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Rosetta Stone: Pricing the 2009 IPO

We are changing the way the world learns languages.

—Tom Adams

It was mid-April 2009. Tom Adams, president and CEO of Rosetta Stone, Inc. (Rosetta Stone), the language learning software company, reached for his iPhone to contact Phil Clough of private equity fund ABS Capital. Adams and Clough had been discussing plans to take Rosetta Stone public for some time. The wait was finally over.

In the wake of the 2008 financial crisis, the market for initial public offerings (IPOs) evaporated. By early spring the market was showing its first encouraging signs. Just a week prior, Chinese online videogame developer Changyou.com had listed on the NASDAQ at a price to EBITDA of 6.5 times followed by a one-day jump of 25%, and the online college Bridgeport Education was currently circulating its plans to go public at a range of 10 to 12 times EBITDA.

Having received preliminary approval of its registration filings with the U.S. Securities and Exchange Commission (SEC), Rosetta Stone was authorized to sell 6.25 million shares, a 30% stake in the company. **Exhibits 1** and **2** provide financial statements from Rosetta Stone's IPO prospectus, required by the SEC to inform investors about the details of the equity offering. Half of the shares were to be new shares and the other half were shares to be sold by existing shareholders. Rosetta Stone management had circulated an estimated price range of $15 to $17 per share, representing a price to EBITDA of about 8 times. Demand for the shares was strong, and some analysts believed that Rosetta Stone was leaving money on the table. Yet with world financial and product markets still in turmoil, there was a strong case to be made for prudence.

Economic Conditions

The previous year had been a dramatic one for the world economy. Prices on global credit and equity markets had been in free fall. The U.S. equity market was down more than 50% from its peak in October 2007 (see **Exhibit 3** for details of the recent price history of U.S. equity market returns in total and for select industries). The collapse of world financial markets had preceded deterioration in economic activity worldwide, including dramatic shifts in real estate values, unemployment levels, and discretionary consumer spending. The severity of economic conditions had prompted massive intervention by world governments with dramatic policy changes, particularly by the U.S. federal government. The economic and political conditions were frequently compared with those of the Great Depression of the 1930s. With the crisis in full swing, investors had flocked to U.S. Treasuries for security, pushing down yields on these instruments to historic lows (see **Exhibit 4**). Heightened investor risk aversion had expanded the risk premium for all securities. The general market risk premium was currently estimated at 6.5% or 8.5%, respectively, depending on whether long-term or short-term government yields were used in estimating the risk-free rate.

In February and March of 2009, there had been some evidence of improvement in financial and economic conditions. Wholesale inventories were in decline. New-home sales were beginning to rise. The equity market had experienced a rally of more than 20% in recent weeks. Yet many money managers and analysts worried that such economic green shoots were only a temporary rally in a longer-running bear market. There was strong concern that the magnitude of government spending would spur inflation in the U.S. dollar. GDP growth was still negative, corporate bankruptcy rates and unemployment were at historic highs, and many believed the economic void was just too big for a quick recovery to be feasible. A *Wall Street Journal* survey of U.S. economists suggested that the economy was expected to generate positive growth in the last half of 2009.[1] In contrast, a survey of U.S. corporate executives stated that less than one-third of respondents expected to see an economic upturn in 2009.[2] The debate regarding the economic future of the world economy raged on.

Rosetta Stone

In the 1980s, Allen Stoltzfus, an economics professor, real estate agent, and history buff, was frustrated with his slow progress in mastering the Russian language. He was enrolled in a conventional classroom Russian course but found it much less effective than the process he had used to learn German while living in Germany years before. Seeking to produce a more natural language learning method, Stoltzfus envisioned using computer technology to simulate the way people learn their native language—with pictures and sounds in context. Rather than learning the language by translating one language to another, his approach would be to use electronic technology to encourage people to think in the target language from the beginning. He sought the aid of his brother-in-law, John Fairfield, who had received graduate training in computer science. Together they explored the concept of how a computer could be made to facilitate language learning. Stoltzfus and Fairfield founded Fairfield Language Technologies in Harrisonburg, Virginia, in 1992. The emergence of CD-ROM technology in the 1990s made the project feasible. The company released its first retail language training software product in 1999 under the name Rosetta Stone.[3]

The Rosetta Stone series of CD-ROMs provided users an effective way of learning new languages. The software utilized a combination of images, text, and sound to teach various vocabulary terms and grammatical functions intuitively by matching images with the spoken word. Following the way children learn their first language, the company called this method of teaching languages the *Dynamic Immersion* method: "dynamic" because digital technology and the teaching method powerfully engaged the learner in an interactive learning process, and "immersion" because learners anywhere, from any language background, started at the very beginning and studied exclusively in the target language. A recent research study provided scientific evidence that the language test scores of students that completed 55 hours of Rosetta Stone training performed comparably to those who had completed an entire semester of a good quality college language course.[4] Rosetta Stone users were broadly satisfied with the experience and regularly recommended the software to others.

[1] Phil Izzo, "Obama, Geithner Get Low Grades from Economists," *Wall Street Journal*, March 11, 2009.
[2] "Economic Conditions Snapshot, March 2009: McKinsey Global Survey Results," *McKinsey Quarterly,* March 2009.
[3] The name *Rosetta Stone* referred to a black basalt tablet discovered in 1799 by a French engineer in Napoleon's army near the Egyptian town of Rosetta. The tablet contained an inscription of a single text in three languages—two Egyptian scripts (hieroglyphic and demotic) and ancient Greek—thus enabling 19th century scholars to decipher Egyptian scripts conclusively for the first time.
[4] Roumen Vesselinov, "Measuring the Effectiveness of Rosetta Stone," working paper, City University of New York, January 2009.

