Q1 2019 Earnings Call - Prepared Remarks

Jason Terry – Investor Relations

Thank you and good afternoon everyone. Welcome to Rosetta Stone's first quarter 2019 earnings conference call. Speaking on the call today will be John Hass, Chairman and CEO. Additionally, Nick Gaehde and Matt Hulett, Co-Presidents of Rosetta Stone, and 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 www.rosettastone.com, both the earnings release and a slide presentation that accompanies today's call. We've also posted supplemental information and analysis on our website. This supplemental information will not be read on today's call.

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 businesses 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 SEC filings, including 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.

Our non-GAAP measures may not be comparable to those used by other companies and we encourage you to review and understand all of our financial reporting before making any investment decisions.

I will now turn the call over to John.

John Hass – Chairman and CEO

Thank you and good afternoon. Please turn to slide 3.

I am happy to report that the year is off to a positive start and we are pushing forward on a number of initiatives to drive future growth. The opportunities we are pursuing are firmly rooted in the areas that make us a global leader in digital learning. A deep legacy in education technology, with over 60 years of combined experience between Rosetta Stone and Lexia. A differentiated technology portfolio with unique capabilities like our speech recognition engine, the Rosetta Stone animation engine and our patented assessment without testing process. And because we are a scale player, with over five million combined paying learners annually, and have an iconic education brand, opportunities for reinvestment and growth are available to us. I will update you on some of the opportunities we are currently pursuing during today's call, but let me begin with an overview of Q1 results.

While a seasonally small quarter, I am pleased that both revenues and earnings came in better than expected across the Company. While much of this outperformance is anticipated to be timing, the year has begun well.

Turning to slide 4, Literacy bookings in Q1 were $4.5 million, in line with expectations and flat with Q1 2018 as both renewals and new business continue to consolidate into the third calendar quarter. Approximately 6% of expected 2019 bookings were recorded in Q1. In fact, also like last year, all of our expected bookings growth is anticipated to come during the school buying season in the second half of the year. Literacy segment revenues grew 20% over the first quarter of 2018, while ARR grew 18% to $51.7 million at the end of the quarter. Literacy retention and renewal rates remained strong while its contribution margin improved from $1.9

million in Q1 2018 to $3.0 million in Q1 2019, as growing revenues began to be more fully leveraged in the business.

Turning to slide 5, Consumer Language bookings of $15.8 million grew 4%, slightly exceeding forecast. In fact, Q1 marked the first quarter that Consumer bookings, excluding SourceNext and FitBrains, have grown on a year-over-year basis since 2014. Enterprise and Education bookings fell 4% to $7.6 million year over year, as expected. Within this we saw good performance in our North American corporate business, offset by lower bookings in K-12 Language which has been without significant product investment pending the introduction of our new English Learning product in 2020. More on that initiative in a moment.

Consumer revenues of $15.4 million grew 6%, excluding Fitbrains, as a result of bookings growth and the realization of previously deferred subscription revenue. E&E revenues in the quarter were down 6% due to bookings levels in 2018 and in Q1 of this year. Overall contribution margin for the combined Language business was $7.0 million, or 23.4% of revenues, up from $3.8 million, or 12.6% of revenues in Q1 last year reflecting reduced operating expenses in the Language business.   Please turn to the next slide.

Total Consumer subscribers at the end of Q1 were 516 thousand, an increase of 32% over the end of Q1 last year and 7% sequentially. Short term subscribers, or those with initial terms of twelve months or less, were 45% of the total, versus 37% in Q1 2018 and 44% in the fourth quarter of last year. The year over year change was driven by continued strong growth in the mobile app store channel.

The increase in short term subscribers led to a decrease in the average term length to 13.7 months versus 15.6 months in both the prior year and prior quarter. This shortening led to a decrease in the average initial selling price to $94 from $100 in Q4 of last year. Most importantly, with expected renewals, the average lifetime value per unit was relatively stable compared to Q4. Turn to slide seven please.

