Fourth Quarter and Full Year 2016 Earnings Call

March 14, 2017

Prepared Remarks

Frank Milano:

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

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 outlook for 2017.

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

I will now turn the call over to John.

John Hass, Chief Executive Officer:

Thank you, Frank, and good afternoon.

In a few minutes Tom will talk about our results in the fourth quarter and for all of 2016. While I am pleased that we met or exceeded nearly all of our financial targets last year, our focus remains on the future and returning the company to profitability, cash generation and growth.

I will first talk today about the Company's progress over the last two years and where we will focus in 2017 and beyond. After Tom concludes his remarks I will then share more detail about our expectations for 2017.

In 2015 I described the three ways we would improve performance: narrow our focus to simplify our business; decrease our cost base to improve efficiency; and, reallocate capital to our non-Consumer SaaS businesses -- especially Lexia -- while making our Consumer business more profitable, even if smaller.

Over the last two years we have made substantial progress executing this plan. In 2015, we simplified and focused our Consumer business by exiting our direct presence in Korea, reducing our retail partnerships by half and focusing on those that are strategic in nature, and reducing and focusing our Consumer marketing dollars to target digital media that combined the best return with the ability to track and optimize performance.

In 2016, we improved our Enterprise and Education Language business by narrowing our global direct sales and marketing presence to those countries where scale efficiencies have either already been established, or are within our reach and can be achieved at economically attractive costs. This led us to exit direct sales in China, Brazil and France. While this resulted in a reduction in sales in 2016, and will do so again modestly in 2017 as we rebuild those geographies through resellers, it improved the profitability of this segment and allowed us to focus E&E Language on its best opportunities.

We also better focused our product development efforts and eliminated product investment in areas outside our core businesses. This allowed us to reduce non-Lexia research and development spending while still introducing significant new Language products, including Catalyst for enterprise customers and a beautiful, all-new native iOS app last year, which will be followed tomorrow by the formal announcement of a major update to our Consumer subscription offering and a completely revamped Android experience. Our mobile-first product innovation is centered around the objective to get learners talking – by providing useful phrases focused on traveling, downloadable audio lessons for use on the go and practice stories to enhance our learners' ability to speak. Both the new iOS and Android offerings are available in their respective stores now if you would like to take a look.

As a result of the efforts across our language businesses and supporting areas throughout the Company to increase focus and improve efficiency, we were able to reduce total expenses, net of our increased investments in Lexia, by approximately $100 million from 2014 to 2016. To accomplish this we incurred approximately $14 million in restructuring expense over the past two years to close five offices and eliminate staff. We also reduced the suggested retail price of our consumer products. We hope to largely complete these efforts in 2017 and expect to finalize our testing in retail to inform the transition from boxed CD sales to boxed subscription sales.

These changes were critical not only to the future of Rosetta Stone's language business, but for our ability to redeploy the savings in order to scale Lexia. Since 2014 we have significantly increased our investment in this business, more than doubling the size of our full-time team from 84 people at the end of 2014, to 181 people at the end of 2016, even as we reduced full-time headcount elsewhere in the company by nearly 400 people, or over 40% of the non-Lexia full-time headcount at the end of 2014. These added resources have been critical to our ability to broaden Lexia's product portfolio and successfully change its distribution model from third-party resellers to a predominantly direct sales team. The well-demonstrated efficacy of our literacy products and the Lexia team's tenacious focus on student and teacher outcomes has enabled our literacy sales to more than double since the acquisition of Lexia in 2013.

If 2015 and 2016 were about focusing on what we do well, improving efficiency and allocating capital to its highest use, our goal for the future is to leverage our best assets – the Rosetta Stone brand, content and tools in language, and the coming together of a full portfolio of outstanding literacy products at Lexia - to put us on the path to growth and cash flow generation.

