FOURTH QUARTER 2010 INVESTOR WEBCAST
28 February 2011

Prepared Remarks

Elizabeth Corse, Investor Relations: Welcome, everyone. Tom Adams, Rosetta Stone's CEO, and Steve Swad, our CFO, are here today to discuss the company's operations and financial results for Q4 and full-year 2010, and our outlook for 2011. Our press release, supplemental financial information and a slide deck supporting this webcast are available on our IR website, investors.rosettastone.com. Please review them to find important additional information.

We've included some new information in the supplemental financial data packet: detail on bookings by market, looking back eight quarters. We've provided this breakout because it offers a more consistent view into the markets we address. As our institutional business becomes more subscription based, and the consumer business drives higher deferred revenue as a result of the launch of Version 4 TOTALe, sales today result in less revenue and more deferred revenue than in prior periods. Bookings can certainly be lumpy from quarter to quarter, but the long-term trend and comparisons to prior quarters better reflects our sales results.

We've also re-classified bookings for sales to home-schoolers, taking those sales out of the institutional numbers and adding them to the consumer numbers. We did this because the home-school solution is typically a single sale, through a retail outlet, much like our consumer offering. It's also how we manage the business. This change affected the units sold and average price per unit information as well, and again we've provided eight quarters of data reflecting the reclass.

Our press release, slides and conversation today include forward-looking statements. We make these statements under the Safe Harbor provided by U.S. law. Risks and uncertainties attach to any forward-looking statement, and some of those risks are outlined in our Form 10-K filed with the SEC in March 2010 and available on our website. I urge you to review those risk factors before making any investment decision.

We also use non-GAAP numbers in our presentation. The definition of those numbers, and their reconciliation to GAAP numbers, is available in today's press release on our website and as filed with the SEC today on Form 8-K.

Now I'm pleased to introduce Tom Adams.

Tom Adams, Chief Executive Officer: Thanks for joining us today. I'm going to open with an overview of 2010 and the fourth quarter, then discuss how we're going to address challenges in the US consumer market, and close with an outlook on our operational targets for 2011.

I'll start on slide 4. As already signaled in our pre-release of Q4 results, despite the continued success of International and Institutional, we saw difficulties in US consumer in the fourth quarter, and therefore delivered overall company results that were below expectations. And while Borders' bankruptcy made our results worse, performance of US consumer reflected an overall softness despite promotional efforts, broader distribution and Q4 being our first full quarter marketing our new core offering.

Of course, we are concerned with the negative top-line trend in the US consumer market and are determined to reverse it, while continuing to fund and support our high growth channels with institutional and international buyers.

And as we undertake a repositioning in our US consumer business, we are taking steps to re-align our cost structure to suit where we see the business going. This will involve reductions in both fixed and variable cost here in the US. Steve Swad, our CFO, is working with managers across the company to see how we can bring down our costs and realign resources to our priorities.

As we announced earlier, we expect to see negative performance continue for US consumer early in 2011, even as international and institutions continue to develop positively. As we take important actions to reposition our business here in the US, we expect increased variability in sales. Therefore, we're offering limited financial guidance for 2011, particularly around US consumer. We are sharing our operational plans, and we will keep you updated on our success versus those objectives throughout the year.

Our decision to work on a significant repositioning of US consumer is driven by a sense that, although Rosetta Stone continues to enjoy a significant lead over other instructional technology companies, we need to move faster on a number of fronts. These include: developing a more segmented approach in our marketing; taking the steps necessary to make the brand relevant for the long term; moving to more download-oriented, digital distribution; developing a more strategic pricing approach; and moving to new digital platforms such as the iPad.

While we have clearly endured broader market challenges over the past two years, with a tightening media environment and continued broad softness in US consumer spending, we believe that we must move more decisively and with greater urgency on a number of these fronts to ensure that the US consumer business continues to be a strong cash flow positive part of our company.

At the same time as we take corrective steps to reposition our business with US consumers, we need to intensify the drive for more targeted solutions that yield longer customer lifetime values globally. So we'll focus on more serious learners, and more results-oriented institutional customers. Our long term relevance is predicated on our ability to be the choice of the coordinator for an ESL student in New Jersey or the committed language learner in Asia.

We're thus pressing ahead to become more core in schools, corporations and government organizations and we're aggressively expanding our international business where the consumer population is more committed to learning and where the value of learning a new language is a multiple of what it is here in our domestic market. To this end, we plan to expand to new markets where learning English is life changing, further develop our institutional markets, and invest in new products that target more advanced English language learners in Asia, Southern Europe and South America. We expect to deliver significant progress on these fronts in 2011 and beyond.

