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Rosetta Stone Thesis – Overview | 12/20/2018

Price: $16.29 | 22.47mm shares OS| $366 million Market Cap | $347 million Enterprise Value

TTM Sales: $174mm (-9.2% growth y/y) | Gross Profit $139.3mm (80.1% GMs) | TTM EBITDA: $-3.9mm (-2.2% margins)

Rosetta's tagline: THE Language and Literacy Experts

Executive Summary:

RST has been a good business/bad business combo, quickly moving to a decent business (Consumer Language subscription)/great business combination (Lexia). The strength of the gem that has been "hidden," Lexia, which we think is the leading literacy software asset on the market. Lexia has been masked and obscured by the declining revenue of consumer language learning segment due to the elimination of product sales, the ubiquitous Rosetta Stone CDs. The company has dismantled their entire retail supply chain and business model and transitioned to a profitable SAAS pure play. Lexia has grown such that we now believe just Lexia's 2018 bookings of $60 million "cover" the current enterprise value of RST and Lexia has a long runway for continued 20% growth. Also, it's a misconception that the consumer language business is collapsing, the elimination of product sales is masking rapid growth in consumer language subscribers.

A central part of the thesis is that there has been a lot of private equity interest in the education software space the last few years with almost all public pure plays having been acquired, with the most recent Cambium Learning (ABCD) being acquired at an EV/Sales multiple of 4.6x, versus Rosetta Stone still at less than half that multiple despite being a superior business with superior competitive positioning. We believe management and the RST board all want to eventually sell the company. We believe this will happen sooner rather than later, with the auction process formally kicking off as soon as 1H 2019, as a large activist shareholder (Osmium Capital, 6.7% ownership), as well as us (2%+ ownership) will amp up pressure the Board for a sale in 2019. A sale process could take 6-12 months, therefore we look for a potential sale at the end of 2019 or beginning of 2020. **Given that the activists (Osmium and David Nierenberg, also on the board) effectively appointed the CEO John Hass we do not believe it will be a huge battle to have the company formally run an auction process.**

Additionally, the management is already taking actions to position the company for a sale by merging Lexia with their K-12 Language product starting in 2019. Given the complete customer overlap, this makes complete sense and will effectively materially increase the total salesforce for Lexia while carving out the two unique divisions of the company (Lexia/Rosetta English) and then Consumer/Enterprise. Furthermore, a reclassification of ~$12 million of sales that will shift from Enterprise Language to Lexia due to this organizational change could create multiple expansion as most investors value the language segment at 1-2x sales and the Literacy/Lexia segment at 5-6x sales.

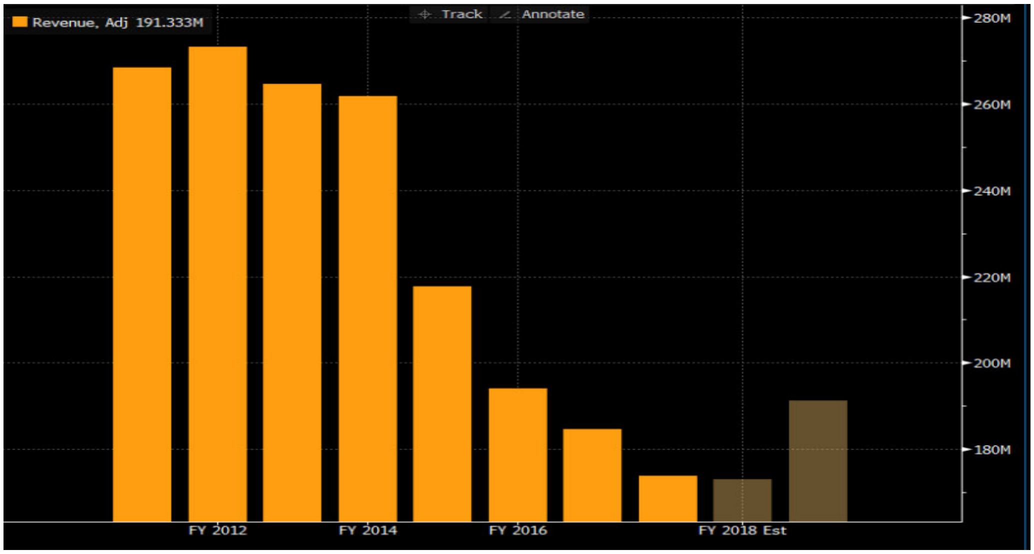
In our Base Case the stock has upside to $30, 87.5% upside from $16, based on a 2.8x multiple of consolidated recurring revenue for 2020. This would also be about 14-15x 2020 EBITDA. In our "bull case", which is still heavily discounting management's guidance, we get upside to $46 per share by the end of 2020, or 170% upside within the next 24 months.

Company Description:

Rosetta Stone offers language learning subscriptions to consumers and government/corporate customers and literacy software to K-8 schools under the Lexia segment (brand name of main reading software product is Core5). Growth temporarily slowed down as they removed resellers and transitioned to direct sales model and exited physical CD sales.

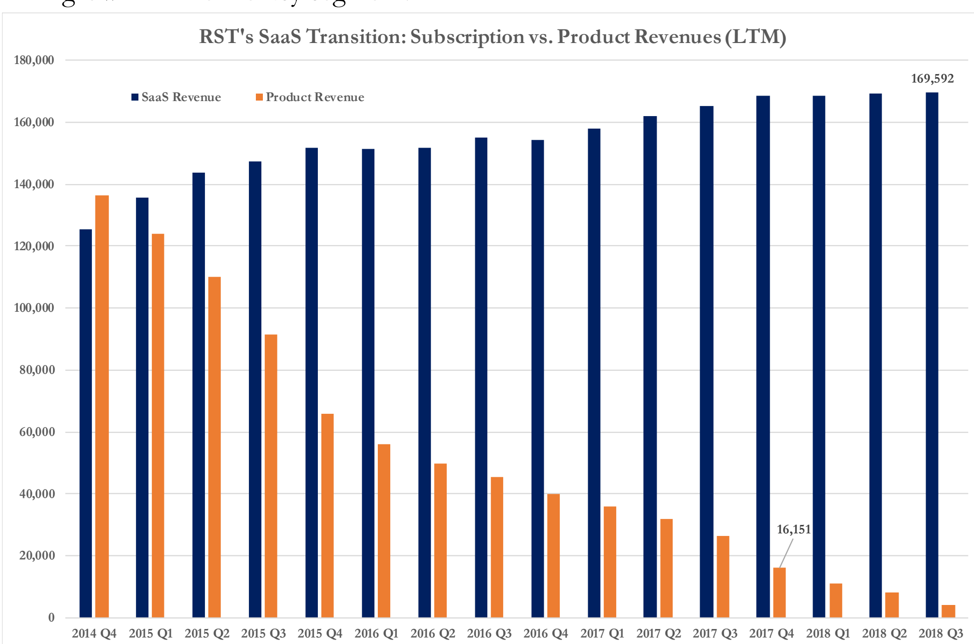
As of end of Q4 2017, RST stopped shipping the ubiquitous language learning CDs they are so well known for, so their reported product revenue has collapsed and has been at zero in 2018.

RST screens poorly for software investors as the annual revenue has looked like this:



<u>We believe the compelling investment opportunity partly exist due to the stock screening so poorly:</u>

- RST screens with -7.5% y/y revenue growth in Q3 (with much larger declines in previous quarters/years), an immediate "pass" for most investors, especially tech/software focused investors, which tend to be more growth-oriented in nature.
    - Sales have gone from >$260mm 2011-2014 to $173mm in the last 12 months due to product revenue (CD sales) going from $136 million in 2014 to $4 million in 2018 (with $0 estimated for Q4). Product sales declines have masked underlying Rosetta Stone app subscriber CAGR in the high teens and 20% growth in the literacy segment.

