THIRD QUARTER 2010 FINANCIAL RESULTS
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Prepared Remarks

Elizabeth Corse - IR

Good afternoon and thank you for joining us today for Rosetta Stone's earnings conference call for the third quarter of 2010. This afternoon's conference call is being recorded and will be available for replay on Rosetta Stone's Investor Relations homepage at investors.rosettastone.com. Our press release, supplemental financial information and a slide deck supporting today's remarks are all available on the website, and we encourage you to review them.

Tom Adams, our President and CEO, is here today; he'll review some of the highlights of the quarter. Steve Swad, our Chief Financial Officer, is here as well to introduce himself. He and Matt Sysak, our corporate Controller, will also provide some color on the quarter's financial results, as well as guidance for the rest of the year. The team will be pleased to take your questions before we finish up for today.

During this call and the question-and-answer session, we will be make forward-looking statements. We do so under the safe harbor provision of the Private Securities Litigation Reform Act of 1995. Those statements are based on management's current expectations and are subject to a number of risks and uncertainties that could cause actual performance and results to differ materially from those discussed in the forward-looking statements.

Important factors relating to our business, including factors that could cause actual results to differ from our forward-looking statements, are described in our filings with the SEC. These statements are made only as of today, and we undertake no obligation to update or revise forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events, or changes in future operating results.

We'll also provide non-GAAP financial measures during our discussion today. These non-GAAP measures exclude the amortization of acquired intangibles and stock-based compensation. We will also provide total sales bookings, which equals total revenue plus or minus the change in deferred revenue; adjusted EBITDA, which is EBITDA less stock-based compensation; and operating EBITDA, which is adjusted EBITDA plus the change in deferred revenue.

These measures are neither in accordance with nor alternatives for GAAP and may be different from other non-GAAP measures used by other companies. Rosetta Stone believes that the presentation of these non-GAAP financial measures provides useful information regarding financial and business trends relating to the company's financial condition and results of operations.

Reconciliation of GAAP and non-GAAP numbers is available in today's earnings press release, which is available on the Investor Relations section of our website at investors.rosettastone.com. You can also find a copy of our press release, supplemental financial information, and the slide deck, under the most recent Earnings Announcement section of the Investor Relations homepage.

Now I'm pleased to introduce Tom Adams.

Tom Adams - CEO

Thanks Elizabeth, and thank you all for joining us this afternoon.

Well, we have now been live with Version 4 TOTALe for almost two months, and I'm delighted to report that the launch, which was our primary focus in the third quarter and for 2010 as a whole, has been a great success from a product, service and operational perspective. It has also created new excitement around the brand.

We have thus switched to a superior solution that provides *all* new individual Rosetta Stone learners in the US with an opportunity for leveled conversation practice with native speakers online, as well as the individualized interactive self study course that we have provided historically. The new offering includes speech recognition-enabled, iPhone-based activities that allow learners to practice their speaking skills on the go. As such, TOTALe represents an effective new way to learn to speak a language. It is revolutionary – in terms of delivering the best of the in-country immersion method by leveraging new technology, engaging content and new service capabilities so that the learner can easily learn a new language.

In a word, it's fantastic.

Initial customer response has been very positive. Indeed, our conversational practice sessions and community games are receiving high marks with learners and these activities are driving up net promoter scores. Our new success teams are delivering outstanding customer service, with 97% satisfaction with our keystone conversational coaching sessions. And our early feedback shows that customers who get conversational coaching in Rosetta Studio have 60% higher Net Promoter Scores than people who only use the self-study option. Learners using Rosetta World, our community game site, are almost twice as likely to recommend us as those who don't.

Operationally, to make this launch successful we needed to hire and train hundreds of new service personnel to deliver socialization and learning success for our learners. We met this challenge with an outstanding recruitment, selection and onboarding effort across the US. These new members of our team are fantastic brand ambassadors and their passion for learner success is total. New coaches and success agents have embraced our learner centric philosophy and we believe that their efforts will pay big dividends for us over the coming years as they help our customers transform themselves by succeeding in their language learning efforts.

