Third Quarter 2015 Earnings Call

November 4, 2015

Prepared Remarks

Frank Milano:

Good afternoon and let me welcome you to the Rosetta Stone third quarter 2015 earnings conference call. I am Frank Milano, the investor relations contact for Rosetta Stone. I am joined today by John Hass, our Interim President and Chief Executive Officer, and Tom Pierno, our Chief Financial Officer. 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.

Our third quarter earnings release went out after the market close and is available on our website at www.rosettastone.com.

I'll 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 and we assume no obligation to update them. 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 GAAP numbers, as well as the risks and uncertainties that could cause our actual results to differ, please read the Company's SEC filings and today's earnings release and presentation, including the paragraphs beginning with the words, “Caution on Forward-Looking Statements” and “Non-GAAP Financial Measures,” which are all available on our website under the “Investor Relations” tab.

Now here’s John.

John Hass, Interim President and Chief Executive Officer:

Thank you, Frank, and good afternoon everyone.

Today I will report continuing progress to make Rosetta Stone a simpler, leaner, more profitable and ultimately, growing business, focused on improving people's lives through language learning and literacy education.

This year, to turn Rosetta Stone around, we are committed to focus on our E&E business, especially Lexia, optimize Consumer for profitability, significantly reduce expenses and sharpen the focus of our business. To do this we have exited business lines, identified approximately $65 million in total expense reductions, introduced new products, and allocated capital to our best opportunities. We have made solid progress on our key initiatives and are putting in place plans to further improve performance. In the third quarter I would note, in particular:

- The completion of the second phase of our expense reductions that has now identified over $15 million of run-rate cost reductions without materially impairing revenues;
- The greater than 50% reduction in our net loss versus the same period last year on healthier, albeit, lower revenues;
- The nearly $5 million improvement in our cash position versus the end of the second quarter;
- The increases in Lexia revenues and bookings of approximately $3 million and $6 million, respectively, that helped drive our total Education business to be more than 50% of the E&E revenue mix; and
- The 54% year-over-year increase in the Consumer segment contribution margin percentage, while sequentially maintaining a stable average sales price per unit.

Let me tell you why I am pleased with what has been accomplished and excited about the future.

In Consumer we are optimizing for profitability while focusing on providing great outcomes for passionate learners. To enhance the performance of this business we have a small, high performing team efficiently using marketing dollars to drive sales while making smart investments to improve the performance of our learning products and delight customers.

I am pleased that for the second quarter in a row, Philip Dunne and the team that oversees our Consumer language learning products increased the segment contribution margin percentage by over 50% year-over-year, delivering a 27% margin in the third quarter of 2015, up from 17% in the same period in 2014. I would note that this was accomplished at an average sales price per unit of $212 that has been sequentially stable through 2015 as we continued to restrict our promotional activity and focus on passionate learners who are motivated, results focused and willing to pay for a quality language learning experience.

And to be clear, Rosetta Stone language learning tools work. We offer learners a proven methodology deeply embedded in over 6,500 hours of content created at Rosetta Stone, that uses patterns, contrast and sequencing to enable learners to infer meanings and deduce correct usage, that uses scaffolding to build from simple to complex words and concepts and that increases the complexity of the challenge with each learner’s skill level. We use technology to teach people the way they really learn.

And it’s not just me saying that it works – I am excited to tell you that we are about to announce that we have received A-G certification from the University of California, meaning that approximately 2-million high school students throughout the state now have the option to use Rosetta Stone to learn Spanish to complete their two-year foreign language requirement for college admission.

At Lexia we are investing in order to rapidly grow our business and share of the expanding technology-enabled K-5 literacy segment. Lexia’s 90%-plus retention rate is proof that when we have a contract to help students learn and teachers teach, the results keep them with us. So we want Lexia to be in as many classrooms as we can, as quickly as possible, without any distraction.

To drive this, in the third quarter we released significant upgrades to our proven Lexia Reading Core5 and myLexia products. We also launched the first version of our assessment product, called RAPID. In addition, we continue to grow the size of our salesforce to have a direct relationship with more of our customers.

We are making these investments because our products work and because states, districts, schools and teachers want to bring our literacy tools to their classrooms. As we have noted before, literacy is the foundation of all learning and early childhood learning is viewed as critical, yet according to a recent study, 64% of 4th graders fail to read at a proficient level. In October, there were 1.4 million students using Core5, an increase of over 50% versus the same month last year. That's 1.4 million kids seeking the opportunity to accelerate their ability to read and build the foundation for their success.

Lexia's great products, relationships and outcomes – which have been the result of our investments – helped Lexia grow bookings by over 70% in the critical third quarter. A portion of the bookings increase was pulled forward from the 4th quarter by resellers who were being terminated in our shift to a more direct sales model, as they worked to bring in business before their contracts ended. But even when we exclude that factor, Lexia's normalized performance was outstanding. Overall, we now expect Lexia to have full-year bookings in the low-$30 million range in 2015, which is almost double the run-rate when that acquisition was completed just over two years ago. And we continue to believe Lexia can nearly triple to be a $100 million bookings business with healthy margins in four to five years.