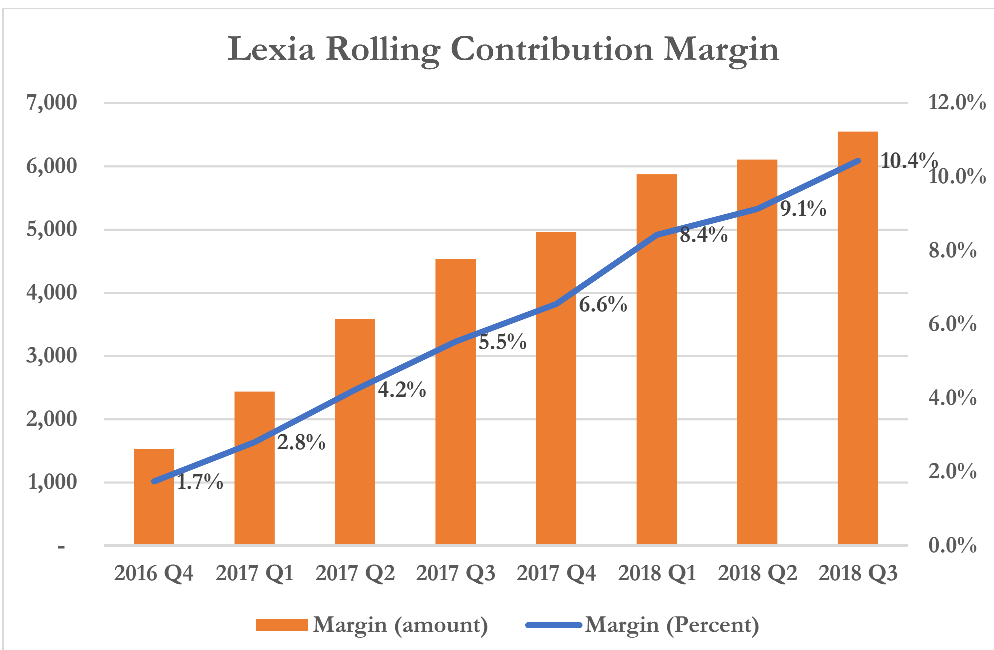


- On the Q3 earnings call, management gave preliminary guidance for revenue growth of 15% for 2019, with 20%+ revenue growth from Lexia (billings growth >25%), 10% growth in consumer sales, and +3-5% in E&E. Sell side is currently modeling about 10% growth and in our Base Case we are modeling 7% growth. Management has an OK, not perfect, track record of hitting guidance, so we feel it's prudent to model in only approximately half of what management is forecasting and be pleasantly surprised if they achieve their goals. The expectations bar is set quite low and can be easily surpassed.

- Catalyst: Starting in Q1 2019, RST will show overall y/y revenue growth again (in the 9% range) for the first time in over three years and thus going forward will once again show positive growth and attract "growth investors" who are screening on this. At the same time, the company is expected to produce material FCF for the first time years.

- Shares also screen poorly on common valuation metrics. RST screens around breakeven EBITDA for this declining revenue stream…therefore RST will not appeal to value-oriented investors at first blush who don't look more closely or have a software orientation/background.
- **Operating losses were as high as $78.8mm in 2014. This is the impression of operations that most investors still have of RST overall, but losses shrank rapidly as management has right-sized OpEx and cut sales and marketing spend (while subscribers have continued growing at a strong pace).**
- Given RST transition to SaaS pure play is essentially complete, equity valuation methodology *should shift* to become valued on a forward recurring revenue basis, even as they turn the quarter on profitability as the true underlying low-growth or steady-state FCF margin is extremely high.

Voss Variant View: Rosetta Stone has completely pivoted their business model from selling language learning CDs in retail locations + kiosks, etc., to become a pure SaaS revenue company with not just one, but two industry leading global franchises and is turning the corner on sustained profitability. The strength of the real gem of the company, Lexia of their Literacy segment, has been hidden and obscured by the declining Language Learning segment revenue as it transitioned from selling perpetual license CDs with all revenue recognized upfront, to subscriptions with revenue recognized ratably over the subscription period. Lexia is hitting its stride and is in the 'operational groove.' Although it is early, there is preliminary indication that Lexia is showing operating leverage, even as their bookings growth accelerates:



We now believe just Lexia's 2019 bookings (~$78 mm) are worth roughly the current EV and it will keep growing at 20%+ for at least the next four years. As total company revenue has declined due to de-emphasizing CD sales and divesting some other divisions, the new CEO from activist fund Osmium Partners has done a good job of right-sizing the cost structure to match the lower revenue base ($124mm of cost cuts since 2014 compared to $77.3mm decline in sales). Lexia is still <10% penetrated into the schools within its US addressable market and has a long secular runway for fast growth as school district supplemental spend shifts from analog (textbooks) to digital, as they cross-sell new products and further penetrate into existing customer base. **The narrative can shift** from one of RST being a cash-burning and negative growth language CD business to a growing FCF machine with industry leading literacy software assets, as Lexia soon could soon make up the majority of company's total bookings (will be >33% in 2018 up from <10% in 2015).

Valuation Overview

- **Base case is the stock can rise by 87% to $30 within 18 months and this is heavily discounting management's guidance.**
    - **Base case ascribes a 1.5x multiple on the ARR for the Language segment and 5.0x Lexia Sales. The blended sales multiple would be an undemanding 2.8x for a growing, 100% SaaS business with two industry leading franchises.**
    - $30 stock price target is derived from assuming:
        - Flat CAGR in recurring revenue in Language segment (staying at ~$100 mm) and ascribing it a 1.5x recurring revenue multiple overall
            - But within Language ARR Multiples: Assigning:
                - 2.0x on K-12/education segment
                - 2.0x Enterprise Segment, and
                - 1.5x consumer Subscription segment
                - Above ARR multiples equates to 1.54x blended, valuing Language segment at $174mm, or $7.48/share by end of 2020.
        - Ascribing 5.0x ARR multiple to Lexia on 2020 ARR of $75mm
            - Base case assumed Lexia growth: +25% in '18, 25% in '19, 20% in '20.
                - Compare this to management guidance 27% CAGR through 2022 from Investor Day and >$100mm of Lexia sales.
        - Plus $3.44 of net cash per share at end of 2020.
        - Total ARR would be $194mm, up from $149mm in 2017 (with almost all of the growth coming from Lexia)
            - Compare conservative $194mm base case estimate to Management's official guidance of >$235mm of SaaS revenue run-rate by end of 2020.
        - This $28 PT implies EV/Total Sales of just 2.57x, 14.26x EBITDA, 16.6x EV/uFCF, 3.0x EV/Gross Profit—for 90% recurring revenue, pure play SAAS with two industry leading franchises and 80%+ consolidated gross margin
            - Lexia 2020 "steady state FCF margin" is guided to 35%. They do not need to come near this level for the stock to perform well.
            - **At 4.5x recurring revenue in 2020, Lexia is worth $450mm compared to current EV of $340mm. We would still have the pure SaaS language business, another globally dominant franchise doing $100mm+ in sales for free.**
    - **Bear Case Valuation build-up:**
            - $11.60 downside target in negative fundamental case by end of 2020
                - Derived from 0.75x ARR multiple on Language Segment with mid-single digit negative revenue growth each year
                    - $84mm in ARR FY '20, valued at $73.5m, $3.16/share
                - 2.5x Lexia 2020 ARR with growth of: +15% in '18, +12% in '19, +5.4% in '20 (a full 20% below management's guidance)
                    - $60mm of '20 ARR * 2.0x = $116mm value, $5.00/share
                - Plus $1.51 net cash (from $1.91 net cash per share MRQ)
    - **Bull/Upside Case, timeframe = end of 2020:**
            - 2.0x Language ARR, worth $10.93/share
            - 6.0x Lexia ARR (growth of +30%/+30%/+25%), worth $23.55/share
            - Plus net cash per share of $4.30 (still slightly below mgmt. guidance)
            - **Px Target = $38.78, 142% upside**

Transaction Comps:

RST Transaction Comps

Date	Target	Acquirer	Deal Size (EV)	EV/Sales	EV/ EBITDA	Revenue Growth	Gross Margins	EV/FCF	Notes
Feb-17	NetDimensions	Learning Technologies Group (LTG LN)	$52mm GE	2.6x	n/a	-1.0%	85.0%		EBITDA breakeven, FCF negative, better comp for Consumer Language
Mar-17	Nearpod Apps	INST		4.0x					Minority stake - presentation sharing software
Oct-11	Renaissance Learning	Permira Private Equity	$455mm	3.3x	10.4x	5.7%	79.1%		Accelerated Reader, bidding war w/ Thoma Bravo
Mar-14	Renaissance Learning	Hellman & Friedman	$1.1 billion		12.0x				Permira flipped to Hellman for 4x ROI.
Mar-12	Archipelago Learning (ARCL)	Edmentum Holdings	$324mm	4.4x	15.9x	9.8%	91.0%	14.4x	
May-10	Edmentum Holdings	Thoma Bravo	$139mm	1.7x	10.3x	1.2%	57.0%	10.9x	Massively negative revenue growth in years preceding buyout
Mar-11	Education Development (EDD	Pearson	$103mm	3.5x	10.1x	3.0%	74.0%		Steadily negative revenue growth for prior 5 years
Oct-11	Cambium Learning (ABCD)	Veritas Capital	$734mm	4.6x	18.2x	2.1%	83.1%	18.3x	28% of sales is printed materials, not SaaS pureplay; 1x net debt/EBITDA
Average				**3.4x**	**11.7x**	**3.5%**	**78.2%**	**14.5x**	
		RST	$ 345.23	2.0x		-10.2%	78.0%		Trailing growth negative due to SaaS transition+divestitures. Lexia growth in 20% range.
		RST upside to Avg EV/Sales:		***64.9%***					

