Q3 2018 Earnings Prepared Remarks
Investor Day

Slide 5 - Cover page

Thanks John, and good morning. I am very excited to kick off our Investor Day with a brief summary of our Q3 performance and our full year outlook.

First, I want to remind everyone that we have filed our 10-Q and earnings release this morning, and have posted our supplemental data document and slides on our investor relations website. There is a lot of detail in those documents, but for today's discussion, I'll focus on the highlights.

Also, you'll hear us refer to "sales" today - as a reminder, when we say "sales" we mean a signed contract or transaction, the majority of which are paid up-front, that we then recognize as revenue over the duration of the license activation term.

Slide 6 - Consolidated Highlights

There were many things we were pleased with this quarter and a few things that need more work. Starting at the top, our ongoing sales - and when I say "ongoing", I mean before last year's SourceNext licensing and discontinued FitBrains sales - grew by 11% or about $7 million in Q3. We're thrilled with this milestone, which has not happened since 2014!

This growth was driven by another record-setting quarter in our Literacy segment, which is 100% Lexia, and where sales grew 37% to $34 million, which included nearly $4 million for the renewal and expansion of Lexia's agreement with Utah, where Lexia was selected as a preferred provider in a state-funded reading improvement initiative. To put Lexia's third quarter in perspective, that $34 million is more than their entire 2015 full-year sales.

In addition, ongoing Consumer Language sales, at $16 million, were flat relative to Q3 2017, also the first time that has happened since 2014. Consumer sales stabilized even as more of our sales came from shorter-term subscriptions where a larger part of the value we expect to realize will come through future renewals.

Partially offsetting this was a sales decline of $2 million in our Enterprise and Education (or, E&E) Language segment, to $17.5 million, which was partially driven by $0.5 million unfavorable foreign exchange impact along with lower operating performance that I will discuss in a few minutes.

The company recorded $42.8 million in revenue, down about 7% from prior year as 20% growth in Literacy revenue was more than offset by Language revenue declines of 16%, largely from the accounting treatment of the Consumer transition to 100% SaaS that we have been executing. We posted a net loss of $6.5 million driven by our investment to drive sales growth at Lexia and because of the accounting of Consumer SaaS sales, and Adjusted EBITDA just shy of break-even at negative $700 thousand. We ended the quarter with $32 million in cash and no debt.

Slide 7 - Literacy Update

Now, let me go a little deeper into the performance of the Literacy segment.

We were very pleased with Literacy's 37% sales growth, which was in line with our expectations and an increase from the lower growth rates seen if the first half of the year, reflecting the ongoing shift of Literacy sales into the third quarter that we have been seeing for the last couple of years as Lexia's services move to the center of schools' literacy curriculum, and consequently follow schools' cycle for operating budgets.

Literacy's ARR grew 13% to $48 million in Q3 2018 versus Q3 2017. As a reminder, Lexia has a growing implementation services business that is included in sales but which we exclude from ARR. In Q3 2018, the mix of implementation services were approximately 17% of Lexia's sales; for the full year 2018, we expect that mix to be 10-15% of their total sales, which would be similar to the 2017 full-year mix.

Lexia's strong retention rate of 93% continues to underscore its importance to its school customers, and it has been 90-plus percent for over two years straight - roughly the period over which Lexia transitioned resellers to a direct sales and implementation team for most of the U.S. Lexia's renewal rates of 100-plus percent, its fifth consecutive quarter of 100% or more, reflects the success of Lexia's strategy to enter districts and expand over time as they demonstrate positive outcomes for students. Further, at the end of Q3, Lexia was in nearly 13,000 U.S. schools reaching over 3.4 million students.

Slide 8 - Literacy Highlights

We have also been extremely pleased with the reception of Lexia's newest product, PowerUp, which was launched in the beginning of this year and has already surpassed our 2018 year-end expectations for the number of schools using it. The power of Lexia's portfolio of products is strong and growing.

Lexia remains on track to deliver sales approaching $60 million this year. This would represent an increase of approximately 25% from 2017. I will also note that, while we have been building out sales support areas, we continue to expect to achieve this growth with little additional direct sales heads 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.

Slide 9 - Consumer Language Highlights

Turning to our Language business, let me start with our Consumer segment. As I mentioned earlier, we couldn't be more pleased with how the Consumer team has stabilized ongoing sales for the first time since 2014, while navigating challenges created by the transition to 100%-SaaS subscription sales in Q3, particularly in the Retail and Homeschool channels, which combined are expected to be about 10% of 2018 Consumer sales.

Slide 10 - Growing Consumer Base and Improving Mix

Consumer added 30,000 net new subscribers in Q3 2018 which brings our total subscribers to a record high of 447,000 at September 30th. Note that nearly all of this sequential growth came from short-term subscribers, which we define as one year or less in duration, following the introduction of 3- and 6-month subscription options on our website last year as well as in mobile app stores earlier this year. You can see on the right hand side of the slide that short term subscriptions are now almost 65% of our total units sold in Q3 this year, up from less than 10% in 2016.