At Lexia, with our transition to direct sales behind us, and the experience level of our sales team growing, we expect to return to bookings growth of 20-25% in 2017, aided as we move into 2018 and beyond, by sales of a complete K through 12th grade literacy portfolio, including curriculum and assessment products and related services. Our intention is nothing less than for Lexia to be acknowledged as <u>the</u> literacy experts in U.S. education.

In Language we will focus our efforts on leveraging Catalyst to grow in the Enterprise space while we rebuild our presence in important geographies like southern Europe and Brazil through resellers. In Consumer, we will continue our transition to a true subscription model. To do this we continue to test the viability of shorter term, lower initial dollar-value subscriptions. While early, the initial results of these tests have been positive and indicate that there is a universe of learners who have not bought Rosetta Stone in the past because of perceived high initial price points.

Across our language businesses we will celebrate our 25th anniversary and use it as an occasion to revitalize our value proposition for learners focusing on the fact that we, through the depth of our content and the quality of our tools, get you speaking confidently.

Whether through licensing agreements, reseller agreements or partnerships, we will seek ways to use our brand and market-leading products to partner with great organizations and advance our ability to reach learners around the world.

Let me tell you about two such partnerships that we have recently finalized.

First, we have reached agreement with Sourcenext, the largest software distributor in Japan, and a developer of world-class software itself, to license our brand on a perpetual basis for the exclusive development and sale of language and education-related products in Japan. To jumpstart these efforts, we will license Sourcenext a copy of the source code for our Consumer download product for development in Japan. In return, Sourcenext has agreed to pay initial royalty payments of approximately $13 million, net of certain adjustments, of which approximately $9 million is being paid at signing, with the additional $4 million paid upon the successful registration of certain Rosetta Stone trademarks and a transfer of a copy of the source code of the digital download product. In addition, Sourcenext has agreed to pay a minimum of $6 million of additional royalty fees over the next ten years. While we expect to receive approximately $13 million in cash in the relatively near term, the recognition of the associated license fees will be spread into the future and have a minimal impact on this year's revenues.

In addition, the agreement grants us the first right to license products developed by Sourcenext using Rosetta Stone intellectual property, including trademarks and technology, for sale in geographies outside of Japan. This gives us the potential to have a great new partner whose product development efforts can supplement our own. We are excited that Sourcenext will focus on and invest in Japan in a way that we have not since exiting the market on a direct basis in early 2014.

In addition, to accelerate our ability to reach the large Hispanic English language learning opportunity in the United States -- which the U.S. Census Bureau estimates at more than 16 million people not yet at proficiency, or approximately 40% of the more than 40 million Americans, age 5 and above, who primarily speak Spanish at home and where we are underrepresented -- we have signed a marketing and product development agreement with Univision Communications Inc. (UCI), the leading media company serving Hispanic America.

Univision, whose mission it is to inform, empower and entertain this community, is the leading destination for U.S. Hispanics, reaching an estimated 106 million average monthly unduplicated media consumers. Univision engages consumers via its portfolio of 17 broadcast, cable and digital networks and partnerships, as well as 123 local TV and radio stations, and a growing digital portfolio of mobile and video properties. Under this agreement we will develop and sell a co-branded consumer language product leveraging Rosetta Stone's expertise in language learning and Univision's unrivaled knowledge of and reach in the Hispanic community along with our combined brand strength. While our partnership with Univision is just beginning, it's a great opportunity and we are very excited about its potential. We expect that it will be well received in the marketplace.

Different approaches in each case, but in both Japan and the U.S. Hispanic and Mexican marketplace, I couldn't be happier about the quality of our partners and the opportunities afforded by these agreements. They serve as models for how I would like to grow our business in many marketplaces and geographies around the world.

With that, Tom will now take you through the Company's fourth quarter and full year 2016 results. I will follow his remarks with an outline of our objectives, investments and expected outcomes for the initiatives included in the 2017 budget. Tom?

Tom Pierno, Chief Financial Officer:

Thank you, John, and good afternoon everyone.