- RST's own divestiture: sold Japanese division at ~1x EV/Sales, despite no scale (<$1mm in sales)
- LTG LN acquired NetDimensions at 2.1x sales ($52mm GBP deal)
  - February 2017; 85% gross margins; EBITDA breakeven (exactly)
  - <u>NetDimensions had -1% LTM y/y revenue growth at time of acquisition and was FCF negative</u>
    - Better comp for Consumer Language segment given flat/negative growth
- INST a March 2017 acquisition of minority stake in Nearpod Apps ("allows teachers to share interactive multimedia presentations to students") at 4.0x trailing revenue
- Permira PE fund acquired Renaissance Learning in October 2011
  - Student assessment software: Accelerated Reader
    - **AR holds a special place in my heart—I was #1 in Accelerated Reader contests in elementary school by a wide margin, crushing every other student to dust.*
  - Bidding war erupted and RLRN had another offer from Thoma Bravo + HarbourVest Partners PE consortium, but co-founders helped facilitate a deal to Permira by accepting a lower cash price on their shares, but allowing public shareholders to get same price as increased offer
    - Looks like Thoma Bravo+HarbourVest were going to use $400mm of debt financing on their ~$538mm proposed deal value, which would have been about **16x debt/EBITDA (Permira website claims cash EBITDA much higher than Bloomberg/sell side reports I am using. At Permira #s, leverage ratio would have been 7.7x).**
  - Permira first acquired block of shares from co-founders at $15.00 (70% of shares out), then tendered remaining public float at $16.60, effective deal value of $455mm
  - Valued at 3.25x 2011 revenue and 10.4x forward EBITDA estimates.
  - Consensus revenue growth at the time was just 5.7%
  - If you back out Renaissance's hardware sales, they only had $100mm of software sales (source: John Lewis, Osimum Capital).
  - Rennaissance software was at 38% EBITDA margin at $100mm of sales.
  - Notably, Permira has the deal case study on their website
    - Divested non-core assets + hardware business, made some acquisitions
    - Transitioned to pure SaaS model
    - Permira states growth accelerated in at least one core segment to 46% p.a. by developing relationship with Google Capital and a commercial relationship with Google in education

        - https://www.permira.com/news-views/news/google-capital-invests-in-renaissance-learning-1/
    - Grew EBITDA from $52mm to $91mm in three years
    - Sold to another PE firm, Hellman & Friedman for $1.1b in March 2014, and made 4x ROI. Google also co-invested in the 2nd sale.
        - 2nd time RLRN was acquired = 12x EBITDA
- Public co: Archipelago Learning (ARCL) acquired by Edmentum Holdings (was also previously public, ticker TUTR, and acquired by Thoma Bravo in 2010)
    - 3/5/2012
    - $324mm deal
    - 4.43x EV/Trailing Revenue
    - 15.90x EV/Trailing EBITDA
- Edmentum Holdings - education software pureplay– acquired by Thoma Bravo – 5/6/2010
    - Deal value 1.72x EV/trailing Revenue
    - >10x EBITDA ($13.5mm EBITDA, TEV of deal $139mm)
    - 57% gross margins, ~30% lower gross margins than RST overall
    - Slightly negative revenue growth in each of the three years prior to being acquired, massively negative organic growth before that from 2004 onwards (down >60% from peak 6 years prior)
    - 20% EBITDA margins
- Education Development Int. (EDD LN)
    - Acquired by Pearson, 3/7/2011, $103.3mm deal value
    - 3.51x EV/Trailing Revenue
    - ~3% revenue growth y/y in year acquired
    - 52% premium
    - 10.1x EV/Trailing EBITDA, ~34% EBITDA margins
    - 74% gross margins, ~10% lower than RST overall
    - Steadily negative revenue growth for 5 years in a row prior to buyout (revenue down by more than 60% from 2004 peak)

- Vista PE bought PowerSchool in June 2015 and has since rolled up another 8 companies for >$900mm combined.
    - https://www.powerschool.com/
    - https://www.edsurge.com/news/2017-02-02-powerschool-closes-deal-to-buy-sungard-s-k-12-enterprise-resource-planning-tools
- Most recent transaction of direct trading comp:
    - Cambium Learning (ABCD); Acquired at 4.6x sales but only 2% y/y revenue growth and much lower gross margin than Lexia; *NOT A SAAS PURE PLAY*: ~28% of ABCD's total revenue is printed materials; also ABCD was levered at ~1x turn of net debt/EBITDA, versus RST in a net cash position

<u>Trading Comps:</u>

RST Trading Comps

	Ticker	Company	EV ($ millions)	EV/Trailing Sales	EV/EBITDA	Revenue Growth	Gross Margins	EV/FCF	Notes
	LTG LN	Learning Technology Ltd.	$814.6	12.65x	51.6x	76.1%			organic growth 10% range
	INST	Instructure, Inc.	$1,130.0	5.8x		33.4%	70.6%		($44mm) EBITDA in '17, & ~ ($22mm) EBITDA '18, growth slowing to +32% in '18 and +26% forecast in '19
	BLKB	Blackbaud, Inc.	$5,353.0	4.6x	27.3x	10.0%	55.1%		Stock has recently fallen >40% and is still at 27x EBITDA
Average				**7.7x**	**39.5x**	**39.8%**	**62.9%**		
		RST	$345.2	2.0x		-10.2%	78.0%		Revenue growth negative due to SaaS transition+divestitures

- **All Global Application Software peers at current average of 6.1x trailing EV/Sales**
  - Education software Pure Play Peers:
    - **Learning Technology Ltd. (LTG LN); 9.3x trailing sales with just +11.8% consensus revenue growth in 2018, +10.8% consensus revenue growth in 2019 (note this is 2% lower than RST consensus consolidated top-line growth); 5% operating margins**
    - Instructure, Inc. (INST): 7.5x trailing sales/6.5x EV/fwd Sales, -$44mm EBITDA, 43% revenue growth, EV is $1.354 billion, 70% gross margins (much lower than RST)
      - ~15% less in total trailing sales than RST but 5.3x the EV
      - Revenue growth moderating to 31.6% in 2018 vs 2017 and +26% in 2019 vs 2018.
      - Continued negative EBITDA forecasted for at least the next two years

Other than Literacy (Lexia) segment, RST has three additional business segments:

- 1) **Corporate Language**: $38mm of LTM Billings, 28% of Language segment
  - Flat to down last several years, but decline has flattened in the last four quarters with introduction of Catalyst product in Q4 2016 to better differentiate corporate product offering (higher ARPU) from consumer offering.
  - E&E mix: 70% US, 30% Rest of World
- 2) **K-12 Language**: $27mm LTM billings, 20% of language segment
  - Subscription service to schools.
  - Rolling LTM Billings flat for 5 quarters in a row
  - Note this Segment will merge with Lexia
- #1+#2 reported together in same segment as **E&E Language** (Enterprise & Education)
- 3) **Consumer Language**:
  - $70mm of LTM Billings, 52% of Language segment
  - ~$52mm of ARR
  - Looks scary with casual glance as has shown rapid decline in revenue, investors may be incorrectly extrapolating downtrend in sales.
  - Reported Bookings include CD sales (called Product Sales), which rolled off entirely at end of Q4 2017, still declining.
  - Completed migration from perpetual license products, e.g. CD sales, where all revenue was recognized upfront, to subscriptions, recognized over time.
    - Total paying consumer language subscribers: ~447,000, up from ~204,000 in Q2 2015
    - Subscriptions broken out into:
      - Long-Term: 12 months or longer
        - Estimated ARPU: $7
          - Lower churn
      - Short-Term: < 12 months
        - Estimated ARPU: $13/month
        - Higher mix-shift to short term subscribers
      - Note mix shift is moving more towards shorter term subscriptions, which is a risk to our model and could add some variability
  - 30 languages

<u>Lexia Overview and Notes</u>

- Lexia was founded in 1982 with grants from *National Institute of Child Health & Human Development (NICHD)*
- *30+ year history of R&D and innovating products*
- Acquired by Rosetta Stone 7/25/2013
  - 4.75x trailing revenue at the time
  - $22.5mm deal price

