Siena Market Line
3rd week of March 2016

Rosetta Stone, Inc.

NYSE: RST

Analyst: Michael Post
Sector: Software

BUY

Price Target: $11.27

Key Statistics as of 3/11/2016

Market Price:	$7.42
Industry:	Educational Software
Market Cap:	$163M
52-Week Range:	$6.17-9.19
Beta:	1.0

Thesis Points:

- RST is undergoing a major operational shift towards a more efficient and profitable form of business
- RST is capitalizing on the ongoing benefits of reoccurring revenue
- RST has 139.4 Million in deferred revenue and plans to recognize 102.7 million of it over the next 12 months (63% of Current Market Cap)

Company Description:

Rosetta Stone, founded in 1992 and headquartered in Virginia, provides technology-based learning products in the United States and internationally. It operates through three segments: North America Consumer, Rest of World Consumer, and Global Enterprise & Education. The company develops, markets, and supports a suite of language-learning and kids literacy solutions consisting of software products, web-based software subscriptions, online and professional services, audio practice tools, digital downloads, and perpetual CD packages. It also provides brain fitness solutions to enhance memory, concentration, thinking, and problem-solving skills using brain training exercises. Rosetta Stone offers its courses in 30 languages under the following brands: The Blue Stone Logo, Lexia Learning, and Lexia. Rosetta Stone Inc. sells its products and services through call centers, websites, third party e-commerce Websites, home shopping networks, consignment distributors, select retail resellers, daily deal partners, and third-party resellers, as well as directly to individuals, educational institutions, corporations, and government agencies.

Thesis

Rosetta Stone is widely recognized today as the industry leader in providing effective language programs. Rosetta Stone is also a leader in the literacy education space, helping a growing number of millions of students build fundamental reading skills through its Lexia Learning division. Currently, Rosetta Stone is in the process of a major operational shift that will lead to substantially higher margins, reduced operational costs, and will result in a bottom line profitable company. This operational shift began when Rosetta Stone recognized why its consumer segment, the largest component of its business, has created huge losses over the past 4 years. As a result of this discovery, Rosetta Stone developed a new strategy that fosters growth with higher margins in a different business segment for the future of the company. This new strategy takes advantage of a subscription based pricing model that enables reoccurring revenue from repeat customers in the education market. By itself, this new pricing model helps Rosetta Stone establish a more reliable revenue stream and also lightens the need for excessive marketing. At this stage in the business transition, the new strategy is about to take over as the major component of the business and will bring a lot of additional value to Rosetta Stone. Coinciding with this successful business transition, Rosetta Stone has 139.4 million in deferred revenue and 102.7 million of that will be recognized in the next 12 months. This appears to be a major catalyst as 102.7 million dollars represents an additional 63% of the current 163 million market cap. As this revenue is recognized over the next 4 quarters it will boost total revenues and compensate for the declining consumer segment that Rosetta Stone is phasing out of.

Old Business Model

Since inception, Rosetta Stone has strategized ways to grow its business in the consumer segment market. This business entails finding individual consumers that are willing and wanting to purchase Rosetta Stone's expensive learning software products as a one time expense for the educational experience. Once found, Rosetta Stone is then responsible for the production and packaging of its products in the form of CD's. These CD's are then shipped to each customer and that process all together is added up into costs of goods sold. In the earlier years of operations, Rosetta Stone was a new and very popular idea that experienced a rapid organic growth in sales as a result. Over time, these organic sales began diminishing as initial excitement faded and Rosetta stone was forced to rely heavily on its marketing in order to maintain a high level of sales. At a certain point, in 2011, the associated marketing expenses required to maintain a positive growth in sales along with the high costs of goods sold, forced Rosetta Stone to have negative net income. This negative net income continued for the next 4 years as operational expenses surpassed revenue every year. Rosetta Stone's old business model turned out to be obsolete and only effective during a short period of natural sales growth.