Please turn to slide 3 as I review Q4 revenue and earnings:

- Total revenue declined $6.3 million (or 11%) year-over-year, to $51.7 million.
- Consumer segment revenue declined 25% year-over-year to $24.0 million, primarily reflecting a decline in the direct-to-consumer channel in North America. The SaaS

migration in the Consumer business is proceeding at a slower pace than we had anticipated and the full year 2016 SaaS unit mix increased modestly from 2015.

- E&E Language revenue declined 6% year-over-year to $17.9 million; North America K-12 Language delivered 5% revenue growth year-over-year, which was more than offset by a 12% decline in Enterprise Language. The decline in Enterprise revenue partly reflected countries like China, Brazil and France which we exited on a direct sales and marketing basis when we initiated the restructuring in March 2016. E&E Language revenue before those exited geographies declined 3% in Q4.
- Literacy segment revenue, which is comprised solely of the Lexia business, grew 35% year-over-year, to a record high $9.8 million in Q4 2016. Adjusting for the impact of purchase accounting on acquired deferred revenue, Lexia's pro forma revenue would have been $10.5 million in Q4 2016 and the pro forma revenue growth rate would have been 19% year-over-year.
- The Q4 2016 net loss improved 51% year-over-year to $5.6 million and EPS improved by 27-cents per diluted share or 52% year-over-year. In the year-ago period, the net loss totaled $11.4 million, or 52-cents per diluted share. The net loss this quarter included a pre-tax charge of $1.6 million for lease termination costs, and the net loss in the year-ago period included pre-tax charges of $6.0 million for impairment and lease termination costs.

Last quarter, we introduced a new performance metric, Annualized Recurring Revenue -- or "ARR" – to aid in understanding our E&E Language and Literacy segments. ARR should be viewed independently of revenue and deferred revenue, as ARR is a performance metric and is not intended to be combined with either of these items.

ARR for the Literacy segment at December 31st was $35.9 million, which was up 31% year-over-year, primarily due to growth in Lexia's bookings. ARR in the E&E Language segment at December 31st was $57.8 million, down 7% year-over-year, compared to $62.1 million a year ago.

Slide 4 reflects the segment contribution and margin percentages for all three segments. Consumer segment contribution in Q4 2016 totaled $6.1 million (or 26% of segment revenue), compared to $7.5 million (or 24% of segment revenue) in the year-ago period. The decrease in terms of contribution dollars was due to the 25% year-over-year decline in segment revenue, and the increase -- on a percent of segment revenue basis -- was due to a 29% year-over-year reduction in direct sales and marketing expense, primarily reflecting lower media spending. Note that we expect modest year-over-year improvement in Consumer segment contribution margin in 2017, both in dollars and as a percentage of segment revenue.

The E&E Language segment had another strong quarterly performance in Q4, with segment contribution of $7.5 million (or 42% of segment revenue), which was up from $6.7 million (or 35% of segment revenue) in Q4 2015. This improvement -- both in terms of margin dollars and as a percentage of segment revenue -- reflects a year-over-year reduction in direct operating expenses of 16%, reflecting the 2016 Restructuring Plan that we initiated in March 2016. Note that we expect E&E's full year 2017 margin to be flat to 2016 as we lap the restructuring.

The Literacy segment contribution more than doubled year-over-year, delivering $2.5 million (or 26% of segment revenue) in the fourth quarter 2016, compared to $0.9 million (or 12% of segment revenue) in the year-ago period. Adjusting for the effects of purchase accounting, the Literacy segment margin percentage increased 800 basis points year-over-year on a pro forma basis, to 27% in Q4 2016. This improved performance reflects Lexia's increased revenue and was realized despite the fact that Lexia’s direct sales and support salaries are increasing in proportion to overall sales and marketing expenses. From an accounting standpoint, base salaries and benefits in the sales and marketing departments are recognized in the period they are incurred, whereas commissions are deferred and amortized over the contract terms along with the associated revenue.

