First Quarter 2015 Earnings Call

May 6, 2015

Prepared Remarks

Frank Milano: Good afternoon and let me welcome you to Rosetta Stone's first 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. Also with us is Judy Verses, President of our Enterprise & Education segment. Judy will be available during the Q&A portion of the call. We will open the call to questions after our prepared remarks.

Our first quarter earnings release went out just 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 risks and uncertainties, please read the company's SEC filings available on our website and today's release, including the paragraphs beginning with the words, "Caution on Forward-Looking Statements" and "Non-GAAP Financial Measures."

Now here's John.

John Hass, Chief Executive Officer:

Thanks, Frank, and welcome everyone. Tom will walk you through the details of the quarter in just a moment.

I want to first express my own appreciation to Steve Swad for his five years of dedicated service to Rosetta Stone. Steve was a big help in my transition and to his credit it has gone smoothly.

Today I would like to share with you a few observations from my first month in this role since my appointment at the start of Q2. I will also provide a sense of where I am focusing my and the team's efforts to operationalize the strategy that was announced in March and which the board and the entire management team are fully committed to.

To begin with, I have found a passionate, hard-working team that is experiencing significant change but responding well. In many cases, I believe, because people joined Rosetta Stone not only to pursue a career, they came here to help better other people's lives. I have been excited to hear stories of young adults learning English in schools in Latin America and teachers in Iowa helping their students catch up to reading at grade level. All with our help.

Each day has also been a validation of what I believed as an investor even before I joined the board. Simply, millions of people in the United States and around the world have a need to learn to speak and read English and since 2010 alone, Rosetta Stone has spent over $325 million on advertising that has built the best brand in the space. This opportunity provides a clear and achievable vision. At Rosetta Stone we will open new worlds and enrich people's lives by helping them communicate better.

Our brand and vision affords us not only the opportunity to directly reach the recent immigrant learning English in their home, it provides a trusted introduction to the principal where his eight-year old daughter attends school. Not only does the soon to be retiring business executive planning to travel abroad trust us to gain a working knowledge of Italian, we can build a multi-year relationship with her current head of HR that is looking to train a global workforce in business English. The Rosetta Stone brand opens doors to a sizeable marketplace.

That said, no one at Rosetta Stone believes that our financial performance is acceptable, or that the work ahead of us is easy or will be accomplished overnight. The bridge between opportunity and outcome is execution. Our execution has to improve.

So what priorities do we have to operationalize our vision and improve execution?

We will succeed by prioritizing these three things:

1. Financially optimizing our Consumer channel for profit, not size, while reinforcing the Rosetta Stone brand;
2. Building an effective sales model and delivering the right products to efficiently accelerate the growth of our E&E channel; and,
3. Simplifying our business and smartly reducing expenses.

The Consumer team that is implementing our first priority has endured significant change. Despite this I have found them to be invigorated by the opportunity to reach customers by once again focusing on how we change lives rather than through a sole reliance on price, and by freeing them to manage to bottom line results.

During March, in support of the E&E channel, we began to change the ways that Consumer markets our products and the price points they offer broadly. In addition, we restructured the Consumer organization at the end of last quarter to reduce fixed costs and focus on managing our variable expenses, principally advertising, with a goal of optimizing profitability and reducing volatility. While it is early, the team has responded well to this strategy and going forward will look to test and tighten their focus on important consumer market segments, rather than the mass marketplace as a whole.

In our E&E business, which is driven by learners where reading or speaking English or another language is a requirement for success, and their relationship with us is through their place of business or school, the requirements are different.

To win in these markets, we will provide a single solution, demonstrating clear learning outcomes, with curriculum aligned to relevant standards. Teachers, tutors, administrators, heads of HR or owners of privately held language instruction centers, will have one place to manage their language solutions. Learners will be placed into the right level of our curriculum, understand their progress against learning goals, and demonstrate their success via assessments. We will support instructors by providing clear indications of learning progress and interventions for learners. When we talk about focusing on learners for K-12 in the U.S. and Corporations worldwide, this is what we mean.