After focusing initially on school and government sales, the company began aggressively pursuing the retail market in 2001. Following the death of Stoltzfus in 2002, the company hired an outsider, 31-year-old Tom Adams, as chief executive. Adams brought an international dimension to the small-town, rural company: A native of Sweden who had grown up in England and France, he was fluent in Swedish, English, and French. He had studied history at Bristol University in the UK and had earned an MBA from INSEAD in France. Prior to arriving in Harrisonburg, Adams had been a commodity merchant in Europe and China.

Adams got right to work by entering new markets and scaling up the current business; from 2004 to 2005, the revenues of the company nearly doubled, from $25 million to $48 million. Acknowledging the need for capital and professional support as the company expanded, Adams solicited a capital infusion from the private equity market. In 2006, two firms, ABS Capital Partners and Norwest Equity Partners, made major equity investments in the company. As part of the recapitalization, the name of the company was changed from Fairfield Language Technologies to Rosetta Stone, Inc., to match the signature product. Over the ensuing two years, revenue continued to expand aggressively, rising to $81 million in 2006, $137 million in 2007, and $210 million in 2008. Since Adams's arrival, the compound annual growth rates of Rosetta Stone's revenue and operating profit were at 70% and 98%, respectively, and the company employed over 1,200 people. By early 2009, Rosetta Stone was the most recognized language learning software brand in the world. Millions of language learners in more than 150 countries were using the Rosetta Stone software. The company offered self-study language learning solutions in 31 languages to its customers. (**Exhibit 5** lists the language training software currently offered by the company.) In 2008, approximately 80% of Rosetta Stone revenue was accounted for by retail consumers, 20% by institutions. Institutional customers included educational institutions, government and military institutions, commercial institutions, and not-for-profit institutions.

In a few short years, Rosetta Stone had successfully developed a strong brand; its kiosks with bright yellow boxes had become an institution in U.S. airports, and its print advertising in travel publications included a popular print ad of a young farm boy holding a Rosetta Stone box, the copy reading, "He was a hardworking farm boy. She was an Italian supermodel. He knew he would have just one chance to impress her." The unaided awareness of the Rosetta Stone brand was more than seven times that of any other language learning company in the United States. Leveraging a strong brand, steady customer base, and diverse retail network, Rosetta Stone had maintained positive profitability in 2008 despite the severe economic downturn and, in both average orders of bundled products and services and in units sold, even had experienced increases.

The company expanded its product line by increasing the number of languages and levels offered and broadened the language learning experience by introducing Rosetta Studio and Rosetta World. Rosetta Studio allowed each Rosetta Stone learner to schedule time to chat with other learners and with a native-speaking coach to facilitate language practice, motivation, and confidence. Rosetta World connected a virtual community of language learners to practice their skills through a collection of games and other dynamic conversation opportunities. Adams envisioned a substantial growth trajectory for the company with a multitude of ways to leverage its novel learning technology and expand its geographic reach. With a fixed development cost, Adams expected the strategy to continue to increase company operating margins and expand revenue, but he recognized that, as the company continued to show strong profit and growth, the incentive for competition to attempt to gain market share would intensify. **Exhibit 6** provides three video excerpts of an interview with Adams in which he describes the future of Rosetta Stone.

Industry Overview

The worldwide language learning industry was valued at more than $83 billion, of which more than $32 billion was for self-study learning, according to a Nielsen survey. The U.S. market, from which Rosetta Stone generated 95% of its revenue, was estimated to be more than $5 billion for total language learning and $2 billion for self-study learning. The total language learning market was expected to expand as proficiency in multiple languages was becoming increasingly important due to trends in globalization and immigration. The self-study market, particularly through electronic delivery, was expected to dominate the industry expansion given that self-study was increasingly accepted by language learning and travel enthusiasts.

The language learning industry had historically been dominated by specialized language schools that taught languages through conventional classroom methods. The largest player in the market was privately held Berlitz International. Berlitz taught languages in its classrooms using the Berlitz Method of Language Instruction, which advocated immersion in the target language, among other things, and according to company literature, offered programs and services through more than 470 centers in more than 70 countries. Auralog, a French company, was another important competitor in the industry. Both Berlitz and Auralog offered electronic software packages that provided quality language training software.

As had the Rosetta World product, businesses such as LiveMocha, Babalah, and Palabea had also adopted a social media approach, connecting language learners through the Internet, but these sites tended to be secondary enrichment sources for language learners.

Major software companies with deep pockets represented the most important potential threat. Although the novelty of Rosetta Stone's approach shielded it from many of the existing players in the industry, the entry of a company such as Apple or Microsoft into the language learning market had the potential to thwart Rosetta Stone's aspiration of dominating global language learning.

The IPO Process[5]

The process of *going public*—selling publicly traded equity for the first time—was an arduous undertaking that, at a minimum, required about three months. (**Table 1** provides a timetable for the typical IPO. **Exhibit 6** links to video of Adams describing the specific ways Rosetta Stone management prepared the company to go public.)