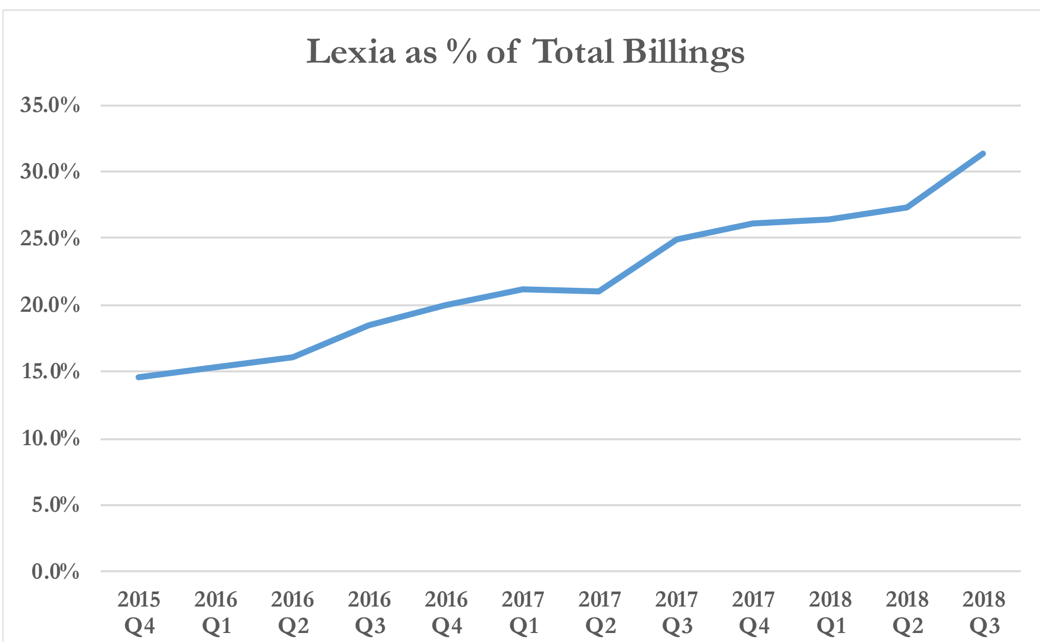
- Personalized and adaptive approach to literacy and scholastic assessment
- Teachers can easily interpret diagnostic reports and connect data on students directly to an individualized lesson plan
- Lexia serves 18,000 schools (25% penetration to target # of schools) and has 3.2mm student licenses
    - Compare to TAM of Literacy marketplace: 70k K-8 schools (100k total schools), 50mm+ US students in K-12, 35mm in K-8, thus Lexia market penetration is 9% of core K-8 market measured by # of students.
- National Center for Education Statistics says total curriculum spend is $460 billion, just software digital is $10.4b. Within this digital curriculum spend, $3.27 billion is for math and literacy content and $3.18 billion is for instructional support. This is the TAM for RST. This curriculum spend is growing at about a 3.8% rate p.a.
- Core Print and Supplemental Print spend is *declining 1-2% per annum*
- Infrastructure just now in place to adopt Lexia (i.e. schools have tablets/Chromebooks for each student)
- **Management claims they can go from $4k/year in revenue from a new school district in year one up to as high as $120k/year by year four. Sample progression of school district relationship and penetration potential:**
    - **Average school district has 10 elementary schools, 2 middle schools, 1 high school**
        - **Year 1: $4k in sales from small pilot of Core5**
        - **Year 2: $40k in sales from 4 unlimited use site licenses + some Implementation Services revenue**
        - **Year 3: ~$78k in sales from renewal of previous schools + four more elementary schools, + 1 PowerUp and RAPID pilot of 100 licenses at a single middle school**
        - **Year4: ~$120k in sales from all ten elementary schools on Core5, PowerUp and RAPID at 2 middle schools and 1 high school (30x increase over year 1)**
        - **Note we believe this is how management is able to forecast their projected growth with reasonable precision, as they are constantly rolling out larger implementations across districts**
- Annual customer retention rate at 93%. **Revenue retention rate was above 100% for the fifth quarter in row for Q3 2018.**
- National Center for Education Statistics claims ~2/3 of 8th graders in the US cannot read proficiently. A steady proportion for the last 25 years.
- RST cites 64% of 4th graders are non-proficient readers.
    - NAEP: National Assessment of Educational Progress: literacy proficiency and reading scores have been steady and terrible for decades.
- There are dozens of third party research reports and 9 peer-reviewed studies supporting Lexia's validity/efficacy claims. Lexia is proven to help close achievement gap that exist for low-income and African American/Hispanic students.
    - Across 210,000 students who have used Lexia, they say 56% started off the school year reading at least one grade level below where they should be and at the end of the year on Lexia program, that was improved to <10%.
- The supplemental digital education industry/Education-Tech (Ed-Tech) within Education sector is still highly fragmented and *NOT* dominated by the existing textbook oligopoly players (Pearson, McGraw Hill, Houghton Mifflin, Scholastic).
- Speaking with salespeople for competitors Renaissance (giant in the space) and ImagineLearning (niche reading player similar to Lexia), we get the impression Lexia and ImagineLearning are taking material market share.
- As part of the Every Student Succeeds Act (ESSA) passed by Obama administration in December 2015, school districts have more flexibility in how they allocate funds for ed-tech initiatives.
    - Additionally: $1.6b Student Support & Academic Enrichment grant
- Link to download report: National Education Technology Plan ("the flagship educational technology policy document for the US"): https://tech.ed.gov/netp/
    - Summary of some key highlights from the report that are relevant to Lexia:
        - #1 goal is **empowering learning through technolog**y
        - Educators shifting away from "one size fits all approach" - A focus will be given to **using tech to personalize learning** – one of the core strengths of Lexia
        - "sophisticated software" allows for **adaptive real-time assessment of each individual student**'s progress that comes **with personalized instructions/lesson plans** for the teacher—this pretty much nails what Lexia aims to do: Personalized, adaptive, data-driven (and patented) "assessments without testing."

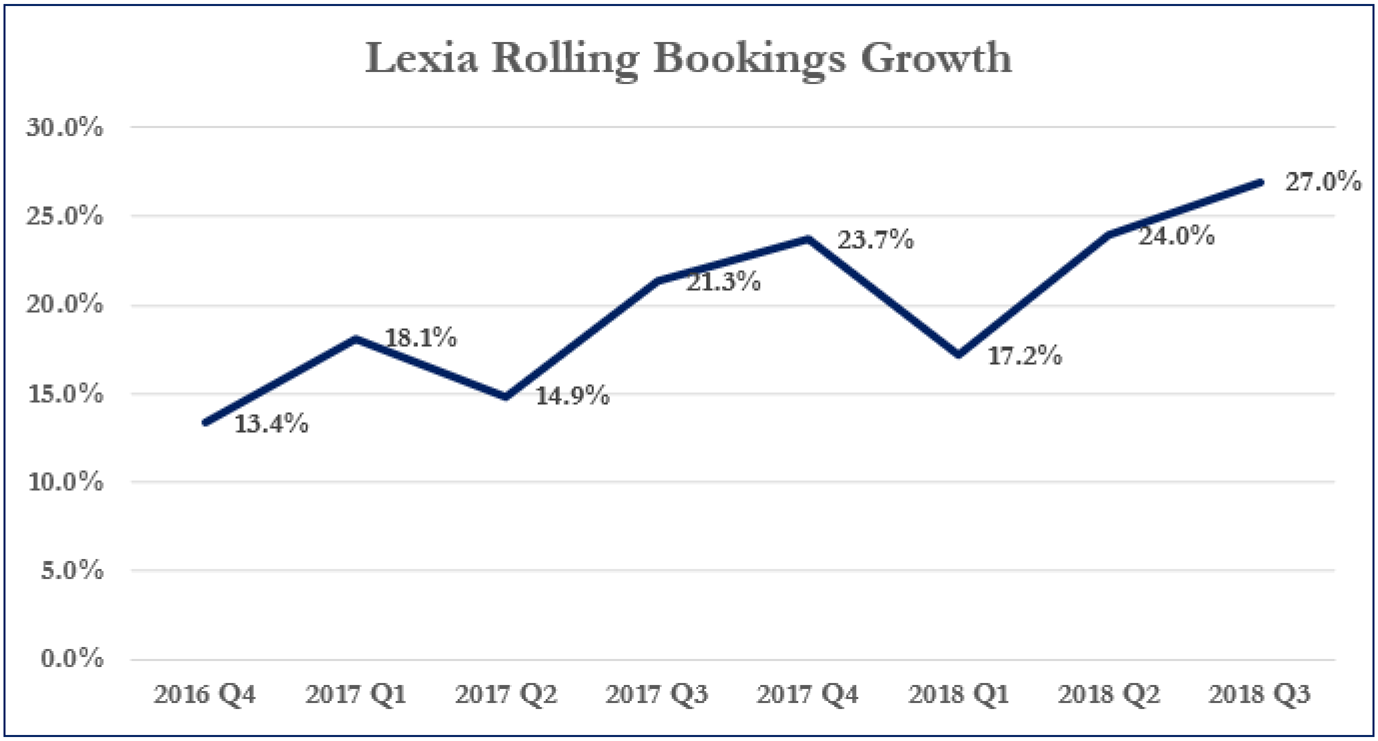
            - For Core5, assessment is incorporated throughout the content, there no pausing to take assessment. Dynamic feedback, student-by-student, and the teacher can monitor and receive suggested lesson plans to help students with their weaknesses.
        - Many school districts have been left behind "which underscores the need to **accelerate and scale up adoption of effective…technologies.**"
            - Side note: *Interestingly, the report also makes the case for Absolute Software's Educational segment and device management/endpoint visibility, as it frequently touches on the need for enhanced cybersecurity on school's investment into tech hardware.*
                - *https://www.absolute.com/en/solutions/education*
        - Fostering a "growth mindset" as part of a broader focus on non-cognitive development.
        - Aim to increase out-of-school learning, i.e. use learning software at home.
        - Increase the use of games and simulations
        - Buying patterns from school districts favor subscription based publishers based on annual funding stream/annual budgets, with high renewals likely to continue
- For Q4 2018, we estimate Lexia bookings will comprise 27.4% of RST total bookings.
- Pivoted to direct sales force (from resellers) in 2016 which was slow to ramp up and caused some disruption.
    - 71% of Lexia Bookings now from Direct sales, up from 29% in 2014
        - Claim going Direct creates deeper penetration and stronger relationship