In E&E Language we will be strategic and we will be selective, growing in those segments and geographies best suited to the efficacy of our underlying pedagogy, the breadth of our English language content, our capabilities in world language and the strength of our brand, all of which should allow us to obtain appropriate renewal rates and margins. I would note, for example, our strength in K-12 language where we have a large share of the market and have delivered approximately $28 million in bookings over the last 12 months. Our foundations in both K-12 language and literacy also provides us the opportunity to be an even bigger player in what we expect to be a growing English Language Learning, or ELL, market in the United States.

Like other parts of our business, we will benefit by simplifying our E&E Language product offering, reducing our costs and modifying our distribution approach to serve this opportunity. To achieve this we are doing two things:

- First, the team is focused on completing the alignment of our three language platforms and moving us towards the consolidation of our legacy platforms. We expect to see the initial fruits of this alignment as we finish our beta in the first half of 2016 and begin to offer corporate customers a single solution that provides streamlined access and simplified pricing for the full suite of English language learning content, along with assessment, placement, ongoing reporting and demonstration of results, all of which address important customer needs to focus and demonstrate payback.
- Second, to assist in optimizing our overall E&E Language business plan, I have asked Al Angrisani, who worked with us on the successful completion of our most recent expense reduction effort, to partner with us to further refine our E&E Language strategy and efficiency.

With the successes we are having with Consumer managing to their bottom-line, Lexia growing its market share and operating expenses being aggressively reduced, I believe simplifying and focusing the E&E Language business is the biggest incremental opportunity we have to drive shareholder value.

That's the business overview. I will now turn it over to Tom to discuss our financial results in more detail. After that I will update you on a few other areas before we open it up for questions.

Tom….

Tom Pierno, Chief Financial Officer:

Thank you, John, and good afternoon everyone.

I will begin with a review of our consolidated results:

- GAAP revenue was $49.8 million in the quarter, down $1.6 million sequentially and down $14.7 million year-over-year. These decreases were driven by the expected decline in Consumer segment revenue. Foreign exchange negatively impacted revenue in the quarter by $1.4 million, or approximately 2% year-over-year.
- GAAP net loss was $7.3 million, or $(0.34) per diluted share. The net loss improved $900,000 sequentially and improved 55% versus the net loss of $16.2 million in the year-ago period. The year-over-year improvement reflected lower total expenses which more than offset the decline in revenue.
- GAAP operating expenses were down $17.5 million (or 26%) compared to the year-ago period. Cost savings were realized in all expense categories, with the largest improvement resulting from a $13.5 million (or 31%) reduction in sales and marketing expense which was driven by the $50 million strategic cost savings initiative we announced in March of this year; lower variable incentive compensation expense also contributed to the year-over-year reduction in costs.

Turning to our segment results, third quarter E&E segment revenue totaled $25.3 million, up $2.8 million (or 12%) year-over-year. On a constant currency basis, E&E segment revenues would have been up $3.8 million (or 17%) year-over-year.

Inside the E&E total, Education revenue exceeded Enterprise revenue for the first time – which is a huge milestone! Third quarter Education revenue totaled $12.8 million, up $3.1 million (or 32%) year-over-year. Lexia drove that strong performance with revenue of $5.8 million, up $3.0 million (or 103%) year-over-year, as Lexia grew bookings 72% over last year, driven by the performance of the terminated resellers John talked about; revenue comparisons also benefited from purchase accounting impacts on prior-year revenue.

Enterprise revenue totaled $12.5 million, which was down $0.3 million (or 2%) year-over-year. On a constant currency basis, Enterprise revenue would have been up $0.7 million year-over-year (or up approximately 5%).

E&E Language revenue was down $0.2 million (or 1%) year-over-year – as 4% growth in North America, was essentially offset by declines overseas. On a constant currency basis, E&E Language revenue would have been up $0.8 million year-over-year (or approximately 4%). We did see some pockets of strength geographically, such as Brazil and southern Europe, with pockets of weakness in other parts of the world, such as northern Europe and China. Overall, while E&E Language bookings in 2015 were impacted by foreign currency headwinds, they were also affected by a lower level of multi-year paid upfront contracts as we pulled back on the discounting that is often necessary to receive upfront payment for multi-year deals versus being paid annually, and tighter control over the types of deals we will accept, as we attempt to build a healthier, more sustainable business.

Consumer revenue totaled $24.5 million, which was down $17.5 million year-over-year. The decline was consistent with our change in focus, whereby we are now committing less media spending toward fewer – but more efficient – promotional campaigns targeted to the passionate language learner – and we are managing the Consumer segment for bottom-line results.

Revenue was also impacted by a shift in the mix of our Consumer product sales towards more 24-month and 36-month subscriptions which we expect to continue in Q4 as we begin to bundle these subscriptions with our perpetual download product. Our reasoning for pursuing this mix shift is two-fold: First, compared with a standalone product sale, this bundle will offer the customer a longer period of time to enjoy access on mobile devices, such as a tablet or smart phone. Second, the shift is in keeping with our broader initiative to move Rosetta Stone away from CD's in boxes towards more cloud-based delivery, saving us the cost of physical packaging and distribution.

