-market strategy of each business and introduce new and innovative products – all while substantially reducing expenses – is delivering tangible results as we create a more focused, efficient company with capital and resources allocated to our most attractive opportunities.

Over the last year we have taken important steps to build a more sustainable Consumer business focused on profitability. We significantly reduced our marketing spend as we concentrate on the most efficient, responsive and quantifiable lead generation and conversion opportunities. And as we continue to simplify our business and shift more to SaaS-based subscriptions in 2016 and 2017, we will build a revenue model with more consistency and the opportunity for renewal growth.

We have also begun bringing customer facing product innovation to market. During the second quarter we released our new native iOS app to enhance our mobile language learning capabilities. This new app not only delivers a faster, cleaner, and more intuitive learning experience but also includes functionality to improve our marketing effectiveness. We are now able to communicate directly with the learner through the app. We can encourage usage and highlight features that drive conversion. We are encouraged by the 25% increase in the number of daily active users in the first 30 days since the app's launch.

You may have seen recently that Macworld also took notice of our new iOS app noting "tried and true Rosetta Stone works the best" and "if you're serious about learning a language, Rosetta Stone is well worth your money." We couldn't have said it better ourselves and we are very proud of the work our Consumer and Product teams put into developing and launching this new product in Q2.

Further innovation is also well underway. We are planning a release in early 2017 of the first all-new Rosetta Stone Consumer language product in many years to be delivered through a modern, mobile-focused platform. This release will be focused on increasing our market differentiation by providing the leading solution to get passionate learners speaking confidently in their new language.

In March we announced the refocusing of, and cost reductions in, our Enterprise and Education Language business, identifying those marketplaces, including U.S. K-12 and Enterprise in the U.S. and northern Europe that are most profitable, with the greatest opportunity for near-term growth, and focusing our direct distribution efforts there. This led us to withdraw resources from areas like Higher Education in the U.S. and our direct sales presence in France, China and Brazil – which were adding sales, but at too high a cost and without the near-term ability to capture scale efficiencies. Going forward, we will approach these attractive marketplaces differently, working with local partners that can amplify the power of our offerings.

We are now in the final phase of our new Enterprise Language product that we call "Catalyst." Work is progressing well, in advance of our fall commercial launch, so that we can begin actively selling during the peak fourth quarter corporate season. We've given an early look of Catalyst to some existing customers during this beta test and we've had some really great feedback thus far. This product addresses many critical needs for our Enterprise customers that will help assess a customer's workforce and provide learning solutions for their entire organization, regardless of the desired language or level of learning.

With the refocusing of this business and its improved product portfolio, the Enterprise and Education Language segment is becoming a more predictable and more profitable business with attractive long-term growth potential.

At Lexia, with its renewal rates that have consistently well exceeded 90% and expanding product portfolio, owning the customer will be the key to broadening our reach and increasing the share of students and educators we can impact in schools and districts across the country. This is why we are continuing to invest heavily in building a largely direct salesforce. This transition is already bearing fruit – with bookings from our direct team increasing 80% year-over-year to 70% of total Lexia bookings in the second quarter, up from 40% in the same period last year. That said, the team is still very new to us, with over half the sales force having been hired within the last year. We expect our sales team to become more productive as they learn to sell the expanding portfolio of Lexia products and build trusted customer relationships. Having recently spent time with the team at Lexia's Summer Sales Conference, I can tell you that their commitment and passion is impressive.

From a product perspective, in the second quarter Lexia released upgraded versions of Lexia Reading Core5 - Lexia's flagship computer-adaptive, personalized literacy program for pre-K through 5th grade - and myLexia - Lexia's learner management and data reporting dashboard for educators. In addition, Lexia announced the introduction of the kindergarten through 2nd grade version of its RAPID assessment product, which won the 'Best in Show' award for tech and learning at the 2016 ISTE conference (ISTE stands for the International Society for Technology in Education). With this launch, Lexia now has a complete RAPID product suite from kindergarten through 12th grade. As a Company we could not be more excited about our opportunity to help millions of students improve their lives through reading as we work to reach $100 million in bookings on an annual basis at Lexia by 2020.