Of course, we're also very proud of the seamless overnight flipping of inventory at approximately 3,500 points of sale throughout our retail and kiosk network. It does not happen without strong operational management and attention to detail. I also would point out that with this launch, we took the step of including serialization and activation for all our products so that we can better track our products and learner lifecycles. And already, it is clear that the new level of optics is stirring up product, service and marketing discussions that will help us deliver even better for customers in the future.

Indeed, there are of course many aspects of sales and marketing, services, operations and the product experience that we need to work on to fully capture the opportunity presented by the important change in our offering. Some of our marketing and product decisions did not play out quite as well as planned. So we are already experimenting with new changes in our product and pricing mix, messaging, timing and focus of services to ensure that we quickly move to optimize our new platform.

As stated in prior quarters, this is a transformational event for us in the US consumer market as we move our business from packaged software towards more of a subscription-oriented model. We did it boldly, by taking advantage of our strong market position to improve customer outcomes, improve the longevity of customer relationships and reduce piracy exposure. As a result, after the successful transition, we can now play offense and extend our industry leadership and drive future growth.

We believe that V4 is nothing short of revolutionary for those that aspire to learn a new language successfully – and that can't spend the time and money required for in-country immersion programs. And the successful launch of this disruptive value proposition is truly the highlight of Q3.

Looking beyond the Version 4 launch, the business performed in line with our expectations. At the bottom line, we had a GAAP net loss of two cents per share, three cents ahead of the high end of our guidance, with non-GAAP earnings of one cent per diluted share. Operating EBITDA, which is our key metric for economic profitability, was also slightly ahead of our forecast, at $13.5 million.

While we continued to fund our investments in new products, new systems and new markets, we ended the quarter with a cash balance of $110 million, $10 million higher than the prior quarter. Over the twelve months to September 30, we generated $34.5 million in free cash flow and $41.5 million in operating cash flow. We remain debt free.

As we make the shift to a more subscription-based solution, bookings metrics become an increasingly important measure of our progress since both product and service components have very high margins and we tend to receive most of our cash close to the time of transaction.

Our aggregate sales bookings in Q3 came in at $73.3 million, as anticipated, down 4% from last year, even as international sales more than doubled, reflecting lower unit sales in the US consumer business.

Revenue came in at $60.9 million, in line with our guidance, and 9% lower than revenue for the same period last year. This relatively greater year on year decline was the result of major revenue deferrals, as we shifted more of our business to a subscription model, and lower media spend that resulted in lower unit sales in the US.

Matt Sysak, our controller, will describe in more detail how revenue deferral was calculated in a few minutes. I will now take a few minutes to describe the performance of our sales and marketing operations in general, beyond the changes related to the Version 4 launch.

Following up on our previous discussion of advertising market dynamics and pricing, we continued to see high prices for TV ads in Q3 even though the market began to stabilize. And while we did not change our judicious approach in media buying, we saw a sequential improvement in our ability to get clearance, though it was still down on a year-on-year basis. The lower clearance and a reduced number of impressions translated into lower unit sales here in the U.S., even as our ASPU went up.

We continue to believe that a stable advertising market is favorable to us, but given the possibility that ad rates will remain near their current levels, we’re undertaking an expanded series of initiatives and tests in our US Consumer business. In Q3 we established initial relationships with COSTCO, Best Buy and Staples. This broader distribution for our brand should counteract some of the reduced frequency in advertising. And to increase promotion of our offerings, we’re already having some success with social media platforms and are launching limited new product mix tests, including a stand-alone $10 iPhone app launched last week and an online-only TOTALe subscription offering that will open up new, lower entry points into the Rosetta Stone brand.

We recently conducted a market survey in the U.S., and I am pleased to report that Rosetta Stone carries a significant premium in customer’s perception when compared to other brands. Indeed, the gap between Rosetta Stone and other language-learning brands has widened in terms of unaided awareness over the past years. Today, we are over ten times more likely to be recalled than the second best known brand in our category.