Our unit volume in mobile is approaching that of our Web business. However, the mobile channel tends to deliver more short-term subscribers with an associated lower LTV than the Web channel, which is reflected in lower LTV per unit on the bottom left of this slide, as we attempt to optimize the trade-off between unit growth and expected LTV per unit.

Slide 11 - Consumer Net LTV Added/LTV:CAC

In Q3, Consumer net LTV added was also up year-over-year, growing to $6.6 million versus $6.3 million in Q3 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 value created in doing so. We are pleased that our Consumer business, after accounting for essentially all fixed and variable sales and marketing costs - that's both people and marketing dollars - produced $6.6 million in net value through initial sales and expected future renewals.

We are maintaining our latest guidance for Consumer for the year given that we are seeing continued momentum in our Direct-to-Consumer channel as well as some positive signs in our Retail channel moving into the peak Q4 holiday season. We see a continuation of the stability in the Consumer business which we expect will be more of a trend leading to future growth. We believe the transformation of our Consumer business is largely complete and it is now positioned to be a solid platform on which to build the exciting new services that Matt and his team will be discussing shortly.

Slide 12 - E&E Language Update

Now I'd like to talk with you about our E&E Language segment performance, which I am putting in the "needs more work" category. While Consumer stabilized for the first time since 2014, E&E under-performed our expectations. We expect this trend to continue into Q4 so we are lowering our sales guidance for the year for E&E by $8 million, which changes our full-year outlook to $58 million, which is $6.8 million less than 2017 sales.

I will talk more about our full-year view shortly, but first let me walk you through E&E's Q3 performance. E&E sales were $17.5 million, a decline of $2.3 million or 12% in Q3 2018 versus the same prior year quarter. Within this, approximately half of the $2 million sales decline was the absence of custom content sales, with most of the balance driven by $0.5 million unfavorable foreign exchange impacts that came through the UK and reseller sales outside of the U.S, along with lower sales from our affiliate channel.

E&E ARR was $54.5 million in Q3 2018, down 2% sequentially and 4% from Q3 2017.

Slide 13 - E&E Vertical Focus

We have traditionally not discussed the distinct verticals within E&E beyond K12 and North America Corporate, but we would like to share some additional detail to help you bridge our revised guidance and some of the work we are doing to improve segment performance going forward.

Our E&E business is made up of a number of different sales verticals with different buying cycles and underlying industries. Besides selling to K12 schools and corporations, we serve the public sector, as well as custom content sales that historically have been primarily to Native American tribes seeking to preserve their language. We also sell through affiliate channels in the US, which sell our products through their networks of enterprise customers.

Two of those verticals are not traditional SaaS-based, strategic businesses for E&E:
- First, is the "custom content" vertical, which are largely non-recurring and not included in our ARR disclosure. We continue to believe in the positive social impact of preserving native languages, however, our focus is primarily on our more traditional SaaS businesses
- Second, sales through corporate affiliate channels, which because we don't control the customer relationship, are also viewed as non-recurring and also excluded for ARR purposes. While historically a profitable channel for us, and one which was expected to be larger in 2018 than it will be, it is not a core focus as we look to build direct relationships with corporations to serve their critical language learning needs.

So, of the year-to-date E&E Language sales decline of $3.9 million year-over-year, about half was from these two non-strategic verticals with most of the rest coming from a $1 million impact from foreign exchange.

For the full year 2018, of the $8 million reduction in sales from our prior guidance, almost half is from these non-strategic verticals.

Overall, the theme of our Language business in 2018 year to date, is that those areas where we are focused on building strong recurring revenues in big markets like U.S. direct to consumer sales and Corporate in E&E, have had good success. While areas like consumer retail and custom content that are not contributors to ongoing ARR or subscriber growth, have been weaker than expected. We are not happy about the lower than expected performance in these areas, but are pleased with the progress in our core businesses.

Slide 14 - FY 2018 Guidance

Let me conclude my remarks this morning with our guidance for the year. First, we are confirming our consolidated Revenue guidance of $173 million, with Lexia increasing to $52 million offset by E&E Language decreasing to $60 million. We are also improving our guidance for Net Loss and Adjusted EBITDA by $4 million, to negative $25 million and negative $2 million, respectively, on lower costs seen in Q3 and expected in Q4. I would remind everyone that the reason GAAP performance deteriorates compared to last 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 sales model that we expect to lap as we move through the first half of 2019.

We are also confirming our last sales guidance for Literacy and Consumer. We now expect consolidated sales to be approximately $184 million - which represents our first sales growth after three years of declines. We now expect to end the year with cash of approximately $39 million. While this is $6 million lower than previously estimated, primarily due to the lower sales now expected from E&E, it represents an increase of $18 million from our seasonally low point at the end of Q2 - remember our cash flow matches the seasonality of our sales, where we are a net user of cash in the first half of the year when sales are lowest, and generate cash in the back half following the large Q3 sales, which has become our peak sales quarter of the year on the strength of our K-12 businesses.

With that, I will ask John, Matt and Nick to join me for any questions you might have before handing it back to John.