In order to better analyze the varying dynamics of unit growth and price change during the Consumer transition we look at estimated gross and net lifetime value added each period. In Q1, net LTV added, or the expected lifetime bookings of the units originated in the quarter, less the fixed and variable costs to acquire those units and renew them in the future, increased from the first quarter last year to $7.6 million due to a decrease in customer acquisition costs of 3%. The dynamics in our Consumer business are different than those in our enterprise and K-12 businesses which are sold through higher fixed cost direct sales channels but have high returns on incremental bookings growth. In the Consumer business, our current variable investment in marketing is returned quickly through purchased subscriptions, but the marginal cost of customer acquisition in each Consumer Language channel increases the more a channel is used. Consequently, as you will hear in a few minutes, we are testing ways to diversify our consumer marketing channels to take advantage of our over 90% aided brand recognition.

Turning to slide eight, consolidated revenues of $44.6 million were approximately 4% higher than a year ago and represents a positive start to the year in which we expect to see overall company revenue growth. The first quarter net loss was $0.5 million versus a loss of $6.4 million in Q1 of 2018. The year-over-year improvement in net loss in Q1 was due to the $1.8 million increase in revenue and a reduction in operating expenses of $1.4 million versus Q1 2018. The improvement in results also benefited from the absence of a $1.3 million inventory charge as a part of cost of goods sold taken in Q1 2018, and a one-time gain in other income in 2019 of $1.4 million from the sale of certain assets no longer used in the business.

Adjusted EBITDA in the quarter, which was not affected by the one-time item, was $3.3 million versus a loss of $1.3 million in Q1 2018.

Ending cash of $28.3 million exceeded expectations due to the timing of expected cash collections and expenditures within the first half of the year. We will be a user of cash through our seasonal low point for cash in Q2 and as we said in March, we intend to make use of our borrowing facility to meet seasonal cash flow needs. These borrowings are expected to be repaid during the second half of the year.

Turning to slide nine, despite better than expected Q1 results, in part due to the timing issues I mentioned, we are maintaining our financial guidance for the year. The first quarter, with only 14% of total expected bookings, is a small part of what we would like to achieve in 2019. Next slide please.

In addition, as shown on slide 10, we remain comfortable with the outlook beyond 2019 that we discussed during our last call, with the investments we have made, especially in our Literacy segment, driving continued top-line growth and earnings improvement. How will we accomplish our goals in 2019 and build a stronger business for the future? Please turn to slide 11.

In our Literacy business, success will be a product of the positive impact we have on schools and their students and the strategies for expanding our impact. In the past we have spoken with you about the ways in which we demonstrate efficacy. Providing data to schools and districts to show demonstrably improved outcomes for their students and conducting detailed research that is peer reviewed and published in third party journals.

But there is a broader way of thinking about impact and that is by looking at the way in which our products and the teachers and administrators that use them affect society. What is the theoretical return on investment for the learners and communities we serve when schools invest in Lexia products? We can begin to answer that question.

Our literacy curriculum products cost approximately $10,000 per building for an annual subscription with training services. A typical elementary school in the United States serves approximately 450 children, or $22 per student per year for Lexia. Conservatively, if you assume a student uses either Core5 or PowerUp for four years to fully build fundamental literacy skills, the cost of Lexia for that student would be approximately $88. Think of that as a school's lifetime investment per child. What is the return?

If a school follows national averages, approximately two thirds of their students will be reading below grade level. And we know that functional illiteracy is highly predictive of a student not graduating or not graduating on time which has tremendous costs for both the student, and society as a whole. In fact, a study has shown that the cost to society of someone that drops out of school, including the costs of lower lifetime earnings and a higher likelihood of incarceration, is approximately $125,000 per student. And the problem is huge with 1.2 million students dropping out each year or approximately 7,000 every school day. So how can we help?

Through Lexia Core5 we offer the leading adaptive blended learning solution to get children reading at grade level on time or catch them back up if they have fallen behind. Year-after-year, we have demonstrated that if children use Core5 with fidelity for the majority of the school year they can advance their reading proficiency by two or more grade levels in a year. And, as of last year with the introduction of PowerUp, we provide support for those students who have gaps in their reading skills in middle school and high school. Our products, by providing personalized instruction to learners and empowering teachers with the data and information they need, are able to reliably help students reach grade level standards and improve their chances of meeting academic requirements and graduating.