On the institutional side of the business, we continue to grow at a strong pace on a bookings basis as we successful shift our business online. While only 45% of our aggregate education, corporate and government sales were online in Q3 2007 (excluding Army), in the most recent period, 75% of our bookings were for online licenses in these verticals (excluding Army). The emphasis on moving customers online has, of course, had the effect of depressing our short term growth rates – since annual pricing is lower than perpetual rates. But by having more of our customer base online, we gain an opportunity to build long-term, renewal-oriented relationships. And this is a much better business model for us, and a better solution for our clients. With strong renewal rates, the visibility here is only going to get better.

Indeed, in the third quarter, we renewed with two of our largest government clients, the U.S. Army and the Marine Corps for $5.1 million and $1.25 million dollars respectively. We also renewed our online license with Best Buy, who is using us to help with their global and diversity initiatives. Finally, we renewed with Intercontinental and many other satisfied institutional customers.

Earlier this year we introduced TOTALe online in corporate, higher education and government. While there is great interest from end customers in these markets, we are still in the process of developing migration strategies for many of our long-term customers. In this way, many of institutional early adopters of TOTALe have been new clients such as Booz Allen, who signed up in Q3.

We continue to see great interest and excitement about the TOTALe solution here and abroad among institutional clients. As a result, we plan to expand its adoption significantly over the coming year.

We continue to be excited about the international business also. We achieved another quarter of triple-digit revenue growth, with especially strong performance in Asia. I was in Japan and Korea last month, and was inspired by the entrepreneurial approach of our teams in these very large markets. In Q3, Japan rolled out in-store kiosks in several of the largest Japanese camera stores, which are more comparable to Best Buy as they sell a whole host of electronics. Sell-through at several of these stores already exceeds our best bookstore locations in Japan. Meanwhile, I am very proud of the strong expansion of our TV shopping sales efforts in Korea and the substantial improvements in marketing efficiency achieved in the U.K. and Germany, where there is renewed entrepreneurial spirit. Of course, there continue to be many unknowns in our international expansion, but these offices are already performing well financially. We're building the basis for a stronger marketing presence over the coming years. Indeed, much of our services, operations and systems teams are now at work to support the roll out of TOTALe throughout our international markets. And given how outcomes are more important to these generally more committed learners, we expect TOTALe to have an even better response in international markets.

International was 17% of total revenue in the quarter, and that will continue to grow given the huge market opportunity. We are projecting to end 2010 with international businesses that are better than break even, while generating about $45mm in sales. Given where we were just three years ago, the teams should be very proud of their accomplishments.

As we've discussed previously, we're also looking forward to delivering an English remediation solution for advanced language students in Asia. Namely, those who've mastered reading and writing, have a reasonable vocabulary and a good theoretical handle on grammar in English, but still aren't comfortable speaking or listening. This is a real need. And it represents a huge market opportunity. So we continue to be excited about our ability to get returns on our innovations.

To conclude: we're offering that market what we believe is the best solution available, marrying innovative technology with highly-effective pedagogy, to solve a millennia-old problem. Given that tens of billions of dollars get spent each year on language learning globally, and that our current share is a small fraction of the overall market, we're confident that our investments in improving our solutions for customers, even as we shift to stronger business model, will allow us to achieve significant long term growth and value creation for shareholders.

After having successfully executed our major transition to Version 4 TOTALe, the company is now moving beyond logistics and launch risk management to focus on capitalizing on the new platform and our existing competitive advantage. This is really positive for the team here at Rosetta Stone. It's an important mindset shift.

With that, I'll introduce the newest member of our team, here to help us achieve that long-term growth, Steve Swad, Rosetta Stone's new CFO. Steve is a great fit for our company. He's going to bring a strong financial perspective to business decisions, helping us execute with greater discipline to create value as a public company. I'm pleased to have him join our team.

Steve Swad – CFO

Thanks, Tom. It's a pleasure to be here.