The E&E channel is not only additive to our historical self-directed Consumer channel, it produces relationships with businesses and schools whose needs are enduring, rather than individuals whose needs are one-off (or episodic) and where our customer recruits the learner for us.

We see this today in the success of Lexia, which is delivering positive outcomes for kids and schools across the country through a strong blended learning product. We are taking a number of steps to grow this important business. At Rosetta Stone we are fully committed to being a significant player in the English Language Arts marketplace (or "ELA") in the U.S.

In Language, we have shifted the focus of R&D to deliver an end-to-end solution with a more complete suite of tools in support of our Enterprise business. We are doing this in order to grow new sales and improve renewals, which are too low in our Corporate and K-12 Language business, generally. Over time this will also provide us the opportunity to simplify our business, as we reduce the platforms we operate and provide administrators and instructors with the tools they need to support themselves.

Finally, our ability, to bring together our Language and Literacy capabilities, will put us in a strong competitive position in the emerging U.S. K-12 English Language Literacy (or "ELL") marketplace.

Our third priority is to increase the simplicity and reduce the cost of our business.

We need to simplify across all areas of our business. We are doing directly, too many things, in too many places. Going forward, we will decide where we have strong competitive advantages, and where we do, we will look to out-compete everyone in the marketplace. Where we do not, we will take prudent action to modify, exit or, in some cases, partner to fully leverage our strengths in brand and technology.

Over the last month we have been implementing the previously announced cost reductions. Going forward, we are working to identify and execute ways to focus and increase the efficiency of our business. Some of these will be apparent to you, while others may only be noticed through enhanced performance over time. We will accelerate certain initiatives that have significant value, and cancel others where the value is less clear or is not sustainable. In some cases, there may be near-term sales costs, but those decisions will be taken with the idea of building a leaner, more nimble organization that can grow efficiently. Quite simply, more revenue dollars have to flow to the bottom line.

We are benefiting in this area from our work with turnaround expert Al Angrisani.

I believe our vision is correct and that we have the right priorities. Now it is a matter of making sure all areas of the Company are aligned against these priorities. This will not occur overnight but I am confident that it will happen.

I am also working with Tom to take a fresh look at how we present ourselves to you. In doing so, I have two overriding goals:

- The long-term health of your business, and
- Providing you the appropriate information to make informed decisions.

To accomplish these goals, I want to begin to evolve the basis of our reporting. Since the acquisitions of Tell Me More and Lexia, Rosetta Stone has emphasized bookings in reporting its performance. While this was done with good intention, it has caused confusion among some investors. You will notice in our release, and in Tom’s discussion, that we will begin to speak more prominently about GAAP results; we are using the first quarter to begin this transition.

Moving forward the goal is to return to financial metrics that you are more accustomed to using and to accompany this with operational metrics that provide visibility into the performance of our primary businesses**.** Like other SaaS companies, revenue provides a more stable base from which to forecast and operate our business and reduces the lumpiness of large, one-time sales.

In addition, we will no longer be providing quarterly guidance. I witnessed first-hand in the last few days of Q1 the volatility in our business arising from the timing of closing contracts or when retail partners run promotions. This volatility is exacerbated by the emphasis on bookings. I don't want to manage these business decisions during our transition in service of reporting an outcome in any particular quarter. As our business grows and we move to more traditional revenue metrics this decision may be revisited.

Finally, given I have only recently begun my work, the Investor Day that Steve had talked about on the March call will now be later in the year – we expect to have more details about that for you on our second quarter earnings call.

By that time I also expect to be able to provide clearer guidance on my expectations for the full year. At this point, I am more comfortable, for the reasons discussed above, with our ability in the near-term to manage the bottom line than the top – where I have less visibility this early, both in the year and in my tenure as CEO, and where decisions made to improve the business could have a near-term sales impact.

I will now hand the call over to Tom, who will take you through the financial details of the first quarter.

Tom Pierno, Chief Financial Officer:

Thank you, John, and good afternoon everyone.

As John noted, I will be re-introducing GAAP revenue and GAAP net income into my commentary as we begin to move back to more traditional financial metrics. GAAP results include the expenses associated with the restructuring we announced on our March call.