Before initiating the equity-issuance process, private firms needed to fulfill a number of prerequisites: generate a credible business plan; gather a qualified management team; create an outside board of directors; prepare audited financial statements, performance measures, and projections; and develop relationships with investment bankers, lawyers, and accountants. Frequently, firms held "bake-off" meetings to discuss the equity-issuance process with various investment banks before selecting a lead underwriter. Important characteristics of an underwriter included the proposed compensation package, track record, analyst research support, distribution capabilities, and aftermarket market-making support.

After the firm satisfied the prerequisites, the equity-issuance process began with a meeting of all the key participants (management, underwriters, accountants, and legal counsel for both the underwriters and the

[5] This section draws from Michael C. Bernstein and Lester Wolosoff, *Raising Capital: The Grant Thornton Guide for Entrepreneurs* (Chicago: Irwin Professional Publishing, 1995); Frederick Lipman, *Going Public* (Roseville, CA: Prima, 1994); Coopers and Lybrand, *A Guide to Going Public*, 2nd ed. (New York: Coopers & Lybrand, 1997); and Craig G. Dunbar, "The Effect of Information Asymmetries on the Choice of Underwriter Compensation Contracts in IPOs" (PhD diss., University of Rochester, n.d.).

issuing firm) to plan the process and reach agreement on specific terms. Throughout the process, additional meetings could be called to discuss problems and review progress.

Following the initiation of the equity-issuance process, the SEC prohibited the company from publishing information outside the prospectus. The company could continue established, normal advertising activities, but any increased publicity designed to raise awareness of the company's name, products, or geographical presence in order to create a favorable attitude toward the company's securities could be considered illegal. This requirement was known as the *quiet period*.

Table 1. Timetable for typical U.S. IPO (in days).

Prior to Day 1: Organizational "all-hands" meeting	1	2	3	4	5	6	7	**1–14: Quiet period**
	8	9	10	11	12	13	14	
15–44: Due diligence Underwriter interviews management, suppliers, and customers; reviews financial statements; drafts preliminary registration statement. Senior management of underwriter gives OK on issue.	15	16	17	18	19	20	21	
	22	23	24	25	26	27	28	
	29	30	31	32	33	34	35	
	36	37	38	39	40	41	42	
45: Registration (announcement)	43	44	45	46	47	48	49	**45–75: SEC review period** SEC auditor reviews for compliance with SEC regulations. Underwriter assembles syndicate and initiates road show.
50: Prospectus (*red herring*)	50	51	52	53	54	55	56	
	57	58	59	60	61	62	63	
	64	65	66	67	68	69	70	
	71	72	73	74	75	76	77	**76–89: Road show** Preliminary price range set. Underwriters, issuing firm's management present deal to institutional investors, build book of purchase orders.
76–89: Letters of comment received from SEC; amendments filed with SEC.	78	79	80	81	82	83	84	
90: Effective date; shares offered	85	86	87	88	89	90	91	**91: Trading begins**
	92	93	94	95	96	97	98	**98: Settlement**

Source: Created by author based on industry standards.

The underwriter's counsel generally prepared a letter of intent that provided most of the terms of the underwriting agreement but was not legally binding. The underwriting agreement described the securities to be sold, set forth the rights and obligations of the various parties, and established the underwriter's compensation. Because the underwriting agreement was not signed until the offering price was determined (just before distribution began), both the firm and the underwriter were free to pull out of the agreement any time before the offering date. If the firm did withdraw the offer, the letter of intent generally required the firm to reimburse the underwriter for direct expenses.

The SEC required that firms selling equity in a public market solicit the market's approval. The filing process called for preparation of the prospectus (Part I of the registration statement), answers to specific questions, copies of the underwriting contract, company charter and bylaws, and a specimen of the security (all included in Part II of the registration statement), all of which required the full attention of all parties on the offering firm's team.

One of the important features of the registration process was the performance of due-diligence procedures. *Due diligence* referred to the process of providing reasonable grounds that there was nothing in the registration statement that was significantly untrue or misleading and was motivated by the liability of all parties to the registration statement for any material misstatements or omissions. Due-diligence procedures involved such things as reviewing company documents, contracts, and tax returns; visiting company offices and facilities; soliciting "comfort letters" from company auditors; and interviewing company and industry personnel.

During this period, the lead underwriter began to form the underwriting *syndicate*, which comprised a number of investment banks that agreed to buy portions of the offering at the offer price less the underwriting discount. In addition to the syndicate members, dealers were enlisted to sell a certain number of shares on a "best-efforts" basis. The dealers received a *fixed reallowance*, or concession, for each share sold. The selling agreement provided the contract to members of the syndicate, granted power of attorney to the lead underwriter, and stipulated (a) the management fee that each syndicate member was required to pay the lead underwriter, (b) the share allocations, and (c) the dealer reallowances or concessions. Because the exact terms of the agreement were not specified until approximately 48 hours before selling began, the agreement would not become binding until just before the offering. The original contract specified a range of expected compensation levels; the selling agreement was structured so that the contract became binding when it was orally approved via telephone by the syndicate members after the effective date.

The SEC review process started when the registration statement was filed and the statement was assigned to a branch chief of the Division of Corporate Finance. As part of the SEC review, the statement was given to accountants, attorneys, analysts, and industry specialists. The SEC review process was laid out in the Securities Act of 1933, which according to its preamble aspired to "provide full and fair disclosure of the character of securities sold in interstate commerce." Under the Securities Act, the registration statement became effective 20 days after the filing date. If, however, the SEC found anything in the registration statement that was regarded as materially untrue, incomplete, or misleading, the branch chief sent the registrant a *letter of comment* detailing the deficiencies. Following a letter of comment, the issuing firm was required to correct and return the amended statement to the SEC. Unless an acceleration was granted by the SEC, the amended statement restarted the 20-day waiting period.