While it's only my second day, and I don't have a lot to say about the last quarter, I thought I would answer the question many of you have asked about how and why I became CFO at Rosetta Stone. On the 'how' side, Ted Leonsis, a long-time tech colleague of mine and a Rosetta Stone board member, suggested that I meet with Tom. We met, and right away there was very good chemistry between us. We had a great exchange of ideas about business in general and Rosetta Stone in particular, and shared a common view of the key elements of a strong partnership between the CEO and CFO.

On the why side, my reasons for coming here are probably similar to the reasons many of you are listening today. First, of course, is the $80 billion worldwide market that Rosetta Stone addresses. This is a market that is extremely large, not well served and expected to increase over time. To me that landscape presents a significant opportunity.

My second reason for joining relates to the quality of Rosetta Stone's product. Their products rank high in customer satisfaction, get strong net promoter scores and great user reviews. In addition, the brand resonates well with the consumer and stands out from the competition. So I think the product is well positioned to serve this massive market.

Finally, my third reason relates to Version 4. To my eye, this latest product has been developed off of a platform that integrates self-study learning technology, coaching and online community interaction. I think the possibilities for leveraging this type of educational platform beyond language could be very interesting over the long term.

As you would expect, I'm in the process of establishing a few priorities as I settle in at Rosetta Stone. Among them is strengthening our investor outreach program. To that end, I look forward to meeting with you, and getting your perspective on the company and its opportunities.

Now, since I just came on board yesterday, I'm going to ask Matt Sysak, our controller, to provide you with the financial details for the third quarter, and our guidance for Q4 and the year. Matt?

Matt Sysak - Controller

Thank you, Steve, and welcome everyone. As Tom noted, our key financial metrics for the third quarter were in line with our expectations. Sales bookings were $73.3 million, down 4% year-over-year. The change is largely due to lighter sales to US consumers.

Total revenue was $60.9 million for the third quarter, down 9% year-over-year. Consumer revenue was 70% of total revenue. We sold 116 thousand units of our language-learning solution in the quarter, at an average price of $405. The total change in deferred revenue was $12.4 million, of which $3.6 million was attributable to sales of Version 4 TOTALe.

Institutional revenue represented 30% of total revenue, up from 24% a year ago. Institutional revenue is primarily subscription-based.

Geographically, revenue from the US was $50.3 million, down 19% from a year ago, with the number of units sold to consumers down year-over-year. International revenue was $10.6 million, an increase of 119% from a year ago. International continues to grow as a share of revenue, and now represents 17% of our total revenue, up from 7% a year ago.

I'll discuss expenses and profitability on both a GAAP and non-GAAP basis. Our earnings press release, available on our website, includes a reconciliation of non-GAAP to GAAP measures.

Gross margin was 83%, down from 87% in the third quarter of last year. Cost of goods sold included a $1.7 million expense for obsolete inventory as we transitioned to Version 4 TOTALe. This was favorable to our initial estimate in the guidance we provided previously. Cost of sales also included incremental expenses for language coaches and success agents. We continue to expect that over the longer term, our gross margins will be in the 84-85% range, in line with our initial expectations and guidance. For this quarter, if we back out the obsolescence charge, the margin would have been 85.7%. That's slightly higher than our expected range, since we had only two weeks of V4 impact in the third quarter.

Sales and marketing expenses were $34.1 million for the quarter and included approximately $1.6 million related to Version 4 TOTALe launch activities. Excluding these costs, sales and marketing expenses represented 53% of revenue and 44% of bookings. The bookings basis, which better captures the full value of our sales, is in line with previous quarters.

We've talked a lot about TV ad rates in the last few months, specifically in the scatter market, where we buy television advertising in a spot-type market. We have targets for return on our media spending, and we've continued to show discipline against those. We believe TV ad rates have largely stabilized, at a somewhat higher level than had prevailed in 2008 and 2009. We're working with our new media buyer to secure effective TV advertising slots, slowly increasing our TV exposure. Internationally, we continue to invest in our growth in key markets in Europe and Asia and believe these campaigns have remained very effective.

