Second Quarter 2017 Earnings Call

August 8, 2017

Prepared Remarks

Frank Milano:

Good afternoon and welcome to the Rosetta Stone second quarter 2017 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.

The 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 full year outlook for 2017.

In keeping with the Safe Harbor statement on Slide 2, I will remind everyone that today's presentation contains forward-looking statements within the meaning of the applicable securities laws. Forward-looking statements can be identified by non-historical statements and often include words such as "believes," "expects," "estimates," or similar words as well as future-looking words such as "will," "should," or "may." These statements may include, but are not limited to, statements relating to: our business strategy; financial guidance or projections related to the business; and other plans, objectives, and related estimates and assumptions. A forward-looking statement is neither a prediction nor a guarantee of future events or circumstances. In addition, forward-looking statements are based on the Company's current assumptions, expectations and beliefs and are subject to certain risks and uncertainties that could cause actual results to differ materially from our present expectations or projections. We expressly disclaim any obligation to update or revise any forward-looking statements, except as required by law. You are encouraged to read our cautionary statements, risks and uncertainties more fully described in the Company's filings with the SEC, including those described under the section entitled “Risk Factors” in the Company’s most recent periodic filings.

Today’s presentation and discussion also contain references to non-GAAP financial measures. The full definition, GAAP comparisons, and reconciliation of those measures are available in this presentation or in our press release which is posted on our website at www.rosettastone.com. Our non-GAAP measures may not be comparable to those used by other companies, and we encourage you to review and understand all our financial reporting before making any investment decision.

I will now turn the call over to John.

John Hass, Chief Executive Officer:

Thank you, Frank.

The second quarter was a period of continuing improvement as our efforts to reduce expenses, invest in new and enhanced learning products and improve sales and marketing across the Company led to further progress towards sustainable annual profitability and future growth.

Revenues year-over-year were flat for the second consecutive quarter and earnings improved as we complete two years of substantial restructuring and start to realize the benefits of focusing on our best products, in our best marketplaces, with a more efficient infrastructure supporting our businesses. I was especially pleased that we achieved these results even as we accelerated the transition of our Consumer Language business to a true subscription model that defers revenue recognition in what is still our largest segment.

Our Enterprise and Education Language business had a good quarter producing sales of $18.6 million. This was roughly equivalent to sales in the second quarter of 2015, but was accomplished with approximately 35% fewer direct sales people helping to lead to a 48%

improvement in the contribution margin of our E&E business between those two periods. While I would have liked E&E to grow over the last two years, the priority was to improve profitability even if that meant sacrificing some sales in the near-term and set that business up for future growth.

We were helped by the continued penetration of Catalyst, our new E&E language product, into our client base. In the second quarter, we are seeing good Catalyst penetration of North American corporate sales following our launch there towards the end of 2016, as well as in Northern and Central Europe even in advance of planned increases in the number of available onboarding languages and Learner Management Systems (LMS) integrations and other improvements for customers in these geographies.

We are investing in our language business to make it easier and less expensive to provide customized language learning content for new languages or customized content for clients' specific needs in our current languages, especially English. An example of our capability in this area is a contract we signed in the second quarter for the preservation of a Native American language for which we received an initial payment in the low single-digit millions of dollars. We believe an improved ability to deliver content that is personalized, effective, engaging and relevant will lead to larger deals with better retention rates.

In the second quarter, our Consumer Language business continued to accelerate its conversion to a true subscription sales model. In our direct-to-consumer (or "DTC") business, which was approximately three-fourths of Consumer unit sales, unit subscription volume as a percentage of total unit volume was 66%, up from 26% in the second quarter of last year and 58% in the first quarter of this year. At the end of the second quarter we had 375,000 subscribers, an increase of 38% from the same period last year and up 6% from the end of the first quarter, despite the continued reduction of sales and marketing spend, which was 29% lower than in the second quarter last year. Our transition is being helped by the App marketplaces – for example, our iOS app that has a nearly five-star rating in the App Store.

As we make the transition to subscription in Consumer we are focused on improving the expected lifetime value (or "LTV") of our subscription sales relative to their cost of acquisition (or "CAC"), and have begun making investments to improve our retention marketing capabilities. While the absolute LTV-to-CAC of each subscription type is important, we manage to the highest value for the total portfolio. This means that even as certain offerings - for example, shorter subscription length offerings - have lower relative initial cash realization, they improve the overall portfolio by expanding our subscriber base and providing a base of future renewals that longer, initial-term subscription products generally do not. As we transition from perpetual sales and multi-year subscriptions to a portfolio with a meaningful share from shorter-term subscriptions, cash flow is temporarily reduced, but the future cash flow and predictability of our Consumer business is improved. We believe with confidence that we are managing this transition well.