Finally, I thought it would be useful to summarize the ongoing transformation of Rosetta Stone with a few facts and statistics.

Through the actions we have taken since early 2015 to focus and simplify our business and reduce our cost base we have significantly decreased operating expenses without sacrificing the necessary investment to drive future growth. In total, when our most recent changes are fully implemented, we will have cut expenses outside of Lexia by over $80 million on an annualized basis. One indication of our continuing progress is that operating expenses were down 15% for the six months year-to-date versus the same period last year. Achieving and sustaining long-term profitable growth remains our objective, and our performance indicates we are on the right path – with more work to be done.

While we focus on reducing expenses we continue to thoughtfully invest resources in our best opportunities, in particular to build Lexia's product portfolio and direct sales force to position the segment for sustainable long-term growth. Consequently, even as we streamline and focus our resources, we have grown the team devoted to Lexia to 21% of our total workforce at the end of June, up from 8% on June 30, 2014. As we focus capital and people here, this business is becoming a bigger and bigger part of our Company – with the total share of bookings produced by Lexia more than doubling from 9% in the second quarter of 2014 to 21% in the same period this year.

We are also building a more stable revenue stream – having fully transitioned to a SaaS-based model in our Literacy and E&E Language businesses – and as we aim to be a fully SaaS-based business in the Consumer segment by the end of next year. In fact, in the second quarter over 80% of our revenues came from subscriptions and services driven by our E&E Language and Literacy segments, and to a growing extent, by Consumer. For example, at the end of the second quarter at Lexia we had over 1.3 million licensed Core5 students and, separately, approximately 2,500 unlimited site licenses for our literacy products.

In the future, we intend to report the number of our Enterprise license customers and Consumer subscription customers and related information as we are able to provide more visibility through our consolidated platform as the current license mix across a variety of products makes reporting these numbers difficult today. Overall though our growing SaaS-user base has driven the 19% annualized growth in our total deferred revenue, from $93.2 million on June 30, 2014 to $132.4 million at the end of June 2016.

Building a more profitable, more consistent and ultimately growing Company with our capital and resources devoted to the best opportunities to build intrinsic value – that has been and will continue to be our goal. With that, let me turn it over to Tom to take you through the highlights of the second quarter's financial results.

Tom Pierno, Chief Financial Officer:

Thank you, John, and good afternoon everyone.

I will begin with a review of Q2 revenue and earnings – please turn to slide 3:

- Total revenue declined $5.7 million (or 11%) year-over-year. Included in second quarter 2016 revenue was the adverse revenue and earnings impact of $3.6 million accrued to recognize the change in suggested retail value to price protect the in-channel inventory of our retail partners that we have previously discussed. The impact of this one-time charge represented approximately 700 basis points of the 11% year-over-year total revenue decline. I will also note that the cash impact of this change will be approximately $4.5 million and will be settled with our retail partners through the second half of the year.
- Consumer segment revenue declined $7.8 million (or 28%) year-over-year, partially reflecting that $3.6 million suggested retail value change, which accounted for approximately 1,200 basis points of the 28% year-over-year total Consumer segment revenue decline. The majority of the decline in Consumer was the result of our change in strategy in March 2015, whereby we continue to manage that business for a targeted bottom-line result.
- E&E Language revenue declined 6% year-over-year, due to the change in our go-to-market strategy announced in March 2016. As John discussed, we are

focusing our direct sales and marketing activity on the K-12 Education marketplace in the U.S. and the Enterprise marketplace in the U.S. and northern Europe. In addition, we are looking to local partners in almost all of the non-U.S. and non-northern European geographies where we have decided to exit the direct presence we had previously. Some of those partnerships are already in place – such as in Brazil and Latin America – but it will take time to ramp-up that business across all of those geographies. The strong bookings growth in the North America K-12 business – which was up 27% year-over-year in the second quarter, enhanced by a $1.3 million, multi-year renewal, after delivering 21% year-over-year bookings growth in Q1 – has been very positive, and a great motivator for our sales team as we continue to execute the E&E restructuring that began in March.