Research and development expenses were $6.0 million for the quarter, in line with the previous year. We continue to invest in new product initiatives, including the remedial English course Tom mentioned, targeted for release in Asian markets late in 2011. General and administrative expenses for the quarter were $12.0 million, also in line with the previous year. You'll notice we disclosed a reversal of a lease abandonment expense on our P&L, for $548 thousand, previously-recorded in Q4 2008.

Turning now to profitability, operating EBITDA in the third quarter was $13.6 million, for a healthy operating EBITDA margin of 19% of sales bookings. The high rate of revenue deferral had a significant impact here, and will continue to affect operating EBITDA going forward.

We recorded a tax benefit for the quarter, of $1.2 million. For the full year, we anticipate a tax rate in the 25-30% range, benefited by our net operating loss carry-forwards in the UK and Japan.

GAAP net loss in the third quarter was $0.02 per share, compared to GAAP net income per diluted share of $0.25 in the year-ago period. On a non-GAAP basis, we did have net income of $0.01 per share compared to non-GAAP net income of $0.29 per share in the prior year.

Turning to our balance sheet, we ended the quarter with $110 million in cash and cash equivalents. Cash from operations was $10.1 million in the quarter, and with $2.5 million of cap ex, we generated $7.6 million of free cash flow.

Total deferred revenue increased by $12.4 million from the end of the second quarter. Again, that reflects $3.6 million specifically attributable to sales of V4, with its 15-20% revenue deferral rate. Of that, roughly two-thirds relates to inventory stock-in of the new V4 solution by our global retail partners. We also had some significant subscription sales to institutional clients, including the US Army renewal, in the quarter that helped drive deferred revenue.

As we developed our guidance for the fourth quarter 2010, we had a number of factors in mind. Those included:

- The gift-giving season in the US and Europe, which drives strong consumer sales.
- The introduction of Version 4, which has been well received in the several weeks since its launch
- Successful testing of and response to new marketing tactics
- TV advertising rates stabilized around Q3 levels, and
- Continually increasing deferred revenue, as consumer sales in the US will all be of Version 4 in Q4.

Incorporating those and other factors, we now expect fourth quarter sales bookings in the range of $82 to $88 million. We anticipate revenue to be in a range of $76 to $81 million, representing growth of 1% year-over-year at the midpoint, reflecting the continued growth of deferred revenue on a full quarter of V4 sales.

While most of our incremental costs related to our Version 4 TOTALe launch are now behind us, approximately $1.5 – 2 million in marketing costs remain in our plan for the fourth quarter, consistent with what we’ve described in the past. This spending supports our broad marketing campaign geared to increasing awareness of Version 4 TOTALe.

We expect operating EBITDA for the fourth quarter to be between $17.5 million and $21.5 million. We expect GAAP net income of $0.28 to $0.38 per share, with non-GAAP net income in the range of $0.31 to $0.41 per share. For the quarter, we are estimating 21.4 million weighted-average diluted shares outstanding.

This guidance is down from prior guidance due primarily to lower expectations around the U.S. consumer market.

As a reminder, we have posted a supplementary slide presentation with our third-quarter results as well as additional information you might find helpful in the Investor Relations section of our website.

So that's the third quarter financials, and the near-term outlook. I'll turn it back over to Tom now.

Tom Adams

Thanks, Matt. So looking back at Q3, I can't overstate the importance of the near-flawless execution of our launch of Version 4. It's important not just for what we've accomplished operationally, but also for the expanded learning experience we're offering our customers. With this platform established, we're now positioned to play a strong offense.

We've got great opportunities, as we roll out V4 globally, prepare to deliver our English remediation solution in Asia, and as we look out over the longer term. I'm confident we can optimize our US segment, while we continue to grow our international business with increasing profitability. I'm more excited than ever about the possibilities ahead for Rosetta Stone.

Let's take your questions now.