- Lexia's main product is **Core5**
    - Typically cost ~$8,500/school for a year (average of 10 elementary schools per district)
        - May not be completely apples-to-apples, but Imagine Learning sales rep said they charged closer to $40k a year for their product. We believe Lexia is significantly cheaper and a better value proposition. It also may leave room for pricing increases over time.
    - Core5 curriculum aligns to common core standards and was designed to correlate with state standardized tests. Also correlates to Dynamic Indicators of Basic Early Literacy Skills (DIBELS) and Measurement of Academic Progress (MAP) assessments.
        - Source: https://www.lexialearning.com/products/core5/alignments-correlations
    - Core5 can be accessed through any web browser, iPhone, iPad, Android tablets
        - School districts typically using iPad or Google Chrome books to access
        - Source: https://www.lexialearning.com/why-lexia/mobile
    - Teachers/administrators access a different platform, myLexia, to access reports and tools

- Core5 targets six reading areas:
    - Phonological Awareness (Pre-K through kindergarten)
    - Phonics (Pre-K through second grade)
    - Structural Analysis (third grade through fifth grade)
    - Fluency (Pre-K through fifth grade)
    - Vocabulary (Pre-K through fifth grade)
    - Comprehension (Pre-K through fifth grade)
        - Source: https://www.lexialearning.com/products/core5/scope-sequence
- Core5 secondary aim is to develop cultural competence/awareness using a different international theme (different region of the world) for the program's 18 different levels.
- There are offline worksheets as part of the program, called Lexia Skill Builders.
    - Example: https://www.lexialearning.com/sites/default/files/resources/ProductDoc_Core5_Picturing_Stories_Sample.pdf
- Management claims Lexia sales force productivity is improving as they've matured.
    - We are unable to really quantify from data given to us
- Competing product to look into and research: ThinkCERCA – a literacy framework rooted in an online platform, helps students form critical thinking skills. Shows statistically significant results (equivalent of a "year worth of gains"
- Other Products: Strategies (6-12 market), ALP (6-12), RAPID Assessment (K-12 literacy assessment)

        - How do they further penetrate? Schools may start off with niche population, then deploy to full student population.
        - Lexia 2018 revenue growth guidance is 25% (Q4 earnings call) - $60mm of billings
- **Potential growth catalysts for 2018 and other potential growth drivers:**
    - Increase revenue/school, further penetrate existing customer base
    - New Lexia product *just launched* in January 2018
        - Lexia PowerUp focuses on literacy for grades six and above (adolescent reading- used to be called ALP before commercial launch?)
        - Commentary in Q3 call indicated confidence in growing "faster in 2019" was partly predicated on seeing good uplift and cross sell with Power Up.
        - This rounds out their pre-K-12 literacy offerings
        - Makes the merging of their Rosetta English Language product make even more sense
        - Now potentially a one-stop shop for school district administrators
        - If Lexia is liked and trusted at K-6 level, easy cross-selling opportunities exist for current install base. Should be similar with their English Language Product
    - Can increase international penetration into English speaking countries (from base of zero)
    - Maturation of their direct sales force (still quite new) and direct sales process (in total <2 years old, avg Lexia sales employee tenure is more like only ~1 year)
    - RAPID Assessment product is still relatively new (launched end of 2015).
        - https://www.lexialearning.com/products/rapid-assessment
    - Q: What % of customers currently utilize more than one product?
- Risks to Lexia segment:
        - Municipal and school budgets decline
        - Competition encroachment- Imagine Learning claims, per their sales rep, that they do "win back" some accounts from Lexia.
        - Potential cash burn if missing targets and no improvement in sales force efficiency (about breakeven now)
        - Longer than anticipated adoption cycle of new products, or lack of adoption and Lexia is more of a one-hit wonder with Core5
        - Larger percentage of revenue coming from Implementation Services vs. Recurring. This was larger in Q3 than we thought so bears monitoring. Implementation Services is actually a good leading indicator for new deal activity, but is much lower margin.





- *Note on Lexia Q3:* There was a large divergence between Annual Recurring Revenue and Sales. This was due to a large mix of implementation services revenue in the quarter of 17% of sales. Full year guidance is for implementation services revenue to be between 10-15% of Lexia total sales. We believe ARR growth will reaccelerate in 2019 to above 20%.
- Recent results from reader's choice awards in the *Journal of Reading Science:*