To be clear, the ability to read adequately is necessary, but not sufficient, to help at risk students. But the linkage between a program that demonstrates clear literacy outcomes and helping a child succeed when 85% of learning requires reading is clear. At $10,000 per school, and with a very small percentage of a typical school's per child budget, if we can help even one more child graduate than would have otherwise, it is one of the best investments in our future I have seen.

So I would ask one thing of each of you, because you are all members of a community, even if you aren't parents of school age children. Ask your local schools how they teach fundamental reading skills. Ask about graduation levels. And for those kids that dropout, ask if there is a correlation with reading scores. And when you hear that there is, know that solutions exist that can empower teachers and their schools to change the lives of students. Please turn to slide twelve.

There are a number of reasons we can expand our impact to reach more students. Our literacy portfolio of curriculum and assessment products is best-in-class and based on 35 years of experience in using technology to support literacy educators. With 16 third-party studies of efficacy that meet the standards of the federal Every Student Succeeds Act we can demonstrate how our solutions drive positive outcomes and we see the impact of these outcomes in high customer retention and renewal rates. And because of the investments we have made in both product and sales and marketing, we have now achieved that necessary, but difficult goal for success in K-12. Scale in customer awareness, product breadth and sales and marketing coverage that provides access to new schools and districts that were previously closed to us.

More tactically, turning to slide thirteen, we expect to grow our K-12 business in three ways. First, by continuing to expand the number of whole school licenses we sell. We are present in approximately 14,000 schools in the US today. Nearly four thousand of those schools currently have whole school licenses, and while this is up from thirteen hundred in 2014, the other ten thousand schools continue to be upgrade opportunities. These opportunities are realized as we become more central to the reading curriculum of our customers across multiple grades. Please turn to slide fourteen.

And now with a full suite of literacy solutions we have the opportunity to sell more than one product to each customer, whether that customer is a school or a district. We saw this explode in 2018 with the introduction of PowerUp, growing from 131 customers using more than one product, to over eleven hundred within the year. This growth continued in Q1 of this year, increasing 37% sequentially, to 1,583 customers in total. Next slide please.

And our opportunities go beyond upgrading existing customers to whole school licenses or selling them additional products. An even larger opportunity is to serve more schools in districts where we are already represented. Today we serve 14% of U.S. public schools but the total opportunity in the districts in which those schools reside represents over 40% of all U.S. public schools. This incremental 26% of U.S. schools are in districts where we have reference sites and can produce and share data demonstrating our ability to help schools like theirs succeed. We continue to pursue the other 60% of schools outside these districts, but existing district expansion is a clear focus. Next slide please.

One of the ways we are looking to leverage our K-12 presence is by introducing additional products that take advantage of our growing footprint and trusted relationships. I believe our ability to do this is important to our future. Our next step is the planned launch in 2020 of a new product to serve one of the most underserved and fastest growing populations in K-12, emerging bi-lingual or English Language Learning, students. You can visit almost any district in the United States, regardless of size or geographic location, and teachers and administrators will tell you that integrating and helping students succeed who come from families where English is not their native language is one of the most difficult issues they face. Why are we confident we can meet the challenge of helping those students and their schools? Because we have the industry knowledge, assets and expertise to build a compelling product offering and successfully deliver it to customers. Leveraging our core language training assets, we have been selling language solutions, including English language learning, to K12 schools for many years and know the issues schools face on a daily basis. And for the first time, we are bringing together the most important capabilities we possess from across the organization in a single product. Our proprietary speech recognition engine will help build speaking skills. Our highly developed adaptive, intelligent branching and our patented assessment without testing, will sit at the core of the learning journey, connecting the online performance of the student to the teacher-led instruction. While our Rosetta Stone animation engine will bring learning to life in a way that engages and makes the product relevant to students' lives. And finally, the product is being built on myLexia, our platform for providing information and intervention materials to educators that is already in 14,000 school buildings in the US. As we move through the year we will keep you updated on our progress in this investment. Next slide please.

In our Language businesses, our impact will grow as we recapture what originally made Rosetta Stone a leader in digital language learning. Great products, built to teach you a language, not words. This is the fundamental difference between Rosetta Stone and many of our competitors.