The economic income statement, included in our supplemental earnings slides available on our website, excludes stock compensation, depreciation and amortization, and other EBITDA adjustments, such as the restructuring charge. All of these elements are adjustments to our GAAP earnings, resulting in Adjusted EBITDA.

I also want to briefly note that we have expanded our definition of Adjusted EBITDA this quarter to exclude from GAAP earnings the consulting fees paid in Q1 2015 and Q4 2014 to a leading education consulting firm as part of the work that resulted in the strategic shift we announced in March. Our Q4 2014 amounts have been conformed to this definition, as shown in our supplemental earnings slides.

Let’s begin with a quick summary:

- GAAP Revenue was $58.4 million in the quarter, a decline of $2.4 million year-over-year. This decline was due to the expected decline in Consumer that was partially offset by a $5.3 million (or 30%) increase in E&E revenue.
- GAAP net loss was $19.9 million, or $0.95 per diluted share, which was narrowed versus the prior year net loss of $20.2 million. The Q1 2015 results included other EBITDA adjustments and impairments, including restructuring charges and other related costs totaling $6.7 million. The Q1 2014 results also included other EBITDA adjustments and impairments, including charges related to the acquisition and integration of Tell Me More, charges to exit Japan and excess space in our corporate headquarters, as well as an impairment charge for ROW Consumer goodwill, all totaling $10.2 million.

Non-GAAP results this quarter were as follows:

- Total bookings were $50.5 million. Compared to the first quarter last year, total bookings were down $10.7 million (or 18%). The impact of the strengthening dollar was $3.0 million year-over-year, so on a constant currency basis, bookings were down $7.7 million (or 13%). I will talk about segment performance shortly, but it’s important to note here that the majority of the decline in bookings was due to the shift in strategy to manage our Consumer channel for profitability, rather than size.

- Adjusted EBITDA was negative $14.5 million, down $7.5 million year-over-year. The impact of the rising dollar was $1.3 million year-over-year, so on a constant currency basis, Adjusted EBITDA was down $6.2 million.
- We ended the quarter with cash on the balance sheet of $45.9 million and zero debt outstanding.

Turning to our segment results, and starting with our E&E business, first quarter revenues were $23.2 million (or up 30%) and bookings were $15.0 million (or down 18%) on a reported basis; note that, like other companies with operations outside the U.S., our results continue to be impacted by the strengthening U.S. dollar – on a constant currency basis, E&E revenues would have been $24.0 million (or up 34%) and E&E bookings would have been $17.0 million (or down 7%).

Inside the total, Education – which is comprised of our K-12 Literacy and Language verticals – delivered revenue of $10.9 million (or up 39%) and bookings of $6.4 million (or down 4%), while Enterprise – which includes all of the legacy Language verticals except K-12 – had revenue of $12.3 million (or up 22%) and bookings of $8.6 million (or down 26%). Note that all of the impact of FX was on the Enterprise side, as the vast majority of our Education business is U.S.-based. It is also important to remember that our first quarter is the smallest of the year for E&E – representing approximately 16% of full year E&E bookings in 2014 – with relatively small amounts resulting in an outsized percentage change in either direction.

Unpacking these results a bit, Education revenues were $10.9 million as Literacy grew $2.8 million (or up 196%) and Language grew $300,000. The growth in Education, and Literacy in particular, reflects, lower revenue in Q1 2014 resulting from purchase accounting impacts on acquired deferred revenue; we expect the year-over-year GAAP revenues to become more comparable as we lap the purchase accounting impact which will result in lower revenue growth rates than what we experienced in Q1 2015. Education bookings of $6.4 million were down $300,000, as Literacy growth of $300,000 (or 9%) was more than offset by lower Language of $600,000 (or 20%).

Enterprise revenue totaled $12.3 million, up $2.2 million (or 22%). On a constant currency basis, Enterprise revenue would have been $13.2 million (or up 31%). The growth in Enterprise reflects lower revenue in Q1 2014 resulting from purchase accounting impacts on acquired deferred revenue; and, like Literacy, we expect growth rates to slow as we lap these impacts over the coming quarters.