As we undertake these changes in 2011, I'm pleased that Laurence Franklin, who has been on the board of Rosetta Stone for 4 years, is going to assume the role of Chairman of the Board to help support our business transformation. We're very pleased to be able to tap Laurence's experience as we reengineer our U.S. consumer business.

You can see on slide five a summary of our financial results for the fourth quarter 2010, and for the full year. For the quarter, bookings were up 6% while revenue declined 5%, year over year, as we deferred more revenue from sales of Version 4. International consumer bookings were up 93% in the quarter, with the greatest strength in Asia. Worldwide institutional bookings were up 37%, driven by new corporate clients and renewals with some large educational customers. Bookings from US consumers were down 11% in the fourth quarter.

US consumer bookings were below expectations in particular because the retail channel fell below our expectations. We delivered lower-than-expected sell-through across all of our major retail partners. This was aggravated in Q4, as we took a full reserve for all the money owed to us by Borders, which Steve will discuss in more detail.

Operating, net income and Operating EBITDA margins all declined, largely as a result of our lower top-line performance in the US consumer market.

Despite these shortfalls, we were able to generate free cash flow of $12 million in the quarter.

For the full year, we achieved $280 million in bookings, up 7% over last year, on revenue of $259 million, up 3%. The gap between revenue and bookings growth is attributable both to the deferral of revenue on sales of V4 in the second half, and to sales to institutional clients, which are largely subscriptions instead of perpetual licenses. Trends by market were very similar to what we saw in the quarter.

We deepened and broadened our international footprint, expanding our Japanese and Korean business at very high rates, and establishing a presence in Germany. In total, we more than doubled bookings from international consumers

We also expanded our presence in education, government and corporate institutions, with bookings from institutional clients increasing 18% in 2010, with accelerating growth in Q4.

Sales to US consumers grew in the first quarter, but then began a declining trend. Again, we're very focused on tackling this challenge.

Net income was $13 million, down 1%, and Operating EBITDA of $45 million was down 24% from 2009. The Operating EBITDA margin narrowed on weaker US consumer performance, about $6.4 million of Version 4 launch costs, and the Google litigation expense of $4.4 million from the first half of the year.

We generated significant free cash flow for the year, ending with over $122 million in cash and short-term investments.

Of course, 2010 included our shift to solution, away from being purely software, we took positive action in this regard with the Version 4 TOTALe launch in Q3. We continue to get very positive feedback from users and are seeing terrific learner results as our customers progress toward conversational fluency.

I believe that the combination of synchronous, voice-based language socialization with our powerful instructional software system continues to be the only viable way to successfully learn a language without leaving home. This strong educational platform foundation is critical as we move towards focusing more on serious learners who are looking to become conversational.

Overall, very much in line with Q4, the full year of 2010 was one where our dramatic and positive momentum in institutions and international, and operationally successful release of a next generation product line, was overshadowed by weakened performance in the US consumer channel.

Going on to the next slide, I'd now like to take a step back and look at the market for language learning more broadly. Based on our own recent survey, which was completed last month, it is clear that the US consumer market has changed significantly in just the past three years. US consumer spending on language learning has shrunk by 24% during this period, even as there's been a 28% expansion in the number of buyers.

While unit declines occurred across the board for all offerings above $50 during this period, it is clear that applications for mobile platforms such as the iPhone took unit share even as they also drew incremental participants into the self study category in language learning. Of course, many of these new offerings have been offered at extremely low prices, and while they are limited in scope, offering very little in terms of learner results, we need to be cognizant that they represent some threat. At the same time, it is evident that there have also been large numbers of Americans using free websites for language learning – and while we would presume that they have enjoyed very limited results, such competition is affecting all participants in the industry.

In this context, although our 2010 survey shows that Rosetta Stone continues to be the clear market leader here in the US from a spend and brand perspective, we're concerned that there is much more new competition and that, since many of the 15 million US consumers who spend money on a language learning product or service are just dabblers and aren't concerned with getting real results, it is critical that we move rapidly towards segments for whom learning a language is important. We need therefore to accelerate our efforts on several important initiatives to ensure that we stay relevant to learners here in the US even as we put our greatest bets on getting to more international and institutional learners for whom learning a new language is "bread" rather than "cake."