Please note that since our Consumer subscriptions are paid upfront and also priced similar to our perpetual products, there is no change to total value received based upon this decision to prioritize our subscription-based offerings. However, there will be a near-term impact to revenue recognition as product sales are predominantly recognized up-front, while subscription-based revenue is recognized ratably over the duration of the subscription period, and this bundle will follow the subscription revenue recognition rules.

As John indicated earlier, the Consumer segment contribution margin percentage was up again on a year-over-year basis, giving us positive momentum in that part of our business as we head into the year-end holiday season. While we expect the year-over-year change in the Consumer segment contribution margin percent will be flattish compared to Q4 2014, due to lower in-period revenue from the increased mix of subscriptions that I just discussed, the full year percentage will be up over 2014.

The improved margin in the Consumer segment resulted from a 940-basis point increase in the gross profit percentage and an approximately 50% reduction in direct sales and marketing expenses.

Turning to the balance sheet, we ended the quarter with $34.4 million of cash and cash equivalents, an increase of $4.6 million compared to June 30, 2015. With zero debt and an unused $25 million revolving credit facility, the increase in cash has improved the Company's liquidity position.

Deferred revenue totaled $139.4 million, which was up $16.2 million compared to June 30 and up $28.5 million compared to the year-ago period. Of the total deferred revenue balance, $102.7 million (or approximately 74%), was short-term and will be recognized as revenue over the next 12 months. I would like to note that the third quarter 2015 marked the first time that short-term deferred revenue exceeded $100 million.

Net cash provided by operating activities was $7.2 million in the third quarter, up from $6.0 million in the same quarter last year. The increase primarily reflected the Company's reduced net loss and better collections on accounts receivable.

Capital expenditures, which primarily relate to capitalized labor on certain product and IT projects, totaled $2.1 million, compared to $2.7 million last year.

Non-GAAP results this quarter were as follows:

- Revenue-based Adjusted EBITDA was negative $1.6 million, a favorable improvement of $7.5 million year-over-year, compared to negative $9.1 million in the same period a year ago. The reduction of the Company's reported net loss was the primary driver of improved Adjusted EBITDA.
- Free cash flow totaled $5.2 million, compared to $3.4 million in the third quarter last year. The $1.8 million increase in free cash flow reflected a $1.2 million improvement in cash provided by operating activities, plus a $600,000 reduction in capital expenditures.

John mentioned that we have increased the amount of incremental cost savings that we had identified in the second quarter. During the third quarter we identified another $3 million to add to the previously announced $12 million of incremental cost savings. We expect little up-front cash costs will be required in the December quarter to achieve what now totals approximately $15 million of incremental expense savings, which we expect to realize mainly in 2016. Also as John discussed, our ongoing focus on costs and efficiency continues as we commence the third phase of work with Al Angrisani this quarter.

Turning to full-year guidance, we continue to anticipate full-year consolidated revenue will be approximately $220 million, although this could be impacted by the mix of 24-month and 36-month Consumer subscriptions that we actually achieve in Q4. Full-year E&E segment revenue is estimated to be approximately $100 million, which was the high-end of our previous range, of which approximately $21 million is expected from Lexia. Full-year Consumer segment revenue is estimated at approximately $120 million, which was the low end of our previous range, due to the subscription mix shift that I discussed earlier.

Our outlook for the full-year GAAP net loss has improved to approximately $50 million, a $2 million favorable change over our previous full year net loss estimate of approximately $52 million. This outlook anticipates approximately $10.6 million (pre-tax) of unusual legal, consulting, recruiting, severance, restructuring and advisor costs, which is $1.6 million higher than what we had estimated on the second quarter earnings call.

Our full-year capital expenditures estimate is unchanged at approximately $11 million. As a reminder, capital expenditures for us is mostly capitalized labor on IT and product development projects.

We have improved our full-year revenue-based Adjusted EBITDA guidance, which we now expect to be approximately negative $17 million, up from our prior guidance of approximately negative $20 million.

And lastly, we continue to expect to end 2015 with a cash balance in the mid-$40 million dollar range, including expected Q4 proceeds of approximately $1.7 million from the sale of a building, which will help to offset the downward pressure from lower E&E Language bookings.

That completes my portion of today's call. I will now pass it back to John for some final comments before questions.

John Hass, Interim President and Chief Executive Officer:

Thanks, Tom.

In terms of updates, we are making excellent progress in the search for our new CEO. While I cannot predict exactly when this process will conclude, the board and I are pleased with the quality of the candidates and are confident in our ability to find a strong and experienced leader for Rosetta Stone.

In addition, in order to help ensure that my successor can hit the ground running, Pat Gross, our chairman, and the board have asked that I become board chair concurrent with the hiring of our new CEO. I look forward to helping continue our progress in this role.

With a simplified business model, the right strategies in place, a stronger product portfolio, reduced expenses, improving financial results, the prospect of a strong permanent CEO and a clear focus on serving the needs of passionate language and literacy learners, I believe we are making solid progress on our turnaround of Rosetta Stone, to be further continued by my successor.

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