In the second quarter, approximately 42% of DTC unit sales were from subscriptions with durations of one year or less, up from only 5% of unit sales in the same quarter last year. In addition, our overall estimated LTV-to-CAC in Consumer's DTC business improved to 1.8x from 1.5x in the second quarter last year.

Even as we make progress in transitioning our direct business to subscription, we are preparing for the conversion of our retail business to subscription sales from CD-box sales. Our retail business year-to-date represents approximately 25% of total Consumer Language segment unit sales. Shifting this channel to subscription creates some risk, but is critical to staying at the forefront with our retail partners and evolving learner needs while reducing ongoing costs. We will keep you posted on our progress over the next few quarters.

Finally, on the partner front, we have now largely completed the development work for our initial co-branded product release with Univision to serve the U.S. Hispanic marketplace.

We look forward to launching this offering a little later this year and helping to meet the critical needs of this very large learner base with an excellent partner.

At Lexia we saw an increase of 22% at the end of Q2 in annual recurring revenue to $39.2 million from $32.2 million at the end of the second quarter last year.

Within the quarter we saw a large number of pending customer contracts shift from June to expected renewal in the third quarter. It is common for the invoicing of K-12 licenses to move from the second quarter, the end of a school's fiscal year, to being renewed in the third quarter, the beginning of a school's next fiscal year. However, the number of renewals that moved from the second to the third quarter this year was uncharacteristically large on both a percentage and absolute basis.

As retention rates in Lexia's direct business have exceeded 90% this year and renewal rates have been even higher, we expect to see, and are already seeing, these renewals come in during the third quarter. To give you a sense, Lexia's sales in the month of July this year were approximately 30% higher than the month of July last year, even though July last year included a low single-digit million dollar order that we expect will grow but not formally renew until later this quarter. In fact, this July was the largest month in Lexia's history, and was larger than the entire second quarter, in part because the deals that were still pending at the end of Q2 began to be realized. I note this as I believe it helps to understand Lexia's Q2 sales performance – normally across our business, the first month of any quarter is not necessarily indicative of how the quarter will turn out – but Lexia's strong July gives us confidence that they are on track.

The shift of renewal bookings from Q2 to Q3, along with the absence this year of an approximately $1-million multi-year deal that was invoiced in the second quarter last year -- and that is not available for renewal again until 2018 -- resulted in a quarterly year-over-year decline in bookings. We do not expect the timing shift to affect overall bookings for the year and we believe Lexia's full year 2017 bookings will be within our original forecast range of 20% to 25% year-over-year growth.

With that, let me turn it over to Tom take you through the financial results and guidance for the year in more detail.

Tom Pierno, Chief Financial Officer:

Thank you, John, and good afternoon everyone.

I will begin with a review of the Q2 highlights - please turn to slide 3:

- Total revenue was flat year-over-year at approximately $46 million. This was our second consecutive quarter of relatively flat top-line results.
- Operating expenses, in total, were down $9.6 million or 20% year-over-year, which included pre-tax charges of $2.9 million for impairment in 2Q last year, and restructuring charges in both periods. In note 13 of the Form 10-Q, we provide a table that associates total restructuring costs with the related line items on the income statement. There you will see that nearly all of the $0.2 million in restructuring expense this quarter was included in operating expense and $2.0 million of the total $2.5 million in restructuring expenses incurred in the second quarter last year were included in operating expenses, with the remaining $0.5 million in cost of goods sold.
- Excluding restructuring and impairment charges in both periods, operating expenses were down $4.8 million, or 11% year-over-year.
- The net loss this quarter totaled $1.1 million, or 5-cents per diluted share, versus a loss in the year-ago period of $9.0 million, or 41-cents per diluted share. Note that the current quarter benefitted from $5.2 million lower pre-tax charges for impairment and restructuring, plus the absence of a $3.6 million Consumer

segment revenue reduction in the prior-year quarter, which I will discuss shortly; and

- We ended the quarter with $26.4 million in cash and zero debt.

Turning to slide 4, I will review revenue by segment.