While we respect what they are doing, we aim higher. There is a place for gamified, flash card based apps to help you learn words. Our goal is to not only to help you build your vocabulary, but to turn that vocabulary into conversations that bring out all of the benefits of a second language. And to reach more learners one of the assets we will look to leverage further is the Rosetta Stone brand. Turn to the next slide please.

Interestingly, even though we have a widely known brand in the United States, with over 90% aided recognition, we have work to do to help people understand who Rosetta Stone is today. For example, while potential customers associate us with quality, in a recent brand research study that we conducted, about a third of customers that were familiar with us, didn't know that we had a mobile product, let alone an almost five star rated app. And even though brand recognition remains strong, there may be opportunities to grow the top of our customer acquisition funnel if we opportunistically diversify our media spending and catch people when they are looking to invest in language learning.

To help update people's understanding of Rosetta Stone and diversify our media spending, over the next few quarters we will be investing in a series of offline media tests. We stepped away from this type of marketing over the last few years as we focused on improving the product portfolio and generating near term operating cash flow. Because this type of media spending typically drives top of funnel traffic which converts over time, the return is not as immediate as email and other direct channels. As a result, over the next few quarters we may see a modest decrease in gross and net LTV added and slower subscription growth as we test our ability to diversify our acquisition channels and prime the pump for future growth. We will size our investment appropriately to what we learn. Please turn to slide nineteen.

Even as we look to produce higher levels of growth in our core U.S. consumer business, we are investing in the larger language learning opportunity internationally. In fact, with over $50 billion spent annually, mostly outside of the U.S. and primarily to learn English, this is the single largest total addressable marketplace we are positioned to serve.

Here too we have assets that can help us be successful. For demanding international customers, many of whom have knowledge of English, we are looking to bring together the capabilities we have built to serve not only U.S. consumer learners, but also demanding global enterprise customers including the ability to learn from a certified Rosetta Stone tutor in an online class. Blending computer and human intelligence to make both better is our strategy to produce favorable outcomes and improved learner satisfaction, while our competitors force learners to choose between one or the other.

We will also approach the marketplace differently from our peers. Our intention is to provide customers the tutoring they want, when they want it. Not packages of tutoring sessions sold a year at a time for a high upfront cost. In Korea last month we turned on the paywall to test pricing approaches. While very small, this is the next critical step in the learning process. We are early in our testing, and as I have said before, view this as a higher risk investment than others in our portfolio and will approach it as such. We will provide updates as we learn more. Next slide please.

At Rosetta Stone we know that we create social good by building great products and growing the number of learners using those solutions. We also understand that as a subscription-based software business, expanding the number of learners is fundamental to profitability. In the past, our lack of profitability came from investing heavily in the K-12 Literacy business while simultaneously making the necessary technology and marketing changes in our Language businesses. Now with a scaled and fast growing Literacy business and a Language business that has stabilized, and which we expect to grow, we have the opportunity to meaningfully improve our profitability.

Our B2B businesses have attractive incremental segment contribution margins of approximately 70% even on a GAAP basis, as we leverage high gross margin products and scaled distribution. In our Consumer business the incremental segment contribution margin before variable media expense is even higher at approximately 75%. Within this business profile we actively manage our Consumer variable media spend to produce the highest absolute dollar return. The contribution dollars produced by this Consumer media spend are valuable, as they are available for reinvestment across our business.

But the opportunity to sell our current products at a high incremental margin is necessary, but not sufficient, to achieving our ultimate goals. Our presence in K12 schools and the Rosetta Stone brand are both capable of being leveraged beyond our existing products to reach more learners. While we will look at strategic opportunities that could accelerate building scale, we are not limited in our ability to build additional great products and successfully deliver them to customers. As we do this we will leverage our brand presence, our sales and marketing infrastructure and business services team to drive high incremental margins.

One example of how we can grow shareholder value, is one I discussed today, the opportunity to build a great product for K-6 ELs that can return a multiple of bookings for every dollar we spend in development. As a board and management team we are committed to identifying opportunities like this to leverage the wonderful assets within Rosetta Stone in the service of our learners and owners. Thank you for listening to our prepared remarks and operator you can now open the line for questions.