

## **Q2 2018 Call Prepared Remarks**

Thank you and good afternoon everyone. Welcome to the Rosetta Stone second quarter 2018 earnings conference call. Speaking on the call today will be Rosetta Stone's Chairman, President and CEO, John Hass. Additionally, 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 [rosettastone.com](http://rosettastone.com), both the earnings release and a slide presentation that accompanies today's call. We have 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 of 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. We undertake no obligation to update such forward-looking statements. Cautionary comments regarding forward-looking statements are outlined on Slide 2 of today's presentation, which apply to our comments today.

Today's presentation and discussion also contain references to non-GAAP financial measures. The full definition, GAAP comparisons 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.

Thank you **Jason** and good afternoon

Over the last few quarters these calls have focused on a high level discussion of our products, businesses, and goals for the future. Going forward, I would like to go deeper in some of the key areas that investors often ask us about. In doing so, we hope to build a library of knowledge to help you better understand our business.

Today, as students prepare to go back to school, I will discuss why Literacy is a focus for us, a company otherwise best known for the quality of its language software. But before I turn to the Literacy discussion, let me share a few updates from the quarter. Overall, turning to slide 3, we are a different business than we were just a few years ago. We have a powerful and growing K12 literacy franchise and a highly profitable, more predictable language business. Our sales are now 100% subscription-based, and as this base of predictable SaaS-sales grows, it will lead to improving cash flow as we leverage a significantly reduced cost structure.

As we have said in the past, absent new opportunities to invest in the business or return capital to shareholders, we expect to grow our cash balance to approximately \$100 million by the end of 2020, with increasing cash flow from there.

Turning to slide 4, I was very happy with the performance of our Literacy business in the second quarter. Literacy sales grew 20% over the same period in 2017 to \$10.3 million, while ARR increased to \$45 million. As a reminder, when we say “sales” we are referring to a signed contract or transaction, the majority of which are paid up-front, that is recognized as revenue over the duration of the license activation term.

We achieved this growth despite the fact that, similar to last year, we are seeing both renewals and new business sales shift from the second to the third quarter. In fact, the just-completed month of July was larger, in terms of sales, than the entire second quarter, and at 40% higher than July of last year, was by far the largest single month in Lexia's history.

We believe the shift of sales to Q3 represents both an industry trend and a change for Lexia as our products move to the center of schools' literacy curriculum, and consequently follow schools' cycle for operating budgets. Lexia's importance to its school customers is demonstrated by their extraordinarily high retention rate - 94% in Q2 - the 9th consecutive quarter above 90%, a period which coincides with when we assumed sales and implementation responsibility in most of the U.S.

With strong growth and retention we remain on-track to hit our \$60 million literacy sales goal this year. This would represent an increase of a little over 25% from 2017.

Importantly, while we are building out sales support areas, we expect to achieve this growth with little additional direct sales headcount versus last year. If we achieve our direct sales expectations for the year, sales per average sales rep will grow from approximately \$875 thousand in 2017, to approximately \$1 million in 2018.

One of the ways we will continue to make progress is through our initiative to service and partner with some of the largest school districts in the country, an area that we began to focus on during the latter half of 2017. These opportunities carry longer lead times, and as such, we don't expect to see the benefit until next year. But we are happy to be included in these conversations, and to be considered for these types of larger-scale implementations.

Our positive momentum in this area is supported by the evolution of our Literacy product and services portfolio with the recent additions of RAPID, and especially, PowerUp. I'll share one example which is highlighted on slide 5. In collaboration with one of our third-party sales partners, last year we were invited into a large California school district to pilot our RAPID assessment product. While the RAPID pilot is ongoing, the introduction allowed us to bring Core5 and PowerUp into the conversation at the district level. This led to the district purchasing 39 new unlimited Core5 school licenses and seven new combined Core5/PowerUp licenses, a more than seven fold increase in the size of our relationship with the district. Each of our products: Core5, PowerUp and RAPID, played a critical role in growing this relationship.

And this is not an isolated case. We are seeing the products in our literacy portfolio, especially Core5 and PowerUp, reinforce each other as we offer customers compelling solutions that are easy to implement regardless of need.

Continually improving our product portfolio therefore remains a focus. Slide 6, lists critical new releases across our entire Literacy portfolio that were introduced in time for the new school year. I'll highlight two.

Core5 Version 3 takes us out of Flash on browser, but unlike many competitors, as we move from Flash to HTML5, we upgraded the code base to include our own animation engine based on industry standards that allows us to move the engagement of our award winning literacy learning program to new levels.

We also released PowerUp Version 1.1. PowerUp is Lexia's literacy learning product for older, struggling learners in grades 6-12 that was launched in January. This is an important content release for PowerUp which incorporates many new features that were

directly driven by feedback from our customers. Nick Gaehde and our literacy team can't wait to share Core5 and PowerUp with you during our Investor Day, which I will talk about more at the end of my comments.

In Language, highlighted on slide 7, I was pleased with the performance of our Enterprise and Education team. While sales were down overall, primarily due to lower sales of custom content and sales through our Affiliate channel, ARR was up on a sequential basis for the second consecutive quarter and totaled \$55.8 million.