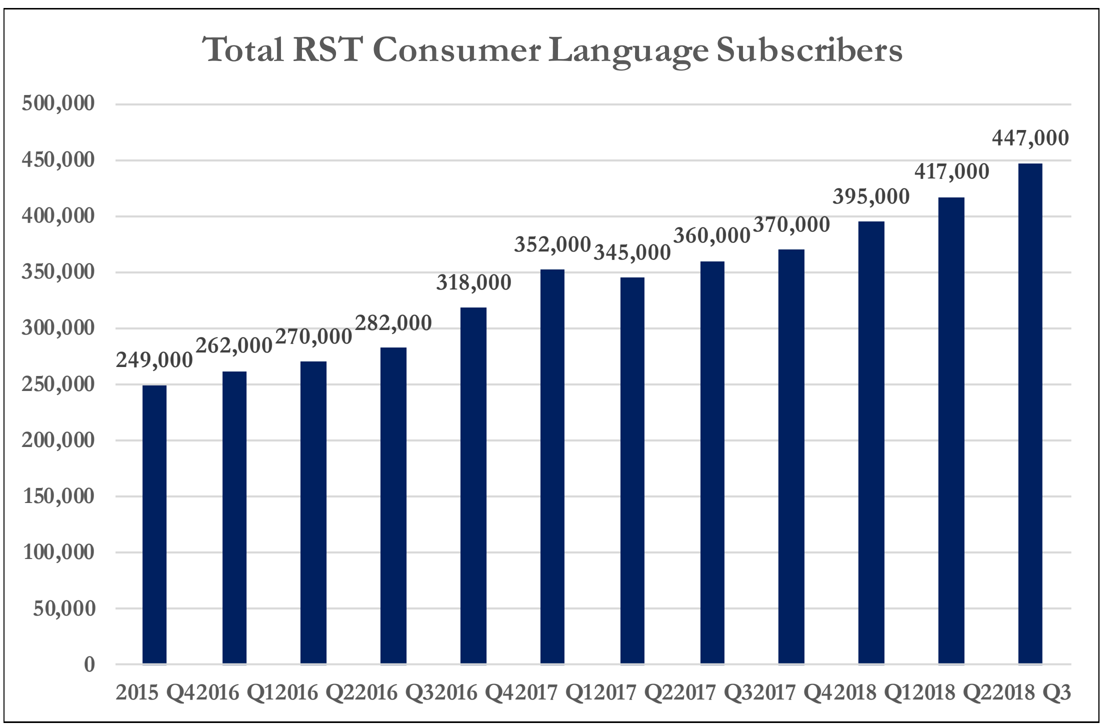
Rosetta Stone Language Segment Overview

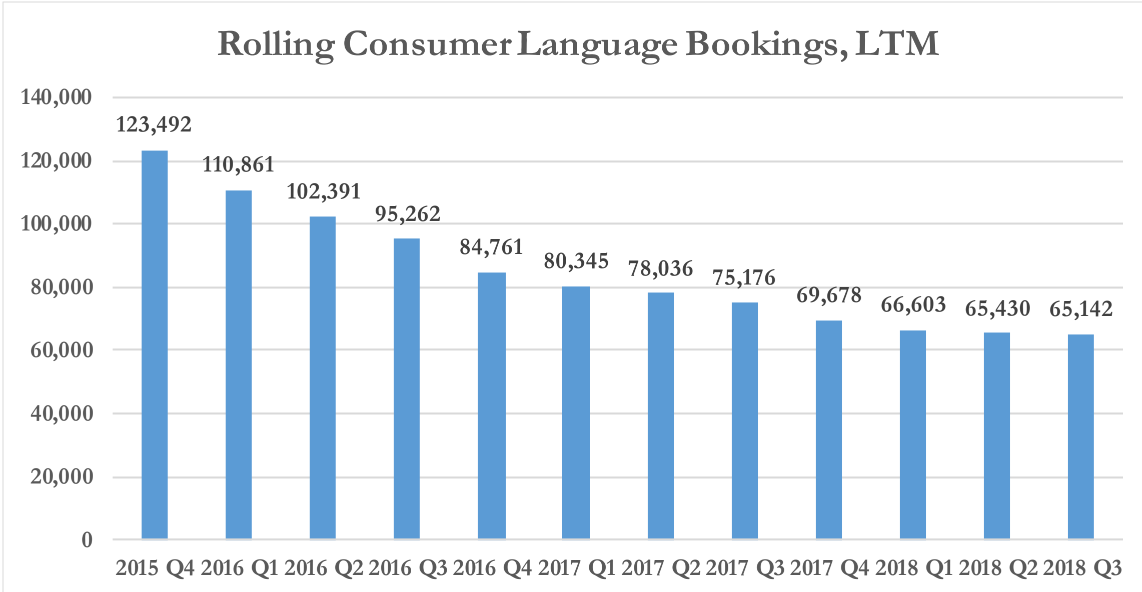
Consumer Language

- Near unanimous brand recognition among consumers

    - >$1.3b in sunk S&M dollars just since 2009, building the brand; S&M spend equates to 56% of cumulative revenue over same timeframe. Much more cumulative S&M spend if going back to 1992.
- **Transition to pure play SaaS improves consumer language revenue predictability going forward**
- They've modernized offering with "mobile first" development focus
    - I subscribe to RST Spanish and have used exclusively from my Android phone, never a PC or Tablet
    - App stores most important place for discovery and purchase
    - Array of subscription offerings is broadening the funnel and improving conversion
- ASP of CD sets in 2014 was $253, compared to $68-87 shorter term subscription ASP, but LTV of a customer is $187 on a "short term" subscription; we believe digital profitability should be higher over time given no need for inventory, distribution system, etc.
- Large opportunity for RST outside of the US in consumer marketplace as the rest-of-world TAM is >4x US TAM
- Looking to juice ARPU and monetize "live coaching" within existing customer base.
    - Wide range on pricing, anywhere from $10-50 per class.
- US based customers have accounted for >90% of Language bookings, but >80% of TAM is international/non-US
- English was only 17% of business, but >60% of TAM opportunity
- DTC channel is largest: call center (shrinking this as they lower off-line media spend), mobile app stores (~50% of purchases made on mobile via app store), web
- Consumer Language conversion funnel in 2016:
    - 22mm unique website visits >> 1.6mm web demos >> 0.9mm app downloads >> 460k product purchases
    - Their aim is to "broaden the base" – less monetary commitment for the consumer upfront than buying the full CD set, so they can potentially get more users to test out the product on a low cost subscription
    - DTC units sold are increasing while media spend continues to decline
- **Consumer language billings guide: $71mm for 2018**
- **Product revenue was down $10mm y/y in Q4 2017, but consumer language subscription was up $9.3mm**

Total Subscribers over time:





<u>**Company expects growth in in bookings in Q4, and in 2019.**</u>

<u>**Note we are extrapolating the recurring revenue by taking short term subscribers, assigning an ARPU, and long term subscribers and assigning an ARPU. This seems to line up reasonably well with reported Consumer Sales once we back out Product revenues and back out some longer term contracts from 2014-2017 where they are burning off some long term deferred revenue.**</u>

- In terms of the performance of the Consumer Language business, we have seen Rosetta Stone work its way steadily up the charts in the IOS App Store (source: AppAnnie) moving from the #11 Grossing Product - US Education in May to #2 in in September. At the same time, Babble has fallen from #10 to #13 and Duolingo has gone from #1 to #6.