New Business Model

By 2012, Rosetta Stone discovered that its old business model had become obsolete and was no longer profitable. In order to prevent the eventual bankruptcy that would result if no changes were made, Rosetta Stone planned to change its operational strategy entirely. The first major change was shifting its products physical form of a CD to a virtual one that could be downloaded from the internet cloud from anywhere. This would remove the majority of costs of goods sold by eliminating the production, packaging, and shipping costs that all used to be associated with a single sale. Rosetta Stone then planned to change its pricing model from a one time purchase item to a subscription based pricing strategy. This would allow customer to subscribe for limited time use of their products and then re-subscribe if the products were proving affective and they wanted to continue. This pricing strategy was estimated to be much more advantageous for Rosetta Stone because of reoccurring revenue reasons and was also very effective because its products were proven to work. Customers would spend a month learning a language, and then want to re-subscribe for additional time with Rosetta Stone software for additional language learning. With this operational change, Rosetta Stone also determined that a more applicable market for this business strategy was the education system. Schools would subscribe for the school year and re-subscribe every year thereafter for their language education programs. With that in mind, Rosetta Stone began shifting its business focus to the education segment and subscription revenue. 4 year later, in 2015, subscription revenue passed product revenue for the first time in Rosetta Stone's history. This is a major moment for Rosetta Stone because its higher margin business segment is now taking over the majority of the company.

Current Business Model Status

Currently, Rosetta Stone has just reached the half way point of its operational transition process and is about to become a new company driven by new financial success. The consumer segment of Rosetta Stones business, previously the controlling factor that was plagued by high costs of goods sold and the need to sustain continuous excessive marketing, has been phased down since 2009 and as of 2015 represents less than half of the overall business. The outline below shows consumer segment revenue and its overall relation to the revenue of the entire company.

Year	2009	2010	2011	2012	2013	2014
Consumer Rev	218.5	215.6	195.4	180.9	156.8	136.3
% of Total Rev	87%	83%	73%	66%	59%	52%

As of quarter 3, 2015, consumer segment revenue has fallen to less than 48% of the overall business and experienced and accelerated 40% revenue decline. On a positive note, profit margin for the consumer segment has increased by 50% y-o-y in 2015 as a result of a 31% decline in sales and marketing expense. This increased margin and revenue decease can be attributed to the decreased need for spending on marketing efforts in the consumer segment. Going forward, reduced cost in sales and marketing can be considered normal as the education segment requires a lot less excessive marketing to penetrate. The outline below highlights the growth of subscription revenue and compares it to the overall revenue of the entire company.

Year	2009	2010	2011	2012	2013	2014
Subscription Rev	33.7	43.3	73.1	92.3	107.9	125.6
% of Total Rev	13%	17%	27%	34%	41%	48%

As of quarter 3, 2015, subscription revenue in the education segment has grown to become over 52% of the overall business. This is a major moment for Rosetta Stone because the education segment has higher margins and is now the controlling factor of the company. At this point, continued growth in this market will begin to have a much stronger effect on the bottom line for the overall company. Investors can expect Rosetta Stone to return to a profitably state in the near future.

Subscription Revenue Growth

The main product driving education and subscription growth for Rosetta Stone is Lexia. Lexia is a language learning software primarily for the K5 literacy segment and has been gaining traction in recent months. Lexia has over a 90% retention rate meaning 90% of schools that have tried Lexia remain long term customers in following school years. Lexia's booking grew by over 70% y-o-y comparing 3rd quarters and totaled roughly 30 million in 2015. Projections are for booking to exceed 100 million in the next 4 years and management believes this is easily achievable. Lexia's revenue increased by 103% q3 compared to a year ago and is estimated to total 21 million in 2015. Though very successful thus far, Lexia still has a very large market to expand in and still a tremendous amount of growth to achieve. Aside from Lexia, Rosetta Stones other products in the educational subscription segment are also experiencing good growth as can be seen by the overall growing subscription revenue. Revenue in this particular segment for these products were up about 12% and are also projected to continue to have high growth success along with Lexia.

Conclusion

Rosetta Stone has just passed the half way point in its operational transition process, and is soon to become a profitable company with growth in sales in higher margin segments. Operational expenses are going to continue to decline as the consumer segment is phased out of the business entirely, and a leaner and financially stronger Rosetta Stone will result. The new controlling business segment, electronic education, will allow Rosetta Stone to achieve all of its plans in changing operations. Products will soon only be downloaded removing a lot of overhead and will only be offered through subscription services allowing for much more dependable revenue streams. At this point going forward, Rosetta Stone is now controlled by this new segment they have chosen to take on as the company's future and will be redefined by the success of this business. With this in mind, I rate Rosetta Stone a strong buy with a 1 year price target of $11.27, representing over a 50% upside. As Rosetta Stone continues to successfully transition its business as planned, I foresee it becoming a cash cow in a reliable market with higher margins of upwards 30%. Therefore, I give Rosetta Stone this 1 year price target but suggest holding for multiple years thereafter. Rosetta Stone is a buy with a long term investment horizon.