- Lexia revenue was a record high $7.9 million in the second quarter, representing growth of 68% year-over-year, while bookings grew 3% to $9.4 million as the transition from resellers and the ramp-up of a new direct sales force continues; we expect Lexia's year-over-year bookings growth to continue to reaccelerate for the remainder of the year as the sales team matures. As a reminder, Lexia's results include the impact of purchase accounting on acquired deferred revenue. Adjusting for this impact, Lexia's pro forma revenue would have been $9.2 million in Q2 2016 compared to $6.9 million in the same year-ago quarter, and Lexia's pro forma revenue growth would have been 33% year-over-year.
- The net loss increased $0.8 million (or 10%) year-over-year, to a loss of $9.0 million, or 41-cents per diluted share. The net loss this quarter included pre-tax charges of $2.5 million for restructuring and a non-cash $2.9 million charge for impairment of the remaining goodwill and other intangible assets related to our Fit Brains business, based upon a reduced outlook relative to our previous expectations. The $3.6 million pre-tax charge for the Consumer segment change in suggested retail value also fell to the bottom-line. By comparison, the net loss in Q2 2015 totaled $8.2 million, or 38-cents per

diluted share, which included pre-tax charges of $2.4 million for restructuring and $0.2 million for impairment.

Slide 4 reflects the segment contribution margins for all three segments. The Literacy segment contribution margin was $1.2 million (or 16% of segment revenue) in the second quarter 2016, up from negative $0.2 million (or minus 4% of segment revenue) in the year-ago period. This growth was primarily influenced by the impact of purchase accounting; the margin improvement related to this effect will diminish over time. Lexia's direct expenses increased 36% year-over-year, resulting from the investments we are making to expand and improve our Literacy product portfolio and to increase the size of the direct salesforce and associated sales support personnel at Lexia. In addition, as we grow the mix of direct sales, we recognize more of our sales and marketing expenses at the time of sale – as a period cost – with only the salesperson's variable commission deferred and recognized over the contract period. By comparison, when we sold principally through resellers, more of the selling cost was deferred and recognized ratably over the contract period.

The E&E Language segment contribution margin increased to $6.8 million (or 39% of segment revenue), up from $4.6 million (or 25% of segment revenue) in the year-ago period. This improved performance reflects a 21% reduction year-over-year in direct sales and marketing expenses, largely due to the initial benefits of the March 2016 restructuring, which we continue to expect will reduce headcount by approximately 17% of the Company's full-time workforce of 855 people at December 31, 2015. These actions are expected to improve segment contribution margins in Q3 and Q4, but the benefits will narrow compared to what we achieved in the first half of this year. Overall, we continue to expect the March 2016 restructuring will result in approximately $19 million of annualized expense reductions when fully realized.

Consumer segment contribution margin was $3.9 million (or 19% of segment revenue), which was down year-over-year compared to $9.5 million (or 34% of segment revenue) in the year-ago period. The decline was primarily due to the $3.6 million revenue reduction associated with the change to our suggested retail value, which represented an adverse impact of approximately 1,200 basis points in the Consumer segment contribution percentage.

The chart on slide 5 depicts sales and marketing, research and development, and general and administrative expenses, which declined $3.8 million or 8% year-over-year in the second quarter – even with our increasing investments in Lexia. All three operating expense categories were lower year-over-year, led by G&A expense, which was down $1.8 million (or 15%) and sales and marketing expense, which was also down $1.8 million (or 6%).

Turning to the balance sheet on slide 6, deferred revenue of $132.4 million was largely flat sequentially at June 30, 2016, and increased $9.2 million or 7% versus the end of Q2 last year. Of the June 2016 total, $99.2 million (or approximately 75%), was short-term and will be recognized as revenue over the next 12 months.

We ended the second quarter with zero debt and $29.7 million of cash and cash equivalents, which was basically flat to where we ended the second quarter last year despite registering approximately $35 million in net losses during the intervening year. Within the second quarter of 2016, we paid $1.7 million of the restructuring we announced in March 2016, bringing first-half total payments to $2.1 million.