While the SEC was reviewing the registration statement, the underwriter was engaged in "book-building" activities, which involved surveying potential investors to construct a schedule of investor demand for the new issue. To generate investor interest, the preliminary offering prospectus or "red herring" (so called because the prospectus was required to have the words *preliminary prospectus* on the cover in red ink) was printed and offered to potential investors. During this period, underwriters generally organized a one- to two-week "road show" tour, which enabled managers to discuss their investment plans, display their management potential, and answer questions from financial analysts, brokers, and institutional investors in locations across the country or abroad. Finally, companies could place "tombstone ads" in various financial periodicals announcing the offering and listing the members of the underwriting syndicate.

By the time the registration statement was ready to become effective, the underwriter and the offering firm's management negotiated the final offering price and the underwriting discount. The negotiated price depended on perceived investor demand and current market conditions (e.g., price multiples of comparable companies, previous offering experience of industry peers). Once the underwriter and the management agreed on the offering price and discount, the underwriting agreement was signed, and the final registration amendment was filed with the SEC. The company and the underwriter generally asked the SEC to accelerate the final pricing amendment, which was usually granted immediately by phone. The offering was now ready for public sale. The final pricing and acceleration of the registration statement typically happened within a few hours.

During the morning of the effective day, the lead underwriter confirmed the selling agreement with the members of the syndicate. Following confirmation of the selling agreement, selling began. Members of the syndicate sold shares of the offering through oral solicitations to potential investors. Because investors were required to receive a final copy of the prospectus with the confirmation of sale, and the law allowed investors to back out of purchase orders upon receipt of the final prospectus, the offering sale was not realized until underwriters actually received payment. Underwriters would generally cancel orders if payment was not received within five days of the confirmation.

SEC Rule 10b-7 permitted underwriters to engage in price stabilization activities for a limited period during security distribution. Under this rule, underwriters often posted stabilizing bids at or below the offer price, which provided some price stability during the initial trading of an IPO.

The *offering settlement*, or closing, occurred seven to ten days after the effective date, as specified in the underwriting agreement. At this meeting, the firm delivered the security certificates to the underwriters and dealers, and the lead underwriter delivered the prescribed proceeds to the firm. In addition, the firm traditionally delivered an updated comfort letter from its independent accountants. Following the offering, the underwriter generally continued to provide valuable investment-banking services by distributing research literature and acting as a market maker for the company.

Pricing the Rosetta Stone IPO

Adams had a preference for a strong balance sheet and cash position for the company. As a private company, corporate investment was limited by the amount of capital the company could borrow from private sources. With constrained resources, Adams was concerned that Rosetta Stone was an attractive takeover target for a company with the needed resources. Led by Phil Clough at ABS Capital, the private equity investors were anxious to recognize the gains achieved through the Rosetta Stone investment.

In March, the board had discussed the matter and yielded the IPO decision to Adams. Despite the uncertainty of taking a relatively young company public in the most volatile markets in decades, Adams was inclined to move forward with the deal. The fourth quarter financials continued to show impressive performance, with a 53% expansion in revenue despite the global economic contraction. (**Exhibit 7** details the historical financial performance of the company along with historical internally generated values of Rosetta Stone shares.) Advisors at Morgan Stanley had shared their view that Rosetta Stone was one of only a handful of companies that currently had a shot at a successful IPO. Senior management had been preparing the systems and organization of the company for public company status for years. Adams saw the IPO event as significant opportunity to establish business credibility and build the Rosetta Stone brand in a global marketplace. His decision was to launch.

Over the following week or two, senior management and bankers visited prospective investors on the east and west coasts of the United States and in Europe. The investor response was highly enthusiastic, with investors commonly asking to "max out" their allocation in the deal. By the end of the road show, Morgan Stanley reported that the book was more than 25 times oversubscribed, meaning that the underwriters maintained orders for 25 shares for every Rosetta Stone share being offered in the deal.

Adams was delighted that many investors appeared to share his vision of Rosetta Stone's unique capacity to play a substantial role in the global language learning market. Such a trajectory implied revenue growth rates of 20% to 35% for some time. Other analysts were more skeptical, predicting revenue growth of around 15% for the next five years and then tapering down to a long-term growth rate of 3% to 4%. Adams believed that the operating leverage in the organization allowed margins to continue to improve for some time; others believed that competitive pressure would soon drive margins down. (**Exhibit 8** provides one view of how the financials were expected to play out in the years to come.) In the debt market, Rosetta Stone faced a prevailing borrowing rate of about 7.5%. The marginal corporate tax rate for the company was 38%. **Exhibit 9** details the current ownership structure of the company and details the new shares to be sold in the offering, which would grow the total number of shares outstanding from 17.2 million to 20.3 million.[6]

Comparable multiples played an important role in the valuation of IPO firms. **Exhibit 10** provides financial data on a broad set of industry comparable firms. Adams liked K12 Inc. as a comparable match, but acknowledged that no other firm perfectly matched Rosetta Stone's business strategy, skill set, risk profile, or growth potential. Still, there was some debate regarding whether Rosetta Stone would be positioned as a technology company or an educational company. See **Exhibit 6** for a link to video excerpts of Adams and Clough discussing this topic.