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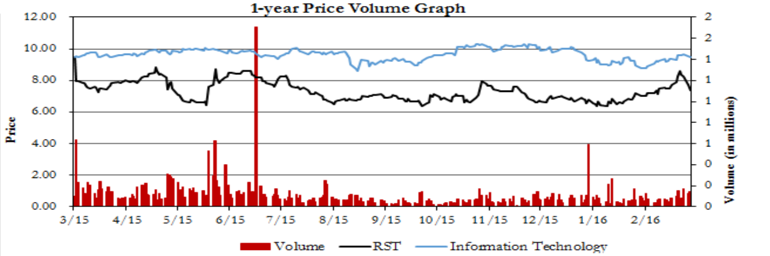
Rosetta Stone, Inc. (RST) | **BULLISH**

Analysis by Michael Post	Current Price:	$7.42	Intrinsic Value	$7.69	Target 1 year Return: 51.93%
3/11/2016	Divident Yield:	0.0%	Target Price	$11.27	Probability of Price Increase: 98%

1-year Price Volume Graph



Description

Rosetta Stone Inc., together with its subsidiaries, provides technology-based learning products in the United States and internationally.

General Information

Sector	Information Technology
Industry	Software
Last Guidance	November 3, 2015
Next earnings date	March 14, 2016
Estimated Country Risk Premium	7.92%
Effective Tax rate	38%
Effective Operating Tax rate	42%

Market Data

Market Capitalization	$161.73
Daily volume (mil)	0.04
Shares outstanding (mil)	21.80
Diluted shares outstanding (mil)	21.45
% shares held by institutions	48%
% shares held by investments Managers	36%
% shares held by hedge funds	33%
% shares held by insiders	3.91%
Short interest	2.46%
Days to cover short interest	5.96
52 week high	$9.19
52-week low	$6.17
Levered Beta	1.09
Volatility	42.31%

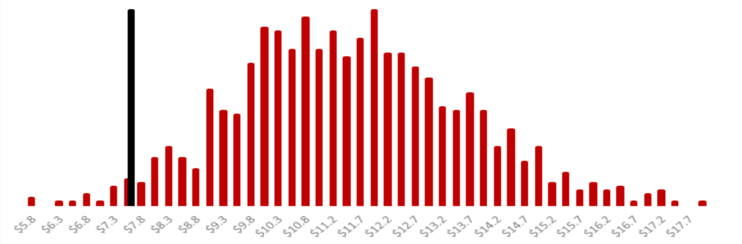
Past Earning Surprises

Quarter ending	Revenue	EBITDA
9/30/2014	-6.48%	-316.64%
12/31/2014	-2.55%	-146.58%
3/31/2015	32.58%	-181.47%
6/30/2015	13.91%	-120.30%
9/30/2015	-3.48%	-179.71%
Mean	6.80%	-188.94%
Standard error	7.4%	33.9%

Peers

K12, Inc.
DeVry Education Group Inc.
Apollo Education Group, Inc.

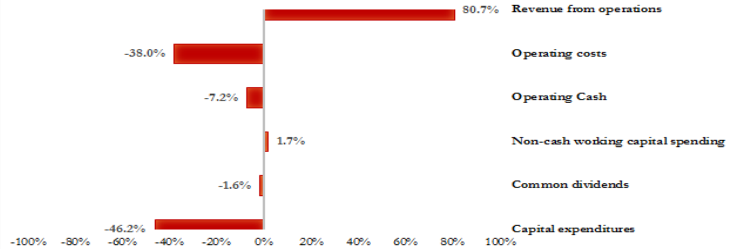
Target Price Distribution--Prob(Price Increase)= 98%