Enterprise bookings totaled $8.6 million, down $3.0 million (or 26%). This performance primarily reflects lower bookings in Europe, Brazil, and Asia – with the exception of China, which was flat year-over-year. The adverse effect of currency on our Enterprise business was $2.0 million. Excluding currency impacts, Enterprise bookings would have been $10.6 million (or down 9%).

Consumer revenues totaled $35.2 million, which was down $7.7 million. Consumer bookings totaled $35.5 million in the first quarter, which was down $7.4 million, compared to the year-ago period. North America drove the majority of this decline, which was as we expected.

Now, as we begin to experience the seasonal growth in our E&E business, which has historically ramped-up in the June quarter and typically has peaked in the September quarter (for Education) and December quarter (for Enterprise), our entire organization is aligned and focused on the successful execution in both Enterprise and Education. We expect the normal seasonality in the E&E segment will reflect sequential increases in revenue and bookings in Q2 and Q3. In addition, we will continue to manage the Consumer business to deliver targeted Adjusted EBITDA, which we will use to fund this strategic transformation.

Turning to costs, our results for Q1 provide little indication of the changes that we have made to lower operating expenses due to the timing of our strategic announcement late in Q1. That announcement included reductions in our global non-E&E headcount and the decision to optimize the amount of sales and marketing activity that we had been conducting in our Consumer segment.

Total operating expense – on an economic basis – was $54.4 million in the first quarter, down $2.4 million compared to the year-ago period. Sales and marketing expense totaled $36.0 million, down $1.3 million compared to the year-ago period. That decrease reflects a $3.1 million reduction in Consumer, which included lower media spending. Partially offsetting those savings was $1.6 million in incremental sales and marketing in E&E designed to accelerate growth. R&D expense was unchanged at $7.8 million, and G&A expense totaled $10.6 million, which was $1.1 million lower than the year-ago period.

Turning to the balance sheet, we had $45.9 million in cash and $120.2 million in deferred revenue at March 31, 2015. Of the total deferred revenue balance, $88.6 million, or approximately 74%, was short-term and will be recognized as revenue over the next 12 months.

Net cash used in operating activities was negative $13.3 million in the first quarter, a $300,000 improvement compared to the year-ago period. Capital expenditures, which for us is primarily capitalized labor on certain product and IT projects, totaled $2.4 million, up $1.0 million compared to last year reflecting higher project activity this year. Free cash flow, which we define to be the sum of these two items, was negative $15.7 million in the first quarter, compared to negative $15.0 million last year.

Turning to guidance. As John indicated we have decided to no longer communicate quarterly guidance. For the full year, we are modifying the prior guidance for E&E bookings of $122 million to $130 million, as we are now tracking towards the low end of this range in part due to the currency effect and lower than expected Q1 performance discussed previously. We are also now tracking to the mid-point of our prior guidance for Adjusted EBITDA and capital expenditures, which were full year Adjusted EBITDA of approximately $10 million and capital expenditures of approximately $11 million. Both the share count estimate of 22 million and the effective tax rate of 39% remain unchanged.

Compared to the cash balance of approximately $65 million at December 31, 2014, we expect to end 2015 with a cash balance down mid-teen levels on lower Adjusted EBITDA and higher cash restructuring costs versus our view in March.

All of the guidance we are discussing today is caveated by the fact that, as John discussed, we are in the early stage of our transformation work and expect to have more changes to come – with the belief that the decisions that create these changes will be good for the long-term health of the business, but could have near-term impacts on bookings, revenue, Adjusted EBITDA and cash which are not reflected in our current guidance.

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

John Hass, Chief Executive Officer:

Thanks Tom. There is much work to do, and we are moving with urgency to align against the three top priorities that I outlined. The opportunity is there for us to better help language and literacy learners, whether we serve them directly, or through our school and corporate partners, while producing much better margins and cash flow for our owners, if we invest in the right areas, simplify our business, and improve execution. In the days and weeks ahead we will make ourselves accessible and hope to meet with many of you as I have always found investors have great insight. This is one of the reasons I am very happy that David Nierenberg recently agreed to join our board.

With that, Operator, if you would please open the line for questions.