The non-GAAP highlights of the business can be found in the charts on slide 7 and the reconciliation of the GAAP metrics to the non-GAAP financial measures can be found in the appendix on slide 11. Starting with the free cash flow chart on the right, net cash used by operating activities improved to $9.9 million in the second quarter 2016, compared to $13.3 million used in the same quarter last year, due to lower operating expenses along with better working capital management. I also want to remind everyone that our cash has historically been seasonal, so that we have traditionally been a net user of cash in the first half of the year – with our low point being between Q2 and Q3 – thereafter becoming a net generator of cash in Q4. Capital expenditures, which primarily relate to capitalized labor on product and IT projects, totaled $3.3 million, up from $2.8 million in the second quarter last year, primarily due to increases at

Lexia. Free cash flow was negative $13.2 million in the second quarter, a $2.9 million improvement versus negative $16.1 million in the year-ago period.

Turning to the net loss and Adjusted EBITDA chart on the left, second quarter 2016 net loss totaled $9.0 million, up 10% compared to the net loss of $8.2 million in the year-ago period. Please note that the net loss in Q2 2016 included pre-tax restructuring and impairment charges totaling $5.4 million, combined with the $3.6 million adverse effect of the change in our suggested retail value; similarly, Q2 2015 included pre-tax restructuring and impairment charges totaling $2.6 million. Adjusted EBITDA was positive $0.1 million, a favorable $0.4 million improvement compared to negative $0.3 million in the year-ago period. The $0.1 million of Adjusted EBITDA in the second quarter 2016 includes the full impact of the $3.6 million change in suggested retail value that I discussed earlier.

With respect to full year 2016 guidance, total consolidated revenue is now expected to be approximately $190 million, up from our prior guidance of $182 million. Our outlook for Lexia revenue is now approximately $32 million and Lexia bookings approaching $40 million, both down somewhat from our prior guidance as Lexia continues to ramp its direct sales force in this year of transition from a reseller model. We continue to expect E&E Language revenue of approximately $70 million. Consumer revenue is now expected to be approximately $88 million, up from our prior estimate of $79 million. The transition to subscription-based sales in our direct channel is anticipated to take a little longer than previously expected, resulting in a higher mix of perpetual sales, primarily in digital downloads; Consumer bookings are expected to be approximately $100 million, down $6 million from our prior guidance on slightly lower expectations from our DTC and retail channels in the second half of the year.

The Consumer revenue outlook includes the one-time impact of $3.6 million to adjust the suggested retail value of our Consumer products, and our current estimate of $8 million in lower revenues year-over-year due to an increase in the unit mix of SaaS-based subscriptions; we now expect Consumer subscriptions will increase to approximately 35% of the unit mix this year, compared to 24% of the actual unit mix in 2015. We expect the Consumer revenue impact of this mix shift to be weighted towards the fourth quarter of 2016 as we plan to emphasize subscriptions more when we enter the holiday promotional period. As a reminder, Rosetta Stone is paid upfront for the subscriptions at the time we book the sales transaction -- so there is no cash impact from the transition from product-based to subscription-based unit sales.

For the full year 2016, we now expect the GAAP net loss will total approximately $42 million, which is an improvement of approximately $13 million versus our prior guidance driven by the higher Consumer revenue just discussed and lower operating expenses. This amount includes the full after-tax effect of the March 2016 E&E restructuring costs, which we now expect will come in at the low end of our previously stated range of $5 – $6 million, plus an estimated $8 million mix shift for Consumer subscriptions, the $2.9 million non-cash impairment of Fit Brains goodwill and other intangible assets and the $3.6 million second quarter adjustment for in-channel inventory in the Consumer segment.

We now expect an Adjusted EBITDA loss of approximately $10 million which is an improvement of $17 million versus our prior guidance, again driven by the higher Consumer revenue just discussed and lower operating expenses.

Our full-year outlook for cash has also improved and we now expect to end the year with nearly $35 million in cash. As I discussed earlier, our cash has historically been seasonal. We expect this trend to continue, but it will be mitigated this year due to the back-half cash impact of the adjustment to the suggested retail value of our Consumer products of $4.5 million, and remaining cash impact of the E&E Language restructuring of approximately $3 million. We expect both of these items to be weighed somewhat more toward Q3 than Q4.

That completes my portion of today's call. I will now pass it back to John.

John Hass, Chief Executive Officer:

Thank you, Tom.

With that, Operator would you please open the line for questions.