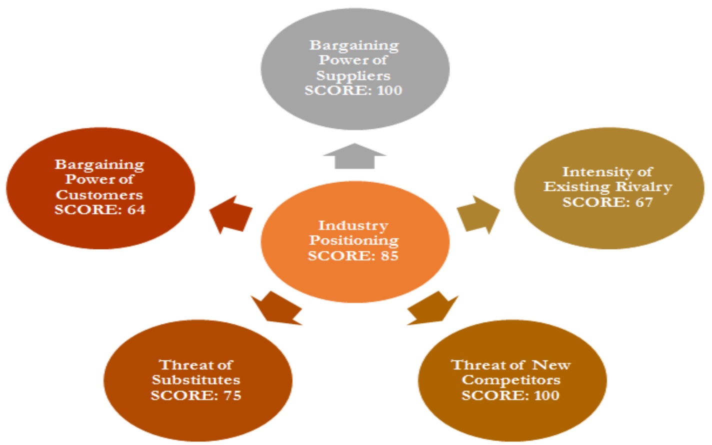
Management	Position	Total compensations growth	Total return to shareholders
Hass, Arthur	Interim Chief Executive Offi	N/M	0% per annum over 0y
Pierno, Thomas	Chief Financial Officer	20.81% per annum over 2y	-11.07% per annum over 2y
Verses, Judy	President of Global Enterpri	-3.22% per annum over 3y	12.88% per annum over 3y
Swad, Stephen	Adviser	-12.57% per annum over 4y	-20.18% per annum over 4y
Hartford, M.	Controller, and Principal Ac	N/M	N/M
Cudd, Sonia	General Counsel and Corporat	N/M	N/M

Profitability	RST (LTM)	RST (5 years historical average)	Industry (LTM)
ROIC	-4.5%	5.71%	11.53%
NOPAT Margin	-4%	1.49%	13.4%
Revenue/Invested Capital	1.26	3.84	0.86
ROE	-5.5%	-2.91%	12.51%
Adjusted net margin	-4%	1.40%	12.0%
Revenue/Adjusted Book Value	1.47	-2.08	1.04
Invested Funds	**RST (LTM)**	**RST (5 years historical average)**	**Industry (LTM)**
Total Cash/Total Capital	19.6%	45.2%	46%
Estimated Operating Cash/Total Capital	19.6%	26.6%	N/A
Non-cash working Capital/Total Capital	-57.1%	-29.4%	-21%
Invested Capital/Total Capital	100.3%	81.6%	63%
Capital Structure	**RST (LTM)**	**RST (5 years historical average)**	**Industry (LTM)**
Total Debt/Common Equity (LTM)	0.20	0.15	0.11
Cost of Existing Debt	2.19%	1.67%	3.81%
Estimated Cost of new Borrowing	1.38%	0.83%	3.81%
CGFS Risk Rating	2.19%	#DIV/0!	CC
Unlevered Beta (LTM)	9.99%	0.92	1.18
WACC	2.19%	8.66%	12.01%

Sensitivity Analysis



Porter's 5 forces (scores are out of 100)



Valuation

Period	Revenue growth	NOPAT margin	ROIC/WACC
Base Year	-8.2%	-3.6%	-0.45
9/30/2016	-1.0%	3.0%	0.40
9/30/2017	2.0%	4.5%	0.42
9/30/2018	2.0%	7.5%	0.59
9/30/2019	4.0%	9.3%	0.71
9/30/2020	4.0%	10.4%	0.77
9/30/2021	5.0%	12.3%	0.88
9/30/2022	4.0%	14.7%	1.03
9/30/2023	3.0%	15.9%	1.09
9/30/2024	3.0%	16.5%	1.12
9/30/2025	3.0%	16.4%	1.11
Continuing Period	3.0%	16.4%	1.11

Period	Invested Capital	Net Claims	Price per share
Base Year	$163.96	$34.03	$6.03
9/30/2016	$86.78	$36.98	$10.06
9/30/2017	$214.49	$34.90	$13.16
9/30/2018	$167.66	$2.65	$16.42
9/30/2019	$189.85	-$31.60	$19.75
9/30/2020	$175.82	-$68.79	$23.13
9/30/2021	$256.06	-$110.91	$26.55
9/30/2022	$305.86	-$160.25	$30.00
9/30/2023	$329.85	-$216.39	$33.43
9/30/2024	$354.77	-$274.42	$36.83
9/30/2025	$377.81	-$333.65	$40.20
Continuing Period			