

Update on Rosetta Stone

This article by Jim Roumell is excerpted from a letter of [Roumell Asset Management](#).

Rosetta Stone (RST) reported continued success in its turnaround efforts. On an overall basis, the company reported its 12th consecutive quarter of year-over-year expense reductions while the company's sales near being 100% subscription-based. For the full year 2017, the company generated over \$6 million in free cash flow compared to burning over \$11 million in 2016. In fact, the company met or exceeded all of its 2017 targets publicly articulated one year ago.

Lexia continued to be the star performer as revenue increased 23% year over year. The company increased this division's going forward growth rate to 25% to 30%. Consumer language's profit profile continues apace as the company's decision to pursue profitability over revenue pays dividends. E & E Language continues to underperform despite the company's expressed confidence in its new Catalyst offering, which was introduced roughly one year ago.

RST's turnaround success has not gone unnoticed by the general market. The company is a far simpler, more focused, subscription-based, leaner company than it was two years ago. Anchored with a first-class literacy product in Lexia, the company's language offerings are no longer the focus of most investors.

Clients are well aware that RST has been RAM's signature investment, and by far its largest position over the past 2.5 years. The stock has appreciated roughly 80% from our average purchase price during our holding period. As was typical for RAM, we were early with our initial investment, but steadily averaged down as our due diligence increased our confidence in the underlying investment thesis despite the market "throwing in the towel" after having lost patience in the company based on headline language revenue declines.

At the stock's lows of sub-\$7/share, RAM's position reached 10% of our AUM as our conviction that Lexia, plus the company's net cash, more or less covered the company's market capitalization giving us access to own the company's two, albeit struggling, language businesses for next to nothing prices. Our strong belief is that our largest positions should not be the ones with the greatest upside, but rather the investments with the least downside. Although we did not know what the ultimate upside was going to be for RST, dependent as it was on a turnaround, we were quite confident that the company's "scrap value" provided significant downside protection. It's a true and persistent investment play for RAM - identify nascent high-conviction assets hidden within a company's borders while the market reacts to struggling higher-profile legacy assets, held within a conservatively financed balance sheet, and be patient. We believe great investing involves sourcing free options. We are always in pursuit of finding free "stuff," often hidden in the basements and attics of companies. RST was a classic free option investment narrative in our opinion.

The leadership of John Hass in ushering in RST's successful turnaround cannot be overstated in providing the company its operational north star, making the tough decisions, and holding people accountable. John was supported by a strong Board. It should also be pointed out that John's predecessor, Steve Swad, deserves great credit for having made the Lexia acquisition in 2014.

RST is now officially on lots of investment screens and attracting the attention of long-term focused growth investors. That's the way it's supposed to go as one group of investors hands off to the next

group – deep value, to value, to growth at a reasonable price, to speculative growth.