[6] To avoid the dilution of the value of securities of pre-IPO investors, it was appropriate in pricing IPO shares to divide the total premoney equity value of the firm by the premoney shares outstanding. In the case of Rosetta Stone, the number of premoney shares outstanding was 17.19 million. Since the pre-IPO investors held claim on the ongoing business, a valuation based on the ongoing business represented a premoney valuation. Valuations based on postmoney shares required adding the value of the new IPO shares to the ongoing business valuation prior to dividing by the postmoney shares.

Exhibit 1

Rosetta Stone: Pricing the 2009 IPO

Rosetta Stone Income Statement (in thousands of dollars)[1]

	2004	2005	2006	2007	2008
Revenue	$25,373	$48,402	$91,570	$137,321	$209,380
Cost of revenue	3,968	8,242	12,744	20,687	28,676
Gross profit	21,405	40,160	78,826	116,634	180,704
Operating expenses:					
Sales and marketing	11,303	22,432	46,549	65,437	93,384
Research and development	1,833	2,819	8,158	12,893	18,387
Acquired in-process research and development	0	0	12,597	0	0
General and administrative	6,484	8,157	16,732	29,786	39,577
Lease abandonment	0	0	0	0	1,831
Transaction-related expenses	0	0	10,315	0	0
Total operating expenses	19,620	33,408	94,351	108,116	153,179
Income from operations	1,785	6,752	–15,525	8,518	27,525
Other income and expense:					
Interest income	84	38	613	673	454
Interest expense	0	0	–1,560	–1,331	–891
Other income	120	134	63	154	239
Interest and other income (expense), net	204	172	–884	–504	–198
Income before income taxes	1,989	6,924	–16,409	8,014	27,327
Income tax expense (benefit)	66	143	–1,240	5,435	13,435
Net income	1,923	6,781	–15,169	2,579	13,892
Preferred stock accretion	0	0	–159	–80	0
Net income attributable to common stockholders	$1,923	$6,781	–$15,328	$2,499	$13,892

Data source: Rosetta Stone preliminary prospectus (Form S-1/A, filed March 17, 2009), U.S. SEC.

[1] Depreciation and amortization expense was reported as $6.5, $7.8, and $7.1 million, respectively, for 2006, 2007, and 2008.

Exhibit 2

Rosetta Stone: Pricing the 2009 IPO

Rosetta Stone Balance Sheet (in thousands of dollars)

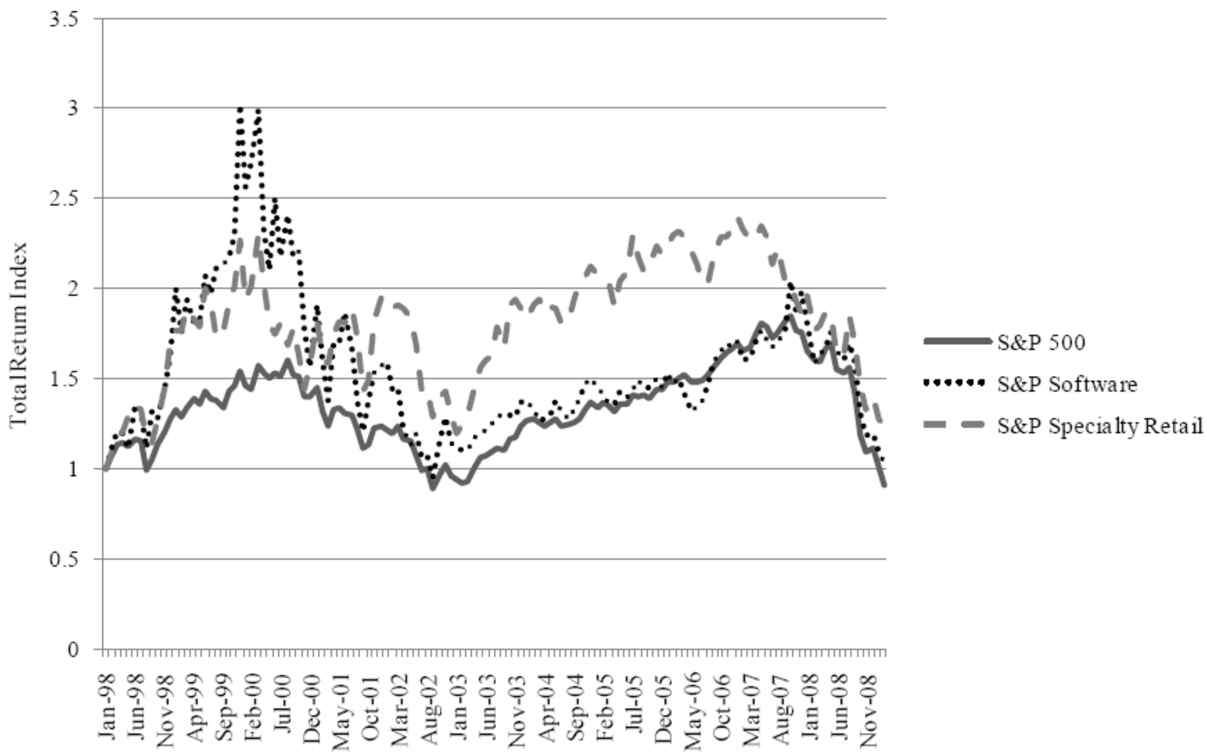
	As of December 31	
Assets	2007	2008
Cash and cash equivalents	$22,084	$30,660
Accounts receivable	11,852	26,497
Inventory, net	3,861	4,912
Prepaid expenses and other current assets	3,872	6,598
Deferred income taxes	848	2,282
Total current assets	42,517	70,949
Property and equipment, net	13,445	15,727
Goodwill	34,199	34,199
Intangible assets, net	13,661	10,645
Deferred income taxes	6,085	6,828
Other assets	469	470
Total assets	110,376	138,818
Liabilities and stockholders' equity		
Accounts payable	4,636	3,207
Accrued compensation	4,940	8,570
Other current liabilities	11,421	21,353
Deferred revenue	12,045	14,382
Current maturities of long-term debt	3,400	4,250
Total current liabilities	36,442	51,762
Long-term debt	9,909	5,660
Deferred revenue	894	1,362
Other long-term liabilities	6	963
Total liabilities	47,251	59,747
Commitments and contingencies	5,000	0
Common stock outstanding	51,038	56,038
Additional paid-in capital	8,613	10,814
Accumulated income (loss)	–1,470	12,422
Accumulated other comprehensive loss	–56	–203
Total stockholders' equity	58,125	79,071
Total liabilities and stockholders' equity	$110,376	$138,818