- Lexia revenue was a record high $10.4 million in the second quarter, representing growth of 30% year-over-year, while, bookings declined 9% to $8.6 million due to timing as John discussed. As a reminder, Lexia's revenue includes the impact of purchase accounting on acquired deferred revenue. Adjusting for this impact, Lexia's pro forma revenue would have been $10.9 million in Q2 2017 compared to $9.2 million in the same quarter a year ago.
- E&E Language revenue declined slightly year-over-year due to the change in our go-to-market strategy announced in March 2016 where we exited a number of markets on a direct basis. Revenue from the retained direct marketplaces increased 4% or $0.6 million year-over-year, while revenue from exited marketplaces declined 35% or $0.8 million year-over-year. Revenue in the North America K-12 business was up 5% year-over-year in the second quarter, while bookings declined $0.8 million or 9% due to the absence of a prior year $1.3 million, multi-year renewal that we talked about in Q2 last year. Absent that deal, year-over-year K-12 bookings would have increased $0.5 million or 6%.
- GAAP reporting of Consumer segment revenue declined $2.0 million (or 10%) year-over-year. Included in second quarter 2017 revenue was the adverse revenue and earnings impact of $0.7 million accrued to recognize planned return of inventory related to the change from a terms to consignment relationship with one of our larger retail partners that we have previously discussed.
- Consumer revenue is being temporarily negatively affected by the shift in sales from perpetual products, including CD box and digital downloads, where we

recognize revenue upon sale, to subscription sales where revenue recognition is deferred over the subscription term. Perpetual products were 43% of unit sales in the second quarter, down from 75% in the same quarter last year. As we transition retail to subscription, perpetual sales will fall even further.

- Note also that prior-year Consumer revenue was lowered by the $3.6 million accrual related to the change in the suggested retail value of the in-channel inventory with our terms retail partners. Both the $3.6 million pre-tax revenue reduction for the Consumer segment change in suggested retail value in the year-ago period and the $0.7 million revenue reduction this quarter for Consumer retail terms to consignment fell to the bottom line.

Slide 5 reflects second quarter sales metrics. Annual Recurring Revenue, or "ARR," for the Literacy and E&E Language segments totaled $97.6 million, a year-over-year increase of 7% compared to $90.9 million in the same quarter last year. Lexia's 2Q ARR was up 22% year-over-year to $39.2 million, and their renewal rate was 85% on a trailing 12-month basis, and was over 100% when calculated on the basis of second quarter sales. E&E Language ARR slightly declined 1% year-over-year to $58.4 million primarily related to exited geographies, and the trailing twelve-month renewal rate increased 300-basis points to 78%.

As John mentioned, the number of Consumer subscriptions increased 38% year-over-year to 375,000 in the second quarter this year, as we continue to migrate toward a 100% SaaS-based business model. The increase in Consumer subscribers was driven by the sale of subscriptions with duration of less than one year. While we expect these shorter-term subscriptions will continue to grow, we expect total subscriber growth will begin to narrow as a large number of legacy two- and three-year duration subscriptions expire.

Turning to slide 6, let me review the Literacy segment contribution margin. The definition of segment contribution was revised in Q1 and there are differences -- primarily around product R&D expense -- between the full cost allocations in the Literacy segment, as compared to the two individual Language segments. The Segment Information in the Form 10-Q has further detail on these differences.

Even as we increased our investment in Lexia's expense base to drive its long-term growth, Literacy segment contribution increased to $1.6 million (or 15% of segment revenue) in the second quarter 2017, up from $0.4 million (or 6% of segment revenue) in the year-ago period. This growth was influenced by the effect of purchase accounting on acquired deferred revenue; the margin improvement related to this effect will diminish over time. Before the impact of purchase accounting, Lexia's segment contribution margin improved to 17% in Q2 2017 from 12% in Q2 2016. Lexia's direct expenses increased 17% 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. We expect Lexia's revenue will increase compared to the second half of 2016, while segment contribution dollars and the segment contribution percentage are anticipated to decline due to thegrowth in sales & marketing and implementation expenses that are recognized in period to support the higher number of customers, while the revenues from those customers is deferred over the contract life, as well as higher R&D expenses.

On Slide 7 we show the segment contribution data for the E&E Language segment, the Consumer Language segment and the combined Language segments. Language R&D expense is a shared service cost that is not allocated to either segment, but is included in combined Language – it is the combined Language view that is comparable to the Lexia segment contribution.

