

This article by MOI Global instructor John Lewis is excerpted from a letter of [Osmium Partners](#), based in Greenbrae, California.

Rosetta Stone Inc.^[1], together with its subsidiaries, provides technology-based learning products in the United States and internationally. It operates through three segments, Enterprise & Education, Literacy and Consumer. The company develops, markets, and supports a suite of language-learning, literacy, and brain fitness solutions consisting of software products, Web-based software subscriptions, online and professional services, audio practice tools, and mobile applications. Rosetta Stone's current market capitalization is approximately \$361 million. The company generated \$192 million in sales for the LTM ending September 30th, 2017. (RST is a holding across all funds.)

Please see below for the transcript of the most recent earnings call where I spoke with CEO John Hass:

Osmium Partners, LLC

I mean, it's really -- So I guess first off, over the next basically 30 months, you're guiding to put \$80 million in cash on the balance sheet. And I think just looking deeper into the underlying value of these assets, we think they're radically undervalued. I mean -- I think we've looked at the peer group and for annual recurring revenue with businesses of better than 80% gross margins and 90% renewals traded 10x annual recurring revenue and Rosetta was at about 2.5x, and it certainly Lexia has an industry-leading growth rate. I think if you peel back the onion a little bit deeper, for 100% SaaS-based companies, they're 4x to 5x sales, we're 1.5x. And if you look at 12 public and privately disclosed transactions, they're all in the 4x to 8x -- 4 to 8 multiple of revenue. And so I think obviously, the space is weight hot late with KKR Vista, Google Capital, Union Square Ventures in the space. And I guess, my question here is, why not both aggressively repurchase stock. I mean, all of these metrics basically gets you to an \$800 million to \$1 billion valuation, and we've got around \$300 million market cap. So we feel wild discount between private market values and where you are in the public markets. And I think you and the team at Rosetta have just done a absolutely incredible job getting us to this spot. But we'd love to see capital return through buybacks and hopefully some attractive reinvestment bets. So I'm just curious, your thoughts there.

A. John Hass

Chairman, President & CEO

Yes, look, I think you have clearly highlighted the 2 opportunities that we have. To date, we have afforded ourselves the opportunity to invest significantly in our Literacy business, and I believe that's why we've been able to grow that business 350% in the 5 years it's been part of the company. And I think there will be opportunities to continue to invest in our K-12 business. I alluded to one in the call, which we'll talk about more at our Investor Day, which is this huge need to help English Language Learners in schools in the U.S., where -- which we serve. But I think there's some really neat things we can do and we're going to talk to you about that when we come together on November 6. I think with Matt's leadership and the team we now have in place language side, I think there's some really exciting investment opportunities as well to take advantage of the fact that we have 80% aided brand recognition in the U.S. How many companies can say that, let alone loan language learning companies? We talk a lot about some of our competitors in space, and we should, but there's nobody that can touch 80% aided brand recognition in the U.S. and we have pretty good brand recognition outside the U.S. as well. And so I view it as my job to have a dialogue with you as investors and will be a part of this at the Investor Day and talk about some of the investment opportunities we see on the business, but I also view it as our job to the extent that we are not able to fully invest that money in a way that will create value for all of us to over time return that capital to shareholders. Like, we are in a seasonal business, right? We're at \$20 million in cash. At the end of June that's going to start to grow. That \$80 million you mentioned, hopefully, \$25 million of that's going to come in the next 5 months. And so we have to be sensitive to that. But I'm a believer in this business and believe [indiscernible] what we can do with this. And again, my first goal is reinvestment, but if that opportunity doesn't start there, it is reinvest in the stock.