We continue to see progress in our corporate business and expect this to become increasingly apparent as we focus on larger, critical need use cases for our customers.

As an example, in July we were awarded a global contract from a Fortune Global 500 consulting firm that we expect to be at least \$1 million annually. The largest annual corporate deal in our history. It includes over ten thousand language licenses and capitalizes on our ability to provide virtual online tutoring to their learners around the world. This was a competitive process for a marquee client and is a perfect example of an opportunity that would have been very difficult to compete for prior to the introduction of Catalyst. In fact, we lost an RFP for this client five years ago before we were able to offer the comprehensive product and tutoring solution through Catalyst that we have today. Armed with these improved capabilities, Fortune 500, and larger accounts generally, will remain a concerted focus for our E&E team.

In Consumer Language, we are seeing progress in important areas of our direct to consumer, or DTC channel, and in particular, mobile apps with growth in new unit sales and total subscribers at attractive LTVs.

The strong performance in DTC was offset by weakness in our retail channel which did not meet our expectations as we shifted from selling physical products to subscription licenses. While retail is down substantially year-over-year, it is expected to be only about 10% of our Consumer Language business. We are beginning to see some signs of improved performance as we work with our partners to better position and market our new subscription products through their channels.

Consumer sales are also being temporarily affected by the year over year shift to shorter term subscriptions that have lower upfront per unit sales prices. This lowers immediate sales relative to longer term subscriptions or perpetual sales, but is largely made up over time through higher renewal rates. Any perpetual to subscription transition is not without its bumps and transitional effects, but to date I feel good about our execution.

As shown on slide 8, growing DTC unit sales drove total subscribers from 395 thousand at the end of Q1 to 417 thousand at the end of Q2, with the growth coming from short term subscriptions. You can see on the right hand side of the slide that short term subscriptions, those with an initial subscription term of one year or less, are now almost 60% of our total outstanding units, up from less than 10% in 2016.

In aggregate, on slide 9, Consumer net LTV added in Q2 was \$6.2 million - an increase of 3% versus the same period in 2017. Remember that our goal in Consumer is to maximize and grow the aggregate dollar amount of net long term value created each quarter. We could operate Consumer at higher LTV to CAC ratios but would sacrifice aggregate profitability in doing so. I am very happy that our Consumer business, after accounting for essentially all fixed and variable sales and marketing costs, that's both

people and marketing dollars, produced over \$6 million in net value through initial sales and expected future renewals during the seasonally slowest quarter of the year.

Consumer is creating substantial value for us and has the opportunity to create even more in the future. We are doing this today by optimizing the balance of subscription growth while maintaining attractive sales per subscriber. Over time, we will look for ways to accelerate growth and add to LTV per customer. Matt Hulett and team are intensely focused on this opportunity and the pace of testing and innovation occurring in Consumer is higher than it has ever been.

On slide 10 let me conclude this portion of the call by confirming our revenue, adjusted EBITDA and net income guidance for the year. I would remind everyone that the reason GAAP performance deteriorates this year, even as we expect sales to grow, is due to the temporary effects of the conversion of our Consumer business to a full subscription model.

We are confirming our sales guidance for Literacy and E&E Language. We are lowering our sales outlook in Consumer Language to \$66 million due to the performance of retail and the higher than expected mix of short term subscriptions. We now expect consolidated sales to be approximately \$192 million - which represents sales growth of \$10 million after three years of declines. We expect to end the year with \$45 million in cash, an increase of \$24 million from the end of Q2. This is a little lower than previously estimated.

I would now like to spend the rest of my time discussing why Literacy has grown to become one of the two pillars of our business. On slide 11, it begins with our Mission

as a company to “change people’s lives through the power of language and literacy education”. Helping people to speak and to read is the core of who we are.

With this mission we are focusing our efforts on two of the most important societal needs in learning today - childhood literacy in the United States and the desire to learn English globally. For this call, I will focus on what is driving the literacy need in the United States and why we are well positioned to address it. In the future we will focus on the opportunity in English language learning.

On slide 12, childhood literacy in the United States is often said to be in a crisis.

Unfortunately, this label doesn’t fit the facts, as a crisis suggests a moment in time. The United States, however, has persistently failed to build sufficient literacy skills in its children. In fact, for decades, 2/3rds of 8th grade students, as shown on this slide with the yellow line, have been classified as non-proficient readers. This is from what is known as “the Nation’s report card” - the National Assessment of Educational Progress which is completed every two years. We see a similar trend over the years in the 4th grade results.

This is the fundamental problem in K12 education in the United States and a critical issue for all of us. Non-proficient readers are not just more likely to struggle in school, but are also more likely to drop out or fail to graduate on time, creating persistent challenges throughout their life impacting our society as a whole.

As a country, we recognize this problem - so why has it endured for so long? Imagine if you will, a well-funded, traditional, 2nd grade classroom. Turning to slide 13, there might be 22 children in the room with a teacher. In that classroom they might spend 90 minutes a day in their literacy block using materials from traditional providers. That

means if the teacher wants to spend time with each student individually they would have just about four minutes per student. Not much time.