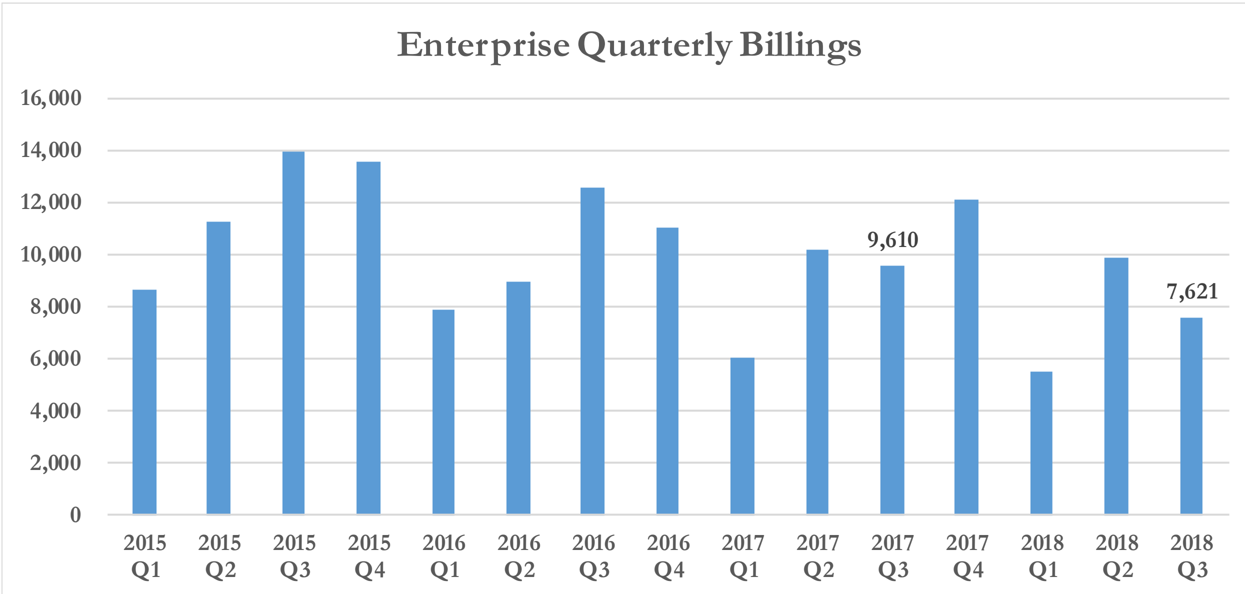
Language Comps

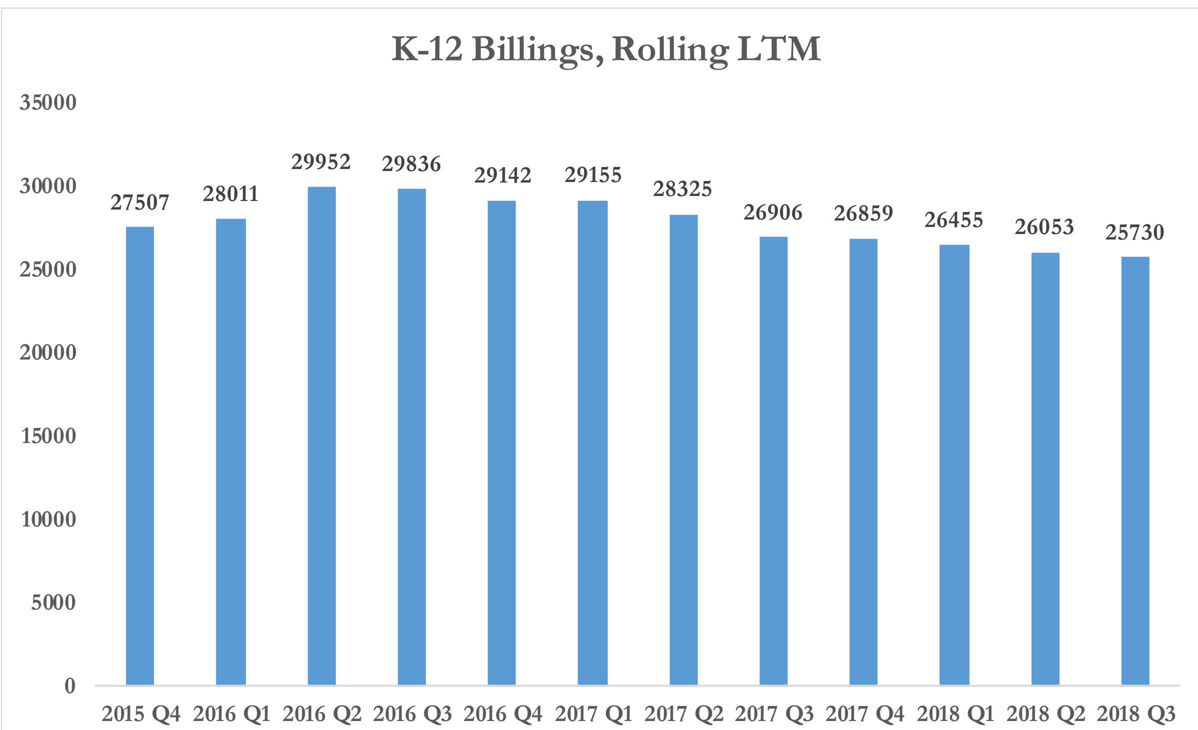
- Duolingo raised $25mm in July 2017 in a Series E funding, valuing them at $700 million at the time. As of that last capital raise they had only recently begun monetizing the user base with advertisements in the ap (ads introduced late 2016) and paid subscriptions as of April 2017. The company was "expecting to breakeven" by the end of 2017.
  - https://techcrunch.com/2017/04/21/duolingo-launches-paid-subscriptions-as-it-struggles-to-monetize-its-service/
- They are looking to have an IPO soon which will set a direct trading comp for the RST consumer language segment.
  - Duolingo has had $108mm of total funding
  - 25 million Monthly Active Users (MAUs)
  - 2017 estimated revenue = $13 million
  - 2018 projected revenue = $30-40 million
  - **Duolingo EV at July 2017 to 2018 estimated sales using $40 million = 17.5x (23.3x if 2018 revenue is at low end of projections).**
    - Duolingo revenue source: https://www.cnbc.com/2018/05/22/duolingo-2018-disruptor-50.html
  - Duolingo founder TED talk: https://www.ted.com/talks/luis_von_ahn_massive_scale_online_collaboration
  - Background on Duolingo: https://producthabits.com/duolingo-built-700-million-company-without-charging-users/
  - We believe Duolingo wants a valuation of $1 billion plus at IPO, valuing it at over 20x sales compared to the 1.5x we use for Rosetta, despite Rosetta consumer language having higher revenue overall and all of it being subscription based as opposed to largely advertising driven.
- **Biggest Risks to Consumer Language Segment and other Red Flags:**
  - Competition from and proliferation of FREE and "freemium" language learning apps, such as Duolingo.
    - Duolingo recently announced their apps will start showing ads so they can generate revenue.
      - Consumers can pay to not get ads and get additional features, namely Offline Mode.
        - Duolingo+ is $9.99 for 1 month, $7.99/month for 6 months, $6.99/month for 12 mos.
        - Compare to RST long term sub: $199 for 24 months, $8.29/month
    - RST is trying to position themselves as above free self-study competitors and go after more premium market, but is cheaper than the "collaborative learning" competitors that are scheduled online classes and cost 2-5x as much.
    - Additional competition for self-study market would be simple podcasts such as "Coffee Break Espanol", though is not the user base RST is going after as much.
    - There is still a large and growing paid digital language learning market size: $2.9b spent worldwide in 2016, forecasted to grow to $4.6b by 2020. *Most of this forecasted growth is coming from Asia*, with the US market being stable.
  - The company will not yet disclose the renewal/churn rate on short term subscriptions.
  - Mix shift or accelerated shift to short term subs would be a headwind.

Enterprise & Education Language Segment (E&E)

- Clearly most disappointing of three core businesses
- E&E TAM around $3.5b, growth driven by transition to online
- RST claims their brand recognition is 3x greater than next closest competitor
- Looking for partnership deals (economics?)
- Focus on improving renewal and retention rates
- Shifting E&E from Direct Sales to Resellers, currently only ~8% Reseller
- E&E Revenue: 70% US/30% roW
- 40% K-12/60% Enterprise customers
- Two acquisitions over last few years: Live Mocha and TellMeMore
- Product Portfolio breakdown: 1) Foundations – beginner content (most all K-12 customers fall here) 2) Advantage – Advance (occasional K-12 use) 3) Advanced English for Business (advanced + purely enterprise)

- Company is hoping Catalyst creates clearer distinction of E&E product set/value proposition versus consumer product
- 2018 E&E Language segment revenue guide: +2% y/y to $66 million





Note we believe around $10-$12 million of this English Language and thus this revenue will be in flux in 2020 (e.g. parts will be merged into Lexia, which could result in sales multiple arbitrage as it will be viewed as part of a faster growing business, e.g. Lexia gets a 5-6x sales multiple while we are giving E&E closer to 1.5-2x sales multiple)

Financial/Operational timeline

- 2015: Begin to pivot consumer to pure SaaS, reduce investment in kids reading line (Rosetta Stone product, $120 ASP), cut retail locations and partners by 50%, shift Lexia to direct sales force, sold Korean subsidiary
    - http://investors.rosettastone.com/phoenix.zhtml?c=228009&p=irol-newsArticle&ID=1803553
- 2016: Initiate E&E restructuring, which closed offices in France, China, Brazil (that came with acquisitions) and downsized all other offices
- Cut run-rate SG&A by $100mm+, but did not cut R&D really. R&D -22% in Language, but +75% in Lexia ('16/'14).
    - R&D spend for Lexia has been maintained at ~30% of revenue.
- Consolidated 2018 Revenue+Change in Deferred Revenue guide: $195-198mm
- Consolidated 2018 Revenue guide: $173mm

Shareholder Activism:

- Roumell Asset Management (1.8%)
    - Filed 13D with letter attached 6/22/15. Had owned 1.2mm shares, down to 400k now.
- Osmium Partners (8.84%)
    - CEO John Hass, came from Osmium Partners and became interim CEO April 2015, full time CEO and Chairman April 2016 through present.
        - Owns $6mm worth of stock, 2.07% of the company
        - Estimated cost basis is $14/share (still underwater)
        - http://www.prnewswire.com/news-releases/osmium-partners-four-point-action-plan-for-rosetta-stone-283180771.html
- David Nierenberg (Nierenberg Investment)
    - 3.5%, on the board

The Osmium plan originally included:

1) Doubling FCF margins
2) Focus the strategy (e.g. cut products and product initiatives)
3) Provide better business metrics to better track "efficiency" of divisions
4) Conduct an aggressive share repurchase via Dutch Tender

We believe since Osmium originally went activist they have supported all the changes John Hass has implemented, including more aggressive growth in Lexia which held up "doubling FCF margins" but has greatly increased underlying intrinsic value.

Miscellaneous

- Seasonality: Q1 is usually only ~15% of consumer sales
    - Q3 is and will continue to be the most important quarter as it's the school budgeting season. In fact, commentary from Hass is that Q2 was becoming less relevant and Q3 even more important
- RST has significant NOLs and will not pay cash taxes for many years
- Board: We would grade the board as A+.
    - David Nierenberg (Activist): should be helpful in push to get company sold in next 18 months
    - George Logue (recently added): former Cambium Learning co-founder, great resource in the space and just went through the process of having his own company sold
    - Jessie Woolley-Wilson (also recent addition): CEO of Dreambox, which is a Reed Hastings VC funded venture that is basically the Math equivalent of Lexia. Imagine Learning sales rep we spoke with said he "feared" that Dreambox and Lexia could merge and would be a powerful "one stop shop"
    - John Hass (CEO): selected by Osmium so should be aligned with getting company sold
    - Steve Yankovich
    - Laurence Franklin
    - Patrick Gross

Price targets and valuation sensitivity:

Base Case	2016	2017	2018	2019	2020	Multiple	Value	Per Share	
Language ARR	**101,468**	**97,224**	**102,500**	**100,000**	**101,500**	**1.74x**	**$ 177,000**	**$ 7.89**	
K-12	29,142	23,000	22,000	20,000	20,500	2.00x	$ 41,000	$ 1.83	
Enterprise	40,502	34,000	32,500	30,000	29,000	2.00x	$ 58,000	$ 2.59	
Consumer	31,824	40,224	48,000	50,000	52,000	1.50x	$ 78,000	$ 3.48	
Lexia ARR	**37,200**	**43,200**	**51,000**	**65,000**	**75,000**	**5.00x**	**$ 375,000**	**$ 16.72**	
Total ARR	**138,668**	**140,424**	**153,500**	**165,000**	**176,500**	**3.13x**	**$ 552,000**	**$ 24.62**	
Cash	36,195	42,964	41,000	55,000	80,000	1.00x	$ 80,000	$ 3.57	Upside
Growth		*1.3%*	*9.3%*	*7.5%*	*7.0%*			**$ 28.18**	68.1%