The E&E Language segment contribution margin increased to $7.4 million (or 43% of segment revenue), up from $6.9 million (or 39% of segment revenue) in the year-ago period. This improved performance reflects a 4% reduction year-over-year in direct sales and marketing expenses, primarily due to the March 2016 restructuring, which we have largely lapped as of Q2 2017. In addition, in the second half of the year we intend to make investments in our resellers to expand our geographical reach, and in marketing to grow our new business. These incremental investments are the results of successes we have seen in the first half of the year with our new Catalyst product and in existing reseller geographies. The return on these investments will be realized in 2018 and beyond. As a result of these factors, we expect second-half E&E Language segment contribution margin dollars and the segment contribution percentage will decline compared to second-half 2016.

Consumer segment contribution margin was $6.1 million (or 33% of segment revenue), which was up $2.2 million year-over-year compared to $3.9 million (or 19% of segment revenue) in the year-ago period. The improvement was due to both the absence of the $3.6 million revenue reduction in Q2 2016 associated with the change to our suggested retail value, and a $3.8 million (or 29%), year-over-year reduction in Consumer segment sales and marketing expenses. Before the prior-year $3.6 million revenue reduction that I discussed, the Consumer Q2 2016 segment margin was 32%. Contribution is also being temporarily negatively affected by the transition to subscription, which I discussed earlier. We expect the second-half Consumer segment contribution margin percentage will remain essentially flat versus the same period last year, on lower contribution dollars.

The combined Language segment contribution was $8.7 million (or 25%) in Q2 2017, which was up from $5.9 million (or 16%) in Q2 2016, an increase of $2.8 million driven by the absence of the $3.6 million reduction to revenue in Q2 2016 I previously discussed. We expect the second-half combined Language segment contribution percentage to decline modestly, largely reflecting lower Consumer revenue as well as additional Consumer expenses from an estimated $2.3 million non-cash writeoff of CD box inventory at our Retail partners as they transition to the new SaaS box product that we expect to record in the second half of this year.

The chart on slide 8 depicts sales and marketing, research and development, and general and administrative expenses, which in total declined $6.6 million or 15% year-over-year in the second quarter – even with our increasing investments in Lexia. Note that these expense categories include restructuring expense of $0.2 million in Q2 2017 and $2.0 million in Q2 2016; before restructuring in both periods, expenses were down $4.8 million or 11% year-over-year. All three operating expense categories were lower year-over-year, led by sales and marketing expense and G&A expense.

Turning to the balance sheet on slide 9, deferred revenue of $134.5 million was up sequentially at June 30, 2017, and increased $2.1 million or 2% versus the end of Q2 last year. Included in deferred revenue is $11.3 million of the $11.5 million of total cash received in the first half of 2017 from the licensing deal with SOURCENEXT, which was reclassified to deferred revenue in Q2 upon the completion of the sale of our Japanese entity to SOURCENEXT; the vast majority of which is long-term and will be amortized over 20 years. Of the June 2017 total, $98.6 million (or approximately 73%), was short-term and will be recognized as revenue over the next 12 months; note that approximately 80% of our deferred revenue before SOURCENEXT is current.

We ended the second quarter with zero debt and $26.4 million of cash and cash equivalents, which was down $3.3 million to where we ended the second quarter last year, and down $13.3 million sequentially from March 31, 2017. The total cash usage in the second quarters of 2017 and 2016 was essentially flat at $13.3 million. The second quarter of 2017 included higher incentive compensation payments – related to fiscal year 2016 performance – of $3.1 million compared to the year ago period, which were partially offset by the receipt of $2.5 million from SOURCENEXT. Before SOURCENEXT and the prior-year Consumer suggested retail value adjustment of $3.6 million, total bookings declined $6.3 million in Q2 2017 versus last year, while, before the $2.9 million FitBrains impairment in Q2 2016, operating expenses declined $6.6 million between the same periods. 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 around the end of Q2 and the beginning of Q3 – and becoming a net generator of cash towards the end of Q3 into Q4. We expect this historical pattern to continue and become more pronounced, as the third quarter becomes our peak bookings quarter for Lexia and the US K-12 Language businesses, and as Consumer becomes smaller relative to the overall mix of business.

The non-GAAP highlights of the business can be found in the charts on slide 10 and the reconciliation of the GAAP metrics to the non-GAAP financial measures can be found in the appendix on slide 17. Starting with the free cash flow chart on the right of slide 10, net cash used by operating activities was $10.4 million in the second quarter 2017, flattish compared to $9.9 million used in the same quarter last year, driven by the same factors I just discussed around our change in overall cash in Q2 compared to last year. Capital expenditures, which primarily relate to capitalized labor on product and IT projects, totaled $3.1 million, flat in the second quarter compared to the same quarter last year, as increases at Lexia were offset by reductions in the Language segments. Lexia accounted for nearly 75% of our capital expenditures in Q2 2017, up from approximately 55% in the same prior-year period. Free cash flow was negative $13.5 million in the second quarter, again flattish versus negative $13.2 million in the year-ago period.