John Hartnett Lewis

Osmium Partners, LLC

I appreciate that. I think just to put a little finer line on it. I mean, I'm just going through my comp list. Renaissance went out -- Renaissance Learning went out at 4.2x sales. Archipelago go at 4.2x sales. Renaissance was resold to second at 5.3x sales. Vista bought Powerschool for 3.5x sales, and let's see, Vista also merged Powerschool and [Onyx] and its 7.5x sales earlier this year. They disclosed that publicly, had a \$3 billion valuation on \$400 million in revenue and so. And Duolingo just did around, I guess, 20x revenue, right? They disclosed \$40 million in revenue, \$800 million...

Thomas M. Pierno
Chief Financial Officer

As far as I know, it could be an infinite multiple of revenue.

John Hartnett Lewis
Osmium Partners, LLC

Yes, it's [indiscernible] I'm not complaining. I'm just really observing about just -- it's a wild discount to literally everything in existence. If you look in annual recurring revenue from public companies, M&A and especially recently M&A, I mean, it's just like 6 ZIP Codes out of -- and like you said, you have Lexia is blowing off the doors and the best consumer brand in the business. So I know you guys are doing a good job, I'll get off the soapbox, but I [indiscernible]

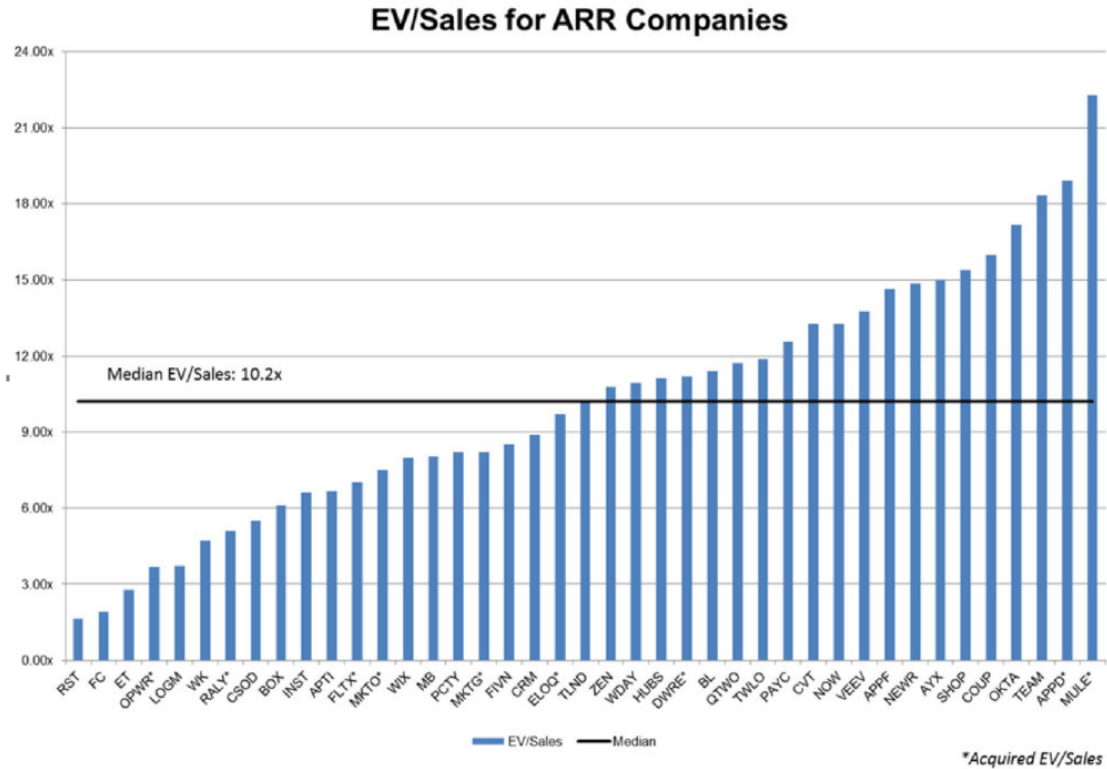
A. John Hass
Chairman, President & CEO

So here's the thing I would add, because I -- and I'm passionately agreeing with you. And which is why I'm really excited about investment opportunities when we have them, because if I can smartly impress, for example, in a K-12 that creates revenues, which can over time be capitalized not just at our multiple, but where our multiple should be over time, you have the -- that arbitrage, if you will, just to spend some product investment dollars to then feed into a terrific sales force with a growing footprint around the country and this is specific to K-12. I will love -- I would love to advantage of those opportunities, and we'll talk to you about some of those. And same whole story on the language side. I think we're in a much better position now than we have been in the past to begin to grow that business again with a smart, capable management team to I could think take it to much better places where we will be afforded those -- a much more appropriate multiple. We don't value ourselves, we appreciate you doing that, but we certainly believe there is a more appropriate multiple than where we are today.

We believe RST is growing intrinsic value in Lexia at about \$4.00 per share per year, and Lexia alone is worth \$12-13 per share in 2018. Our low-end, sum of the parts, distressed valuation now is \$24 (using 1x sales for Consumer, Enterprise, and K-12 Language, which is a -75-80% discount to M&A multiples). Using this valuation is not reasonable as Rosetta Stone Consumer brand is known by 80% of Americans (250 million people), Duolingo is doing rounds at 20x revenue or a \$800 million valuation with \$40 million in sales, Rosetta Stone grew subscribers 11% quarter over quarter to 417,000. Enterprise signed the largest deal in company history for 10,000 seats and \$1 million a year from a global Fortune 500 company.