Data source: Rosetta Stone prospectus.

Exhibit 3

Rosetta Stone: Pricing the 2009 IPO

Value of $1 invested in January 1998



Source: Created by author using data from Morningstar.

Exhibit 4

Rosetta Stone: Pricing the 2009 IPO

U.S. Yield Curve Data (in percent)

	Yields				
Date	3-month	1-year	5-year	10-year	30-year
1/30/2009	0.24	0.51	1.85	2.87	3.58
2/27/2009	0.26	0.72	1.99	3.02	3.71
3/31/2009	0.21	0.57	1.67	2.71	3.56
4/1/2009	0.22	0.58	1.65	2.68	3.51
4/2/2009	0.22	0.59	1.74	2.77	3.57
4/3/2009	0.21	0.60	1.87	2.91	3.70
4/6/2009	0.20	0.60	1.90	2.95	3.73
4/7/2009	0.20	0.60	1.87	2.93	3.72
4/8/2009	0.18	0.59	1.83	2.86	3.66
4/9/2009	0.18	0.60	1.90	2.96	3.76

Data source: U.S. Department of the Treasury.

Exhibit 5

Rosetta Stone: Pricing the 2009 IPO

Language Coverage of Rosetta Stone Products (2008)

	Instructional software			Audio companion		
	Level 1	Level 2	Level 3	Version 1	Version 2	Version 3
Arabic	●	●	●	●		●
Chinese (Mandarin)	●	●	●	●		●
Danish	●				●	
Dutch	●	●	●	●		●
English (UK)	●	●	●	●		●
English (U.S.)	●	●	●	●		●
Farsi (Persian)	●	●	●	●		●
French	●	●	●	●		●
German	●	●	●	●		●
Greek	●	●	●	●		●
Hebrew	●	●	●	●		●
Hindi	●	●	●	●		●
Indonesian	●				●	
Irish	●	●	●	●		●
Italian	●	●	●	●		●
Japanese	●	●	●	●		●
Korean	●	●	●	●		●
Latin	●				●	
Pashto	●				●	
Polish	●	●	●	●		●
Portuguese (Brazil)	●	●	●	●		●
Russian	●	●	●	●		●
Spanish (Latin America)	●	●	●	●		●
Spanish (Spain)	●	●	●	●		●
Swahili	●				●	
Swedish	●	●	●	●		●
Tagalog	●	●			●	
Thai	●	●			●	
Turkish	●				●	
Vietnamese	●				●	
Welsh	●				●	

Data source: Rosetta Stone prospectus.

Exhibit 6

Rosetta Stone: Pricing the 2009 IPO

Video Exhibit Links

Video Exhibit 1. What is the future for Rosetta Stone?
Interview with Tom Adams, CEO, Rosetta Stone, Inc.

(http://www.youtube.com/watch?v=FjxZ6VhWPBw)

Video Exhibit 2. What does it take to go public?
Interview with Tom Adams, CEO, Rosetta Stone, Inc.

(http://www.youtube.com/watch?v=QVl9NNgmT7U)

Video Exhibit 3. What kind of business is Rosetta Stone?
Interview with Tom Adams, CEO, Rosetta Stone, Inc. and
Phil Clough, Managing General Partner, ABS Capital Partners

(http://www.youtube.com/watch?v=Lnilib9UJx0)

Exhibit 7

Rosetta Stone: Pricing the 2009 IPO

Rosetta Stone Historical Financial Performance, 2006 to 2008
(in thousands of dollars except percent and share value)

	2006	2007	2008
Revenue	91,570	137,321	209,380
Revenue growth	89%	50%	52%
EBITDA	1,290	16,318	34,625
EBITDA margin	1.4%	11.9%	16.5%
Total debt		13,309	9,910
Total equity		58,125	79,071
Total capital		71,434	88,981
Capital turnover		1.92	2.24
Return on capital		11.9%	30.9%
Estimated share value[1]	$6.08	$11.19	$17.49

[1] Estimated by Rosetta Stone board of directors based on multiple of EBITDA for industry comparables.