The chart on slide 5 depicts sales and marketing, research and development, and general and administrative expenses, which were reduced by $8.6 million or 16% year-over-year in the fourth quarter. We have now delivered eight consecutive quarters of year-over-year improvement in aggregate sales and marketing, general and administrative, and research and development expenses, even as we continue to make investments to grow Lexia and position E&E Language for future growth with the introduction of Catalyst and the rebuilding of formerly direct territories via resellers. While all three operating expense categories were lower year-over-year, the most significant reduction was in sales and marketing expense, which was down $7.5 million or 21% year-over-year, primarily due to the lower media spending in the Consumer segment, which I mentioned earlier.

Turning to the balance sheet on slide 6, we ended the year with zero debt and $36.2 million of cash and cash equivalents. The ending cash balance was down $11.6 million compared to December 31, 2015, but that 12-month change in the cash balance compares favorably to the full year 2016 net loss of $27.6 million and primarily represents approximately $9 million in cash payments made in 2016 related to our E&E Language Restructuring efforts (which was $4.3 million, of which $1.3 million was paid in the fourth quarter) and the change in our suggested retail value (which was $4.6 million). As a reminder, we had estimated between $5 and $6 million in cash costs when the E&E Language restructuring plan was announced in March 2016, and we now expect the total to be at the low end of that range, with the balance of the cash to be paid in 2017.

Deferred revenue totaled $141.5 million at December 31, 2016, which was down slightly from $142.7 million at December 31, 2015. Of the total, $113.8 million (or approximately 80%) was short-term and will be recognized as revenue over the next 12 months, which was up from $106.8 million (or approximately 75%) at December 31, 2015.

The non-GAAP highlights can be found in the charts on slide 7 and the reconciliation of the GAAP amounts to the non-GAAP financial measures can be found in the appendix on slide 15. Starting with the net loss and Adjusted EBITDA chart on the left, fourth quarter 2016 net loss totaled $5.6 million, compared to the net loss of $11.4 million in the year-ago period. Included in the Q4 2016 net loss were pre-tax lease termination costs totaling $1.6 million, and included in the Q4 2015 net loss were pre-tax impairment charges and lease termination costs totaling $6.0 million. Total Adjusted EBITDA was positive $3.5 million, an improvement of $1.9 million compared to positive $1.6 million in the year-ago period.

Turning to the free cash flow chart on the right, net cash provided by operating activities totaled $7.2 million in the fourth quarter 2016, compared to $13.7 million in the same quarter last year. Capital expenditures, which primarily relate to capitalized labor on product and IT projects, totaled $2.9 million, up from $1.6 million in the fourth quarter last year. For the quarter, Lexia accounted for essentially all of the increase year-over-year, and on a full year basis, Lexia accounted for more than three-fourths of the increase year-over-year. This growth in capital spending reflects the heightened level of investment we are making to support Lexia's growth over the long-term. Free cash flow was positive $4.3 million in the fourth quarter, down from the positive $12.1 million in the year-ago period, which primarily reflects a combination of lower bookings and an increase in capital expenditures year-over-year; as a reminder, last year's Q4 2015 cash flow included $2.2 million in cash from the combined sale of a building and a tax refund.

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

John Hass, Chief Executive Officer:

Thank you, Tom.

Please turn to slide 8. Before I talk about the year ahead, let me begin with a quick review of the transition that has taken place over the past two years. When the restructuring was set in motion in March 2015, we were reporting a full year 2014 where Consumer Language represented approximately 2/3rds of our business.

No part of this transformation has been easy -- and we certainly aren't finished, but make no mistake -- our strategy is working to successfully shift the mix of business from one-time Consumer sales toward repeatable E&E Language and Lexia Literacy sales.

We realize that with the reduced size of the Consumer business, and focusing the E&E Language business on our core markets, sales have been in decline these past two years. But inside these numbers, we have improved the profit margins of these businesses and successfully transitioned the combined total for Lexia and E&E Language from roughly 1/3 of the overall mix, to 55% in 2016, with Lexia now constituting approximately 1/5 of our total business.