Often times, the teachers don't have the critical tools and data needed to understand what the needs of each child are, and even if they did, they couldn't provide individualized instruction to address them. Consequently, they are left teaching to the mean and we know from research and experience that each child is different. Children learn in different ways and each student's learning pace may be different than his or her peers. They struggle with different areas of literacy acquisition and receive varying levels of support inside and outside the classroom. Consequently, the conventional approach doesn't work very well even in the best circumstances.

Now assume the school has greater burdens. There are thirty kids in the classroom reducing a teacher's time to three minutes per student. Assume many of the children come from homes where providing educational support outside of school is more difficult due to time or economic constraints. In many instances they are emerging bilinguals, learning English while trying to progress in school. In the thousands of schools where these facts are the norm, not the exception, educators will struggle to be successful if they are limited to traditional approaches. So when we consider all of these factors, it is actually quite easy to see how teaching a child to read can be quite difficult.

But there is hope. Instructional software that empowers students and educators and provides alternative, individualized paths to instruction, transforms the traditional one-size fits all approach. Turn to slide 14 and let's put Lexia at the center of that same 90 minute literacy block.

Lexia can be used to provide personalized, data-driven instruction and activities that transform how students learn and educators teach. A group of children can start the reading block working for thirty minutes in our comprehensive reading instruction program Core5, at an appropriate level matched to their needs, and in a learning path that adapts to their progress, providing structured support when and where appropriate. And it is important to note that, if they are English language learners learning to read English, the directions and instructions in Core5 can be provided in six additional languages to match the native language of the child.

Next, that group of children moves to work directly with the teacher for thirty minutes where they use teacher-led lessons provided by Core5 based on each students' needs. The teacher is empowered to help the children by using the data captured in Core5 and shared with them through their data dashboard, myLexia. The myLexia portal helps teachers group students with similar needs and provides links to lesson plans targeting specific skills that that group of students are struggling with in their online activities. For the last thirty minutes, those children can practice what they are learning, by reading a book or other material. By the way, we are not in this part of the reading block today.

With this approach children are empowered because they are working in engaging software that guides them along a journey, developed from decades of research, to support their progress. The teacher is able to optimize his or her most valuable resource - time - to provide targeted guidance using tools and information that clearly show them what is needed and how to provide it. This is an important and fundamental change in the approach to learning.

And we have to do better because not only has U.S. literacy education been a persistent problem, it is a large one. Turning to slide 15 there are approximately 100,000 public schools in the United States and another 30,000 private and parochial schools. The good news is we are already making an impact as Lexia is now in about 12 thousand U.S. schools.

But why Lexia? A few things clearly set us apart. Turning to slide 16, first, Lexia's history and focus. Lexia has been solely focused on using technology to address literacy needs since its founding thirty-four years ago. Even then, Lexia's founder recognized the power of technology to drive individual assessment, personalized learning and optimized teaching strategies at scale.

Second, Lexia is also unique in the depth and quality of its research and how this informs its approach to instruction. Lexia was started in part through a grant from the National Institute of Child Health and Human Development (NICHD) and has maintained this focus on research throughout its history. This research is unrivaled in depth and quality with more peer-reviewed, published studies than anyone else in this space. The covers of a few of these studies are represented here.

The results of one study are shown on the left of the slide. In this study - published in Computers in Schools - English language learning students using Core5 almost entirely closed the reading gap with a control group of native English speaking learners. The proven ability to repeatedly drive outcomes like this is what makes our offering so compelling.

And while Lexia's focus on research has existed for decades, its literacy portfolio, shown on slide 17, as we have discussed on prior calls, is new and more

comprehensive than other alternatives in the marketplace. From Core5 and PowerUp in Curriculum, to RAPID in assessment, to the data analytics available through myLexia, we have the tools to improve outcomes for all students. And we also have high quality implementation services to drive successful implementations and achieve school and district specific goals.

So even though we are smaller than the biggest general education players in the K-12 Space, Lexia delivers unmatched experience, expertise and capability in literacy education. Our ambitions for our literacy business are substantial. The societal need that we are addressing is huge. Ultimately, we will not be satisfied until new worlds are opened through literacy for every child in the United States, regardless of circumstance. Finally, I wanted to let you know, on slide 18, that we will be holding our annual investor day on November 6th in New York City. This year we will focus on the products we are using to change lives in our language and literacy businesses and the way we see our business evolving in the U.S. and internationally. We will walk you through the innovation we are bringing to the marketplace and preview some of the exciting products and investment opportunities coming next as we leverage our growing leadership in K12 literacy and our iconic Rosetta Stone language brand. Among other things, we will preview the work we have begun to bring a brand new product to build language proficiency for English Language Learners to the K12 marketplace. A product which will be the fulfillment of one of the opportunities that originally brought Rosetta Stone and Lexia together. I hope all of you can join us.

With that operator, could you please open the line for questions.