While our urgency to make changes is heightened as a result of recent trends in our US Consumer business, many of our initiatives are geared towards the same strategic imperatives that we have pointed to in our prior communications with investors. On slide seven, we describe how we plan to drive growth.

First, we're taking a more targeted approach to attract more users in more segments to our offerings. Of course, this will mean going after:

- specific segments such Generation Y learners, who have the distinction of being the highest language training spenders per capita and prefer classroom, while they also like social online solutions;
- serious learners such as advanced Japanese or Korean learners who know English and yet cannot speak the language in a conversational setting; and
- early technology adopters who prefer to use their iPad for interactive experiences

Secondly, we're extending our efforts to provide greater lifetime value and revenue capture over time. We're:

- intensifying our efforts to engage new large institutional customers for whom language training is critical, even as we work to grow existing partnerships;
- adding subscriptions that give individual consumers access to the full solution over a fixed period of time; and
- reducing the initial free subscription period to our box offerings to just 3 months to enable more extensions and renewals

Third, we're expanding overseas, and in this regard, we're:

- supporting the roll out of new products that suit local market tastes;
- nurturing our existing international offices with expanded marketing support; and
- opening new markets such as China or Brazil as we leverage our learning from existing profitable markets to help get new markets off the ground more rapidly and thus position the company in markets where learning a language is life changing.

As we execute across these areas, we expect to end up with a business that has strong growth dynamics and whose customers are international, more serious about results and whose commitment level is much greater than our current typical US consumer.

And yet given market dynamics, investing for growth is insufficient to create value over the medium and long term. We must also take the necessary actions that support our desire for longevity. If you turn to slide 8, you can see here the key elements of what is required for us to do that:

Firstly, we are embracing many of the new technology trends and platforms that have emerged over the past several years with new product roll outs to these platforms during the year

Secondly, we need to continue to optimize the efficacy of our solutions as we optimize content efficiency and evaluate further improvements to existing and new platforms.

Thirdly, we must strengthen our brand leadership by elevating our message even as we promote action among prospects in a tactical and direct way. In this way, we will devote time and resources towards elevating our value proposition with a more emotional message, while we engage in social media and reduce the most pushy aspects of our current marketing approach.

I believe these actions will gradually strengthen our brand, stop the negative growth trend, improve our position and establish the basis for sustainable, long-term growth.

As we go through this strategic acceleration in the business, we recognize the need to report on our changes. To this end, I've summarized our targets for 2011 on slide nine. We'll keep you up to date on how we're performing against these specific initiatives.

First, we're looking to launch an advanced English conversation solution for Korea.

Second, we're driving several initiatives to reposition US consumer. These include coming up with a segmented approach in marketing and product, with a new pricing mix rolled out that increases unit sales. Recent market tests suggest real sales lift potential exists with just this driver that would make the best language learning solution within reach of more prospects. Also, we're developing an emotional brand idea with targeted messages that resonate with segments, even as we pare back our pushiest spots. We're rationalizing our distribution and moving to new delivery platforms, so that our offering is downloadable to various devices such as the iPad. And, finally, we're taking action to adjust our cost structure, so that we turn our focus and capital to where new value is being created.

Third, we need to deliver Institutional expansion and development with large new deals getting closed.

Fourth, we are looking to open new markets (including China or Brazil).

Finally, we plan to do this even as we continue to generate positive free cash flow for FY2011.

Now Steve will review our financials in detail.

Steve Swad, Chief Financial Officer: Thanks, Tom, and welcome everyone.

I want to start my comments on slide 11, with a high level look at bookings and Operating EBITDA, which are two key metrics of our company. As we've laid out, international and institutional bookings grew nicely in the fourth quarter and for the year, but the decline in US consumer sales constrained overall bookings growth to just 6%. That decline was the primary driver to Operating EBITDA moving down from $20.3 million to $13.4 million.

Let's take a deeper look at the numbers, starting with bookings from our three markets: international consumer, worldwide institutional and US consumer. On slide 12, you can see the strong top-line results from our international consumer business. Bookings were up 93% for the quarter; and 146% for the full year. This growth was on target with our expectations, with all four country locations showing solid results.

Looking ahead, we plan to begin rolling out Version 4 internationally in 2011. In fact, we started with a smooth launch in Japan on February 22nd. The U.K. is next with a launch planned for mid-2011. And then, before the end of the year, we'll launch Version 4 in South Korea. We believe that these roll-outs will further strengthen our language learning platform, and change our business model from a single point of sale to one where we have multiple opportunities to engage with our customer.