Exhibit 8

Rosetta Stone: Pricing the 2009 IPO

Financial Forecast for Rosetta Stone
(in millions of dollars)

	2008A	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E
Revenue growth	52.5%	35.0%	35.0%	30.0%	25.0%	23.0%	21.0%	18.0%	13.0%	10.0%	5.0%
Gross margin	86.3%	86.0%	86.0%	85.0%	84.0%	83.0%	82.0%	81.0%	80.0%	79.0%	78.0%
SGA exp / revenue	63.5%	63.5%	63.5%	63.0%	63.0%	62.5%	62.5%	62.5%	62.5%	62.5%	62.5%
R&D exp / revenue	8.8%	9.0%	9.0%	8.5%	8.5%	8.5%	8.5%	8.0%	8.0%	8.0%	8.0%
Capital expenditures	7.0	5.0	8.0	9.0	9.5	10.0	11.0	11.0	9.0	8.0	5.0
NPPE turnover	13.5	15.0	15.2	15.4	15.6	15.8	16.0	16.2	16.4	16.8	17.3
NWC turnover	8.9	9.0	9.0	9.0	8.5	8.5	8.0	8.0	8.0	8.0	8.0
Revenue	209.4	282.7	381.6	496.1	620.1	762.7	922.9	1,089.0	1,230.6	1,353.6	1,421.3
Gross profit	180.7	243.1	328.2	421.7	520.9	633.1	756.8	882.1	984.5	1,069.4	1,108.6
SGA expense	133.0	179.5	242.3	312.5	390.7	476.7	576.8	680.6	769.1	846.0	888.3
R&D expense	18.4	25.4	34.3	42.2	52.7	64.8	78.4	87.1	98.4	108.3	113.7
EBIT	29.4	38.2	51.5	67.0	77.5	91.5	101.5	114.3	116.9	115.1	106.6
Net working capital	23.4	31.4	42.4	55.1	73.0	89.7	115.4	136.1	153.8	169.2	177.7
Net PPE	15.7	18.8	25.1	32.2	39.7	48.3	57.7	67.2	75.0	80.6	82.2

Source: Author analysis.

Exhibit 9

Rosetta Stone: Pricing the 2009 IPO

Principal and Selling Stockholders
(in thousands except percent)

Name of beneficial owner	Shares owned prior to offering		Shares offered in IPO
Entities affiliated with ABS Capital Partners	7,556.1	44.0%	1,889.6
Norwest Equity Partners VIII	4,940.0	28.7%	1,235.4
Tom Adams (President, CEO)	743.7	4.3%	
Eric Eichmann (COO)	146.3	0.9%	
Brian Helman (CFO)	91.0	0.5%	
Gregory Long (CPO)	106.2	0.6%	
Michael Wu (General Counsel)	45.5	0.3%	
Patrick Gross (Director)	20.7	0.1%	
John Coleman (Director)	16.2	0.1%	
Laurence Franklin (Director)	16.2	0.1%	
Other owners	3,507.6	20.4%	
New IPO shares			3,125.0
Total shares	17,189.5		6,250.0

Source: Rosetta Stone prospectus.

Exhibit 10

Rosetta Stone: Pricing the 2009 IPO

Financial Data for Industry Comparables[1]

	Recent Price	Number of shares (in millions)	Debt (in millions)	Beta	Revenue growth	Income growth	Price/EPS		EV/EBITDA	
For-profit education							2008	2009	2008	2009
Apollo Group, Inc.	63.81	160.15	0.0	0.60	15%	491%	19.2	14.5	9.7	7.2
American Public Education Inc.	37.56	18.06	0.0	NA	55%	54%	42.4	29.3	20.5	13.8
Corinthian Colleges, Inc.	16.88	86.45	31.9	0.75	16%	78%	28.7	18.1	11.6	7.8
Career Education Corp.	21.05	90.09	1.7	0.70	–2%	9%	19.5	20.0	6.8	6.8
Capella Education	50.34	16.69	0.0	0.55	20%	32%	31.5	23.4	13.4	10.3
Strayer Education	168.01	13.88	0.0	0.55	25%	24%	33.2	25.8	17.8	14.1
DeVry Inc.	42.47	71.64	20.0	0.55	17%	33%	23.2	17.5	12.5	9.6
ITT Educational Services Inc.	101.6	38.56	150.0	0.60	17%	45%	19.0	13.6	10.1	7.4
K12 Inc.	15.29	28.86	13.7	NA	61%	44%	18.3	35.4	13.4	8.7
Grand Canyon Education, Inc.	14.72	45.47	32.1	NA	62%	126%	NA	24.3	30.2	11.5
New Oriental Ed. & Tech. Group, Inc.	50.33	149.19	0.0	1.20	43%	–3%	32.9	24.5	23.8	17.2

Data source: SEC filings, Value Line Investment Survey, and other analyst reports.

[1] The reported multiples are based on the same valuation numerator but with 2008 actual profits or 2009 expected profits, respectively.