Bear Case	2016	2017	2018	2019	2020	Multiple	Value	Per Share	
Language ARR	**101,468**	**97,224**	**99,000**	**97,000**	**93,000**	**0.75x**	**$ 69,750**	**$ 3.11**	
K-12	29,142	23,000	21,000	20,000	18,000	0.75x	$ 13,500	$ 0.60	
Enterprise	40,502	34,000	32,000	29,000	27,000	0.75x	$ 20,250	$ 0.90	
Consumer	31,824	40,224	46,000	48,000	48,000	0.75x	$ 36,000	$ 1.61	
Lexia ARR	**37,200**	**43,200**	**49,000**	**55,000**	**60,000**	**2.50x**	**$ 150,000**	**$ 6.69**	
Total ARR	**138,668**	**140,424**	**148,000**	**152,000**	**153,000**	**1.44x**	**$ 219,750**	**$ 9.80**	
Cash	36,195	42,964	40,000	40,000	40,000	1.00x	$ 40,000	$ 1.78	Downside
Growth		*1.3%*	*5.4%*	*2.7%*	*0.7%*			**$ 11.58**	-30.9%

Bull Case	2016	2017	2018	2019	2020	Multiple	Value	Per Share	
Language ARR	**101,468**	**97,224**	**110,000**	**116,000**	**130,000**	**2.25x**	**$ 292,500**	**$ 13.04**	
K-12	29,142	23,000	24,000	25,000	26,000	2.00x	$ 52,000	$ 2.32	
Enterprise	40,502	34,000	35,000	36,000	39,000	2.00x	$ 78,000	$ 3.48	
Consumer	31,824	40,224	51,000	55,000	65,000	2.50x	$ 162,500	$ 7.25	
Lexia ARR	**37,200**	**43,200**	**56,160**	**73,008**	**91,260**	**6.00x**	**$ 547,560**	**$ 24.42**	
Total ARR	**138,668**	**140,424**	**166,160**	**189,008**	**221,260**	**3.80x**	**$ 840,060**	**$ 37.46**	
Cash	36,195	42,964	45,000	70,000	100,000	1.00x	$ 100,000	$ 4.46	Upside
Growth		*1.3%*	*18.3%*	*13.8%*	*17.1%*			**$ 41.92**	150.0%

	Bear Case	Base Case	Bull Case
Target Price	$ 11.58	$ 28.18	$ 41.92
Implied EV	$ 179,750	$ 472,000	$ 740,060
EV/Sales	1.2x	2.7x	3.3x
EV/Gross Profit	1.4x	3.1x	3.9x
EV/EBITDA	12.0x	17.0x	18.5x
EV/FCF	14.4x	15.7x	24.7x
~EBITDA	$15,000	$27,700	$40,000
~Gross Profit	$130,050	$150,025	$188,071
~FCF	$12,500	$30,000	$30,000

Competition:

1. ABC Music & Me (Kindermusik International) is an early childhood literacy and language curriculum that uses 30-minute lessons with music and movement to teach language, listening and social skills. It has been especially effective for students with autism in the Madison-Oneida Board of Cooperative Educational Services in Verona, N.Y., a state initiative that provides cost-effective, supplemental education programs. Students participate more using in-depth, music-based literacy curriculum than they do in general music classes, says Renee Worn, assistant director of special education.

2. Amplify ELA is a rigorous digital software curriculum that is native to the Common Core standards. It includes reading and writing tools that expose students to new vocabulary, dozens of immersive games, and an e-library with hundreds of titles. The software makes it easy for the teacher to initiate the learning objectives, see each student's work, and comment on it.
   - https://www.amplify.com/curriculum/amplifyela
3. The Fountas & Pinnell Leveled Literacy Intervention (Heinemann) is a small-group, supplementary program for the lowest-achieving K4 students. The program combines reading, writing and phonics lessons with language modeling to bring students to grade level in an average of 14 to 18 weeks.
4. iLit (Pearson), short for "inspire literacy," is a complete iPad program for struggling readers. It tracks progress, and includes a digital library, lessons with personalized support based on each learner's needs, and a built-in rewards system to motivate students.
5. Lexia Reading Core5 (Lexia Learning) covers the six areas of reading for pre-K to 5 students of all abilities. Students work on listening and reading comprehension activities, and get immediate feedback. Adaptive placement personalizes a learning plan for each student. Within the first month, teachers know a student's likelihood of meeting end-of-year, grade-level benchmarks, and are given resources to help at-risk students.
6. Literacy First (Catapult Learning) is a pre-K to 12 teaching and leadership framework that helps accelerate reading achievement. A Literacy First reading expert works with administrators and teachers to create a three-year strategy to boost student reading and writing success, and provides professional development and curriculum materials. More than 85 percent of Literacy First schools make Adequate Yearly Progress in the first year using the program, according to literacyfirst.com.
   - https://catapultlearning.com/professional-development-2/programs-professional-development/pedagogy-curriculum/literacy-first/
7. myON reader (Capstone) is an interactive digital library with more than 4,000 books for pre-K to 12. The program creates a profile for students based on their reading level and interests, and generates a recommended book list. In the St. Vrain Valley School District in Colorado, reading in and outside of school has skyrocketed thanks to myON, says Assistant Superintendent Regina Renaldi. Schools that have read the most have shown the most overall growth in test scores, she says.
   - https://www.edsurge.com/news/2017-02-21-capstone-sells-digital-reading-platform-myon-to-private-equity-firm
8. Reading Assistant (Scientific Learning) allows students to receive individualized reading coaching every time they use the software. Patented technology provides real-time corrective feedback via speech recognition, enabling students to self-correct as they are reading aloud.
   - https://www.scilearn.com/products/fast-forword/reading-assistant
9. The Reading Wonders (McGraw-Hill Education) program combines research-based instruction with interactive tools designed for the Common Core Reading/Language Arts standards. The program helps students find and use text evidence, and engage in collaborative conversations.
   - https://www.mheducation.com/prek-12/program/mcgraw-hill-reading-wonders-20142014/MKTSP-BGA01M02.html
10. SRA FLEX Literacy provides teachers with insight into student progress through use of the Lexile measurement system, a widely adopted measure of reader ability in text difficulty.
    - Launched February 2013
    - https://www.mheducation.com/prek-12/program/microsites/MKTSP-RBT01M0.html
11. http://lsg.freedomscientific.com/products/wynn.asp
12. https://www.kurzweiledu.com/default.html
13. http://www.readingrockets.org/article/reading-intervention-programs-comparative-chart

Lexia Core Competitors
Imagine Learning
Scientific Learning
Odyssey (Compass Learning)
Renaissance Learning
Houghton Mifflin Harcourt
Curriculum Associates
iStation

E&E Language Core Competitors
EF Language Live
Global English
Wall Street English (Pearson)
inlingua
Imagine Learning
Transparent Language
Duolingo
Middlebury Interactive Languages
Speexx

Consumer Language
Berlitz (Benesse Holdings)
Pimsleur (Simon & Schuster, part of CBS)
Living Language (Penguin Random House)
McGraw Hill Education
Duolingo
Fluenz
Busuu
Babbel (Lesson Nine GmbH)

Babbel:

Babbel app downloads are not growing while Rosetta Stone app downloads are growing quickly sequentially.

Mobile App Metrics by Apptopia

Overview

Downloads Last 30 Days	562,807	Monthly Download Growth	-8.36%

Babbel has 562,807 monthly app downloads. The most popular apps downloaded are Babbel – Learn Languages, Babbel – Learn English, and Babbel – Learn Spanish.

Global monthly usage overview for all apps (iOS & Android)

App Name	App Store	Monthly Downloads
Babbel – Learn Languages	Google Play	453,289
Babbel – Learn English	Google Play	51,047
Babbel – Learn Spanish	Google Play	24,835
Babbel – Learn French	Google Play	10,733
Babbel – Learn German	Google Play	10,023
Babbel – Learn Italian	Google Play	5,748
Babbel – Learn Russian	Google Play	2,560
Babbel – Learn Dutch	Google Play	2,025
Babbel – Learn Turkish	Google Play	1,308
Babbel – Learn Polish	Google Play	732

Babbel pricing:

+Babbel

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Spanish

1 month	Our bestseller 3 months	6 months	Best price 12 months
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Select	Select	Select	Select
$ 12.95 charged every month	$ 26.85 charged every 3 months	$ 44.70 charged every 6 months	$ 83.40 charged every 12 months

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