Shown below are Annual Recurring Revenue business models (typically software) with usually 80%+ gross margins, 90%+ annual renewal rates, and typically substantial growth. At first glance, the valuations seem quite high, but given these are very sticky, high margin, high growth businesses we believe these valuations are not unreasonable.

We added FC as the company's All Access Pass has 85% gross margins and 90%+ annual renewal rates, with substantial growth. RST and FC are the two lowest valued businesses on our chart below.



Rosetta Stone continues to hire strong talent with the most recent hires from Amazon, Microsoft, Gartner group, and iTutorGroup. Jerry Huang was formerly the Global COO of iTutorGroup with a \$1 billion+ valuation, and recently joined Rosetta Stone to expand internationally. iTutorGroup had 25,000 tutors in 80 countries. Both the online tutoring and international expertise should really help RST. [\[link\]](#)

Rosetta's Seattle Office made some key hires and is growing very nicely^[2]:

- Christine Chambers, VP of Finance, joined Rosetta Stone from RealNetworks and also worked previously for the Bill & Melinda Gates Foundation.
- Roya Salehi, VP of literacy customer success has been an executive at education companies Achieve3000 and Kaplan;
- Greg Spils, VP of product for the language division, worked at Microsoft, Amazon, Rhapsody and Shazam before joining Rosetta Stone in March;
- Dan Holmes, senior VP of global sales and marketing, spent 14 years at research and consulting powerhouse Gartner.

^[1] Market price as of the date of dissemination of the letter

^[2] <https://www.geekwire.com/2018/beyond-yellow-box-rosetta-stone-reinventing-help-growing-seattle-office/>

Certain factual and statistical (both historical and projected) industry and market data and other information contained herein was obtained by Osmium Partners from independent, third-party sources that it deems to be reliable. However, Osmium Partners has not independently verified any of such data or other information, or the reasonableness of the assumptions upon which such data and other information was based, and there can be no assurance as to the accuracy of such data and other information. Further, many of the statements and assertions contained herein reflect the belief of Osmium Partners, which belief may be based in whole or in part on such data and other information. The information contained herein is provided for informational purposes only. This is not an offer to sell, or a solicitation to buy, limited partnership interests in Osmium. An investment in Osmium is not suitable for all investors. Graphs/charts are provided for illustrative purposes only and should not be relied on to form an investment decision. Stocks mentioned in the newsletter do not constitute a recommendation to buy or sell the individual securities.