Exhibit 10 (continued)

Financial Data for Industry Comparables

	Recent Price	Number of shares (in millions)	Debt (in millions)	Beta	Revenue growth	Income growth	Price/EPS		EV/EBITDA	
Internet							2008	2009	2008	2009
Activision Blizzard, Inc.	$10.03	1,359	$0.0	NA	124%	340%	18.5	17.2	6.9	6.9
Amazon.com, Inc.	74.71	429	74.0	1.10	29%	24%	53.8	47.9	27.1	23.6
Dice Holdings Inc.	3.2	62.21	60.2	NA	9%	2%	12.3	25.7	4.5	6.9
drugstore.com, Inc.	1.3	97.36	2.1	1.65	8%	63%	NA	NA	NA	91.1
eBay	14.32	1,287.81	0.0	1.15	11%	–22%	12.8	17.1	7.0	8.1
Google	379.5	315.25	0.0	0.90	31%	9%	23.6	20.7	13.2	11.3
GSI Commerce	14.93	47.93	195.9	1.15	29%	–2%	NA	NA	12.2	10.6
TechTarget Inc.	2.38	41.75	0.0	1.45	20%	–117%	NA	NA	8.8	11.3
WebMD Health Corp.	25.58	57.58	0.0	0.85	15%	114%	45.8	46.0	18.1	16.4
Electronic Arts Inc.	19.16	322	0.0	0.90	15%	55%	NA	24.1	NA	11.5
Yahoo! Inc.	14.02	1,393.35	0.0	1.00	3%	–78%	32.6	37.3	10.2	10.3
Software										
Adobe Systems	23.64	524.27	350.0	1.20	13%	–41%	14.9	22.9	8.6	12.6
ArcSight Inc.	14.15	31.5	0.0	NA	34%	509%	NA	52.8	39.2	21.8
Intuit	25.35	320.53	998.1	0.90	15%	9%	19.5	16.2	9.2	7.9
Microsoft	18.83	8891	0.0	0.80	18%	–32%	10.2	12.0	5.9	6.8
Omniture	13.54	75.05	13.2	1.30	107%	37%	NA	NA	16.4	9.6
Salesforce.com	37.36	122.43	0.0	1.20	44%	93%	NA	57.7	35.0	20.7
Symantec	16.47	819.92	1,766.0	0.90	5%	–234%	9.4	9.5	4.7	4.9
McAfee Inc.	34.49	153.72	0.0	1.00	22%	77%	26.1	24.1	12.3	10.1
Vmware Inc.	29.6	389.86	450.0	NA	42%	62%	27.1	33.9	21.0	23.8

Data source: SEC filings, Value Line Investment Survey, and other analyst reports.

Exhibit 10 (continued)

Financial Data for Industry Comparables

For-Profit Education

Apollo Group, Inc.	Education programs for working adults at the high school, undergraduate, and graduate levels, online and on-campus through subsidiaries.
American Public Education Inc.	Online postsecondary education degree programs and certificate programs including national security, military studies, intelligence, homeland security, criminal justice, technology, business administration and liberal arts; primarily serves military and public service communities.
Corinthian Colleges, Inc.	Private, for-profit postsecondary education degree programs in health care, electronics, and business.
Career Education Corporation	North American private, for-profit postsecondary education in information technologies, visual communication and design technologies, business studies, and culinary arts.
Capella Education Company	Online postsecondary education services company; doctoral, master’s and bachelor’s programs through their subsidiary.
Strayer Education, Inc.	Holding company of Strayer University, which offers undergraduate and graduate degree programs in business administration, accounting, information technology, education, and public administration to working adults.
DeVry, Inc.	North American higher education programs, offering associate, bachelor’s and master’s degree programs in technology; health care technology; business, and management; also offers online secondary education to school districts and medical education.
ITT Educational Services, Inc.	Technology-based postsecondary degree programs in the United States.
K12 Inc.	Technology-based education company; proprietary curriculum, software and educational services created for online delivery to students in kindergarten through 12th grade.
Grand Canyon Education, Inc.	Online undergraduate and graduate degree programs in education, business, and health care.
New Oriental Education & Technology Group, Inc.	Foreign language training and test preparation courses in the United States and the People’s Republic of China; development and distribution of primary and secondary educational content and technology.

Data source: Adapted from company sources.

Exhibit 10 (continued)

Financial Data for Industry Comparables

Internet

Activision Blizzard, Inc.	Interactive entertainment software and peripheral products.
Amazon.com, Inc.	Diversified online retailer with emphasis on books.
Dice Holdings Inc.	Career services and recruiting.
drugstore.com, Inc.	Online drugstore.
eBay Inc.	Online trading community.
Google Inc.	Web-based search engine and global technology company.
GSI Commerce, Inc.	E-commerce business developer/operator.
TechTarget	Industry-specific portal operator.
WebMD Health Corp.	Health information services for consumers, physicians, health care professionals, employers, and health plans.
Electronic Arts Inc.	Interactive entertainment software and peripheral products.
Yahoo! Inc.	Internet media company providing web navigation, aggregated information content, communication services, and commerce.

Software

Adobe Systems Incorporated	Computer software products and technologies.
ArcSight, Inc.	Security and compliance management solutions.
Intuit Inc.	Business and financial management software solutions.
Microsoft Corporation	Operating system software, server application software, business and consumer applications software, software development tools, and Internet/intranet software; also video game consoles and digital music entertainment devices.
Omniture, Inc.	Online business optimization software.
Salesforce.com, Inc.	Application services that permit sharing of on-demand customer information.
Symantec Corporation	Security, storage, and systems management solutions.
McAfee Inc.	Computer security solutions.
VMware Inc.	Virtual infrastructure solutions.

Data source: Adapted from company sources.