Turning to the left-hand chart on slide 10, second quarter 2017 net loss totaled $1.1 million, versus a net loss of $9.0 million in the year-ago period, primarily due $5.2 million lower pre-tax restructuring and impairment charges and the absence of the $3.6 million adverse effect of the change in our suggested retail value recorded in Q2 2016.

Adjusted EBITDA was positive $3.9 million, a favorable $3.8 million improvement compared to $0.1 million in the year-ago period. As I discussed earlier, Adjusted EBITDA in the second quarter 2017 included the full impact of the $0.7 million return reserve, while the prior year included the full impact of the $3.6 million change in suggested retail value.

With respect to full year 2017 guidance, we are maintaining guidance for total revenue, GAAP net loss, Adjusted EBITDA and our year-end cash balance. While we continue to believe total consolidated revenue will be approximately $182 to $185 million, our outlook for the mix among the three segments has changed slightly. Lexia revenue is now expected to be slightly below the $43 million previously guided, due to the shift in bookings to later in the year, while Lexia bookings growth is projected to be towards the low end of the 20% to 25% we guided to previously. We now expect E&E Language revenue to approach $70 million. Consumer revenue is now expected to be at the high end of our previously stated range of approximately $70 to $72 million.

The Consumer revenue outlook now includes the one-time impact of approximately $2.0 million to move our terms Retail partners to consignment, and our current estimate of approximately $4.0 million in lower revenues year-over-year due to an increase in the unit mix of SaaS-based subscriptions in our DTC and Retail channels; we now expect the cash impact of these three non-recurring items in Consumer will be approximately $5.0 million versus the $9.0 million we had originally estimated at the start of the year, with approximately $2.0 million of that settled in 2017 and the balance in 2018. The lower overall amount is primarily due to lower inventory levels than previously estimated at our Retail partners, and higher net unit volume in DTC as a result of introducing the lower-duration offerings. Finally, we now expect Consumer subscriptions will increase to approximately 58% of the new units sold this year, compared to 26% in 2016.

For the full year 2017, we continue to expect the GAAP net loss will be between $13 to $15 million, and while the guidance range for positive Adjusted EBITDA is unchanged at approximately $8 to $10 million, we expect full year results will be towards the low end of that range. As a reminder, that represents a significant increase over 2016's $4.4 million Adjusted EBITDA.

Our full-year outlook for cash has not changed and we continue to expect to end the year with approximately $44 million in cash and no debt. This estimate continues to assume that we will have received all of the approximately $13 million in up-front payments from our long-term licensing agreement with SOURCENEXT, of which $11.5 million has been received as of June 30. We anticipate the remaining payment will be received in 2017, however there is a chance the timing may slip to 2018 as it relates to registering certain trademarks in Japan. Finally, we expect capital expenditures to approach $14 million for the year, which is down from our previous guidance of $15 million.

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

John Hass, Chief Executive Officer:

Thank you, Tom.

I was pleased with our progress in Q2 and look forward to more of the same during the rest of the year. In the second quarter we also held our first investor day in three years and began to lay out the themes and investments that I expect to carry us forward next year and beyond as we return to profitable growth.

Finally, I am especially excited to announce that Matt Hulett will be joining Rosetta Stone in the newly created position of President, Language. Like Nick Gaehde, the

President, Lexia, Matt will oversee all areas, from product development, to sales and marketing, driving our Consumer and Enterprise and Education Language businesses forward. Accelerating product innovation and allocating investment across the language businesses to their highest and best use have never been more important.

Matt brings wide-ranging and relevant experience with deep SaaS-domain knowledge in fast growth and turnaround situations, in consumer and enterprise businesses, and in public and private companies. He was a founding executive and the President of Expedia's corporate travel business; he helped turn around AdXpose, a B2B business as Chairman and CEO, which had a successful acquisition by media measurement company Comscore; he was the Chief Revenue Officer at RealNetworks; he successfully revitalized ClickBank as its CEO; and, most recently, Matt has been the Chief Product Officer of TinyPulse, a pioneering startup in the HR space. I have really enjoyed getting to know Matt and I am certain his expertise, innovative spirit and passion, working with the outstanding leaders in our Language businesses, are what we need to successfully drive Rosetta Stone forward.

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