Now, as I talk about 2017, I hope to show how our plans will build upon this initial success in transforming Rosetta Stone's overall mix of business and moving to growth and profitability. We continue to believe in our previously stated goal for Lexia to achieve $100 million in bookings in 2020. In part we will accomplish this because our transition to a direct sales model is working well. In 2016, direct sales as a percentage of total Lexia sales increased to 71%, up from 42% in 2015 and 29% in 2014.

That said, this team was very new to us in 2016 and we expect that the knowledge and relationships that accompanies an increase in experience, should lead our direct sales team to become increasingly effective in 2017 and beyond, especially in the sale of new business. While we will continue to incrementally invest to grow the size of our direct sales force, the majority of the staffing increase should be behind us. Going forward we will focus on the acquisition of new accounts and expansion within existing account relationships, with our robust product suite that includes Core5 and RAPID -- and, in the future -- a new Adolescent Literacy Product and RAPID. We are pleased with the feedback we are receiving from our Alpha sites and look forward to our Beta program this coming fall, with the marketplace launch expected to follow early next calendar year.

We will continue to allocate our R&D and capital investment dollars to our best opportunities. In recent years this has meant that Lexia has received a growing portion of the total spend. In 2017, I would expect approximately 45% of our cash product investment dollars to be spent in our Literacy business, up from less than 20% in 2014, even as total company product investment dollars are expected to remain roughly flat. We expect this trend to continue beyond 2017.

In addition to the ongoing investments in product, we continue to invest to scale Lexia's infrastructure to accelerate the business’s growth. These investments -- in people and the systems and processes to support them -- are designed to ensure the long-term success of Lexia as a leader in K-12 literacy solutions. In 2016, full-time headcount at Lexia increased 28% year-over-year. Measured as a percentage of Rosetta Stone's employee population, Lexia has grown to represent 25% of full-time employee headcount at year-end 2016, up from 8% of the Company's total full-time headcount at the end of 2014.

Our full year revenue guidance for Lexia is approximately $43 million, or growth of approximately 25% over full year 2016.

Turning to the E&E Language segment, the reduction in top-line -- resulting from the geographies that were exited -- is expected to continue in 2017 as we still had sales in exited markets for a good part of 2016, but should be partially offset as a result of growth in our ongoing direct marketplaces driven by the successful Catalyst launch in September 2016. Our full year 2017 revenue guidance for E&E Language is approximately $70 million. With the relatively flat top-line expectations we have for the year for the E&E Language business, our focus will continue to be on bottom-line profitability. Our view is that the 2016-2017 performance levels will serve as the platform for future growth in this attractive SaaS-based segment of the business, as we work to enhance our reseller and partner networks in the geographies we no longer serve directly and develop Catalyst sales in these and our core marketplaces.

Please turn to slide 9. In 2017, our Consumer revenue outlook is $70 to $72 million, a decline of approximately 19% at the mid-point, compared to 2016, primarily due to a number of transitional events related to our move to a fully subscription business.

There are three things impacting revenue in the Consumer segment this year. First, we talked last quarter about testing shorter-duration subscriptions in our U.S. DTC channel. Over the last two quarters we have, in particular, been testing three-month subscription offerings. Initial performance would suggest that this offering is attracting new customers to Rosetta Stone, generating incremental purchases across the range of subscription options. Our Outlook assumes that we will complete the shift from perpetual to subscription sales by the end of 2017, consistent with our overall strategy to make Rosetta Stone a more valuable, 100% SaaS-based business. In order to accomplish this, we have already started to shift the U.S. DTC channel to subscriptions, which will lower revenue by approximately $5 million in 2017, with a related 2017 cash impact of approximately $4 million that would be offset by a growing pool of renewable shorter-term subscriptions that will contribute to future cash flow.