In addition, as Tom indicated, we're on track to roll out our conversational English platform for the Asia/Pac market late in the year. And we plan to open an office in either China or Brazil within the next twelve months.

Moving to the institutional business, you can see on slide 13 that we had a strong quarter with bookings of $14.4 million, up 37% in the fourth quarter and 18% for the year. This strong finish was better than we expected as we saw growth in each category – government, education, and corporate. As is typical for a fourth quarter, corporate had the highest bookings. In fact, we had record corporate bookings, double the previous quarterly high.

I put a premium on these bookings because they contribute to a large and growing subscription business, with high renewal rates and significant expansion opportunities in the US and abroad. In 2011, we expect to continue to achieve healthy bookings growth as we invest more in our sales force both here in the US and abroad, and go hard after our strong pipeline. We'll also continue to upsell our institutional clients on to the TOTALe platform, allowing them access to the best possible Rosetta Stone experience.

Now let's move to slide 14 and look at the US consumer market. You can see bookings were $52.2 million, down 11% from last year, as the decline in units outpaced our average price increase. These results were below our expectations.

We have three key distribution channels in the US – kiosks, direct-to-consumer, or DTC, and retail, which includes both brick-and-mortar stores and e-commerce sites.

Kiosks are the smallest channel today, and bookings were down sharply for the full year and the quarter. This decline is consistent with what we've seen in each of the last several quarters, as we've reduced the number of domestic kiosks and experienced cannibalization from other points of sale, particularly our retail partners. We reduced our US kiosk count during 2010, and we'll monitor performance closely and continue to optimize the kiosk footprint in 2011.

The DTC channel was down modestly compared to last year. We're still getting good returns on our media spend, with higher conversions, but we placed fewer ads given the tighter pricing. As a result, we generated fewer orders.

Last, our retail channel was also down modestly in the quarter, which we hadn't expected. The largest single driver relates to our decision to go to cash basis for bookings and revenue for Borders. This resulted in about $2 million of de-bookings and a reserve for bad debt of about $900 thousand, which is reflected in G&A expenses for the quarter.

In addition, we saw lower sell-through at our retail partners, despite record results on Black Friday. This caused some stores to return inventory after Christmas and New Year's, which required us to de-book. Even so, we're starting 2011 with a few key partners carrying inventory above their historical levels, so we don't expect them to buy significant new stock this quarter. As a result, we are expecting bookings from sales to retailers to be down sharply in the first quarter of 2011 compared to Q1 of last year.

Moving back to the consolidated business, let's look at the cost side. Gross margins of 83% were slightly below our expectations, as cost of sales increased, as expected, in Q410 for the additional services offered with Version 4.

Sales and marketing expense increased 22% to $39 million, and included $1.7 million for the Version 4 launch, as expected. Excluding the launch marketing costs, most of the increase was related to generating growth in International bookings. Our International businesses continue to get stronger, and in Q4 we saw our marketing spend deliver better yields than the same quarter last year. Sales commissions relating to the growth in the Institutional business drove the rest of the increase. Sales and marketing expenses related specifically to US consumer market were flat Q4 2010 versus Q4 2009, so the yield on that spend was down.

General and administrative costs were up 19% to $14.5 million due principally to the Borders bad-debt reserve, higher IT costs to support US and International operations and higher stock compensation costs related to the addition of new senior executives.

Net-net, Operating EBITDA margins compressed as contributions from the US consumer market declined. That decline more than offset expanding margins internationally and strong margins on the institutional business.

Moving to the GAAP numbers, slide 15 lays out revenue and net income. You can see on this slide that both were down for the quarter.

In addition to the trends I described relating to operating EBITDA, in September 2010 we began deferring 15-20% of our US consumer revenue with the launch of Version 4. This means that, while every $100 of sales to US consumers used to result in $100 of revenue, after mid-September of 2010, that same $100 of sales results in $80 to $85 of revenue on the P&L, and $15 to $20 of deferred revenue on our balance sheet. This deferral makes the revenue and net income comparison to previous quarters difficult and inconsistent.

Net income was positively affected by the reversal of tax reserves relating to international tax assets. The reversal reflects the profitability of our international operations in 2010, so that we now expect to get the tax benefit from losses previously incurred. As a result, we recognized a one-time benefit of $2.3 million. In 2011, we expect our effective tax rate to be between 35 – 38%.

The difference between revenue and bookings is the change in deferred revenue for the period. You can see on slide 16 that deferred revenue increased from $39.6 million at 9/30 to $47.2 million at 12/31. That means we deferred about $7.6 million, or 26 cents per share this quarter. Almost all of this change came from sales of Version 4 in the US.

I'm calling out this number because it's a big one, and it contributes to the decline in net income year-over-year. I think it's important to recognize that we've secured the sale, collected some or all of the cash, and created value for the company. However, part of that value is on our balance sheet, waiting to be recognized over future periods as we fulfill our service with the customer. You can see from our balance sheet that 89% of this deferred revenue is current, which means we expect it to come into revenue in the next 12 months.

Now let's move to slide 17, which highlights a summary balance sheet. You can see that our ending cash and short term investments is $122 million, or roughly $6 per share. Our management team and board believe that this level of cash provides plenty of financial flexibility to support our business initiatives and, at the right time, may allow for select acquisitions to accelerate growth.

Year-on-year free cash flow is down because cash flow from operations is down with lower operating results. However, we did continue to generate cash in Q4, adding a total of $12.5 million to the balance sheet. This was attributable to $15.1 million of cash from operations, offset by $2.6 million of cash used for cap ex.

Our guidance for 2011 is on slides 18 and 19. Let me set the stage for this discussion by noting that I'm well aware Rosetta Stone has been inconsistent in meeting its guidance. I'm determined to offer you as much insight into our expectations as I can, to be as transparent as possible, and to keep you updated on our progress against operational goals.

I'll begin with our projections for the first quarter. We anticipate bookings to be in the range of $52 to $56 million. We expect bookings for institutional and international to be up year-over-year – about 20to 30% combined. However, continued softness in the US consumer markets, especially in retail, where we started the year with inventories being high, will result in a year-over-year decline of about 25% to 30% in bookings. Revenue for the quarter is expected to range from $54 to $58 million.

Given weaker performance in US retail and lower expected returns on DTC and kiosk, we're expecting continued operating margin compression, resulting in negative Operating EBITDA of $10-14 million and a net loss of $7-10 million, or 34-48 cents per share.

For the year, we expect bookings to be up in 2011 compared to 2010. In particular, bookings from international consumers and worldwide institutional customers, combined, are expected to increase by 40-50%. Bookings from US consumer are expected to decline. We also expect revenue to be up in 2011.

Since we expect softness in the US consumer market, we also anticipate lower operating income and Operating EBITDA compared to 2010.

Because we're in the process of implementing a number of new initiatives that have inherent uncertainty with respect to timing and performance, we are not providing any more specific guidance. Instead, we'll keep you updated on the progress we are making around the key initiatives Tom discussed.

With that, Tom's going to wrap up now, before we take your questions.

Tom Adams, Chief Executive Officer:

So as we look at our business today, we see both strong positive performance in Institutions and International, and challenges in our US consumer business. Given this context, we believe that we need to accelerate changes to our US consumer value proposition and continue investing where the long term growth opportunities for the company lie. We plan to do this even as we trim costs in areas that are not aligned to where we see the future direction of the business.

To recap: we're going to accelerate our move towards more serious learners (whether they are in schools or are lifelong learners in Asia); and we're planning to develop a more segmented approach to the US consumer market, and thus consolidate our leadership position so that sales stabilize and then we return this vertical to strong growth rates.

In closing I would say that there are three core themes related to Rosetta Stone that investors should keep in mind:

First, our unique combination of a natural learning method with leading technology, proprietary content and innovative coaching services makes learning a language with Rosetta Stone more effective, faster and easier. And we're working to build a similarly superior solution for advanced English language learners.

Second, the market for learning languages is huge, and while it is increasingly dynamic and deflationary at the casual low end, most spend is by serious learners and learning institutions that need results. We are well positioned with those that value outcomes, as is seen by recent momentum with International and Institutions, and believe that this part of the market should offer plenty of runway for growth for the company. We are intensifying our efforts towards becoming even more relevant to these key segments of serious learners.

Third, while there are clearly challenges in our US consumer business near term, we continue to experiment and move to discover more efficient price, product and marketing mixes to establish value propositions that draw more revenue from more learners. We will endeavor over the coming quarters to take the actions that put us on a better course with our home market. We will be reporting on our progress in this area as we make critical changes.

We remain excited about the prospects for Rosetta Stone long term as we continue to innovate and work to change how people learn languages successfully around the world.

Now I'll pause a moment while we assemble the queue for your questions.