The second phase of the Consumer segment SaaS conversion will be to move our U.S. Retail channel from boxed CD sales to nearly all subscriptions during the second and third quarters. We anticipate the effect of this Retail mix shift will be to lower revenue by approximately $4 million as we begin to defer the recognition of revenue that was previously realized at the time of sale.

The final initiative impacting Consumer revenue in 2017 is certain retailers who have been selling packaged products on a terms basis will be transitioning to working with us on a consignment basis, starting in the second quarter. Assuming all remaining terms partners switch to consignment, the revenue impact is estimated to be approximately $4 million, with a related cash impact of approximately $5 million, as these retailers will no longer buy and hold product for eventual resale to the end consumer.

All three of these changes are reflected in our full year 2017 revenue guidance for Consumer. Before these items, the revenue decline would have been approximately 4% at the mid-point, compared to 2016. Importantly, if achieved, this would complete the major changes required to move us to a fully subscription-based Consumer language business -- a place that we need to be as a business.

Please turn to slide 10 for a summary of our total Company 2017 outlook. I have already discussed the revenue projections by segment, so you have the detail that goes into our full year 2017 revenue guidance of approximately $182-185 million. I would note that before the transitional items in Consumer that I mentioned, revenue would have been roughly flat this year. We expect the full year 2017 GAAP net loss to be approximately $13-15 million and positive Adjusted EBITDA of approximately $8-10 million. Included in our net income outlook is a cash charge of approximately $1 million in costs related to the reduction of approximately 60 people due to our decision to outsource certain support functions starting this month. We expect cash flow, excluding Sourcenext, would be about $5 million positive for the year before the impact of outsourcing certain support functions, the transitional effect of the DTC mix shift and transitioning select retail partners to consignment relationships, which I just mentioned. Including these costs, and if we conclude the expected near term aspects of the Sourcenext partnership as intended, then we expect to end this year with a cash balance of approximately $44 million. Finally, I am also happy to note that, while we have not borrowed – nor do we have plans to borrow – under our $25 million credit facility, we have extended it through April 2020.

Given the proximity to the quarter-end, we are providing first quarter 2017 guidance on slide 11. We expect total revenue of approximately $45 million, which reflects Lexia revenue of approximately $10 million, E&E Language revenue of approximately $16 million, and Consumer revenue of approximately $19 million. In Q1, we expect a GAAP net loss of approximately $4 million and positive Adjusted EBITDA of approximately $2 million. We expect to end the quarter with a cash balance of approximately $39 million, which anticipates the proceeds from the completion of certain aspects of the Sourcenext partnership, plus the usual seasonality in our business – meaning that we have historically been a net user of cash in the first half of the year, with the low point being between Q2 and Q3, and a net generator of cash thereafter. We expect this trend to continue in our 2017 outlook.

Before I end, I would like to take this opportunity to thank Al Angrisani. After almost two years, Al will shortly be ending his formal work with Rosetta Stone. Al has been much more than a consultant – he has been a thought leader, coach, and friend to many people here, including myself. He will be missed but we are a better organization for the time he spent with us.

Finally, I would like to invite all of you to our Investor Day that will be held in conjunction with the release of our first quarter earnings, which is currently anticipated to be on Tuesday, May 9th. This is the same week as our 25th anniversary – a perfect opportunity to talk to you about the future we see for Rosetta Stone. We will share more specific goals, but in general you should expect to hear about a business that has fresh, innovative products in each of its segments. A company that has substantially reduced costs and is ready to scale profitably. A consumer business producing strong cash flow and increasingly aligned with modern, mobile-first subscription learners. A growing Enterprise and Education segment with solid margin contribution. A Lexia business with the products and team in place to become the $100 million sales company we believe it can be. A business that is leveraging the power of its brands and products to partner with great companies around the world. And a team of people intent on fulfilling our mission to change lives through the power of language and literacy learning. I believe that is who Rosetta Stone is, and I look forward to sharing this with you at Investor Day. I hope you are able to join us. An announcement with the time and place will go out within the next week or so.

That completes our prepared remarks. Operator, please open the line for questions.