1-1-2008

Vol. VI, Tab 38 - Ex. 35 - Rosetta Stone DTC (Direct to Consumer) Report 2008

Rosetta Stone

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I. 2008 Mission
II. 2008 Goals
III. Current Situation and Overview
IV. Competitive Overview
V. 2007 Key Learnings
VI. 2008 Financial Plan
   I. Assumptions
   II. Upsides/Downsides
   III. Leverage Points and Vulnerabilities
   IV. Key Initiatives
VII. Test Plan
VIII. Timeline
I. To enable millions to successfully learn another language, with a system that is fast, fun and effective

II. To be the #1 consumer-preferred language learning solution, and to be seen as the one that is proven to work – even as other systems may have failed you.

III. To be the awareness building engine that helps build not only the DTC business, but also the company's other business segments: Kiosk, Global Retail and Institutional
I. Financial Goals:

I. Sales Revenue: $76.3mil (+29%)
II. Net Contribution: $34.8mil (+36%)
III. Net Contribution %: 45.6% (+5%)
IV. Return on Media: 2.98 (+7%)

II. Build brand awareness above 50%, and maintain the #1 position in the category

III. Be seen as the preferred solution for serious language learning by consumers, because Rosetta Stone is more effective and proven to work.

IV. Grow the business without de-scaling (expanding successfully tested concepts in Creative, Call Center and the Web Site)

V. Develop and expand new creative (TV/Radio/Print/Infomercial) to increase the breadth of Rosetta Stone appeal to more consumers, and to resonate even more strongly with the core.

I. Youth
II. Hispanic
III. Freshen for target customer
I. CY2007 was a successful year for the DTC business (+48% Y/Y revenue growth), but have experienced – for the first time in our history – challenges in growing. It will take new initiatives and an inventive style to continue strong double digit growth.

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTC Revenues</td>
<td>$1,133,805</td>
<td>$8,906,080</td>
<td>$20,544,878</td>
<td>$40,031,629</td>
<td>$59,331,716</td>
</tr>
<tr>
<td>Y/Y Growth</td>
<td>786%</td>
<td>231%</td>
<td>195%</td>
<td>148%</td>
<td></td>
</tr>
</tbody>
</table>

II. As seen above, the growth rate has slowed as we have scaled. Note: 2003 data begins with October, so this is not a full year.
## 2007 Revenues by Vehicle (thousands)

<table>
<thead>
<tr>
<th></th>
<th>Jan</th>
<th>Feb</th>
<th>Mar</th>
<th>Apr</th>
<th>May</th>
<th>Jun</th>
<th>Jul</th>
<th>Aug</th>
<th>Sep</th>
<th>Oct</th>
<th>Nov</th>
<th>Dec</th>
<th>Total</th>
<th>% Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>TV</td>
<td>$853</td>
<td>$508</td>
<td>$822</td>
<td>$597</td>
<td>$592</td>
<td>$721</td>
<td>$1,054</td>
<td>$899</td>
<td>$681</td>
<td>$646</td>
<td>$673</td>
<td>$1,473</td>
<td>$9,518</td>
<td>16%</td>
</tr>
<tr>
<td>Print</td>
<td>$783</td>
<td>$626</td>
<td>$612</td>
<td>$491</td>
<td>$468</td>
<td>$560</td>
<td>$672</td>
<td>$617</td>
<td>$627</td>
<td>$544</td>
<td>$556</td>
<td>$599</td>
<td>$7,156</td>
<td>12%</td>
</tr>
<tr>
<td>Radio</td>
<td>$214</td>
<td>$161</td>
<td>$225</td>
<td>$133</td>
<td>$171</td>
<td>$221</td>
<td>$299</td>
<td>$232</td>
<td>$264</td>
<td>$305</td>
<td>$295</td>
<td>$325</td>
<td>$2,845</td>
<td>5%</td>
</tr>
<tr>
<td>PPC</td>
<td>$976</td>
<td>$817</td>
<td>$772</td>
<td>$791</td>
<td>$859</td>
<td>$616</td>
<td>$855</td>
<td>$663</td>
<td>$541</td>
<td>$608</td>
<td>$754</td>
<td>$1,534</td>
<td>$10,095</td>
<td>17%</td>
</tr>
<tr>
<td>Affiliate</td>
<td>$350</td>
<td>$283</td>
<td>$374</td>
<td>$296</td>
<td>$323</td>
<td>$347</td>
<td>$450</td>
<td>$581</td>
<td>$433</td>
<td>$331</td>
<td>$435</td>
<td>$924</td>
<td>$6,127</td>
<td>9%</td>
</tr>
<tr>
<td>EM/DM</td>
<td>$159</td>
<td>$690</td>
<td>$146</td>
<td>$222</td>
<td>$493</td>
<td>$720</td>
<td>$120</td>
<td>$161</td>
<td>$641</td>
<td>$203</td>
<td>$605</td>
<td>$1,855</td>
<td>$6,312</td>
<td>11%</td>
</tr>
<tr>
<td>Untracked</td>
<td>$1,146</td>
<td>$928</td>
<td>$1,217</td>
<td>$1,178</td>
<td>$1,246</td>
<td>$1,175</td>
<td>$1,496</td>
<td>$1,785</td>
<td>$1,450</td>
<td>$1,793</td>
<td>$2,024</td>
<td>$3,474</td>
<td>$18,889</td>
<td>32%</td>
</tr>
</tbody>
</table>

## 2007 Cost by Vehicle (thousands)

<table>
<thead>
<tr>
<th></th>
<th>Jan</th>
<th>Feb</th>
<th>Mar</th>
<th>Apr</th>
<th>May</th>
<th>Jun</th>
<th>Jul</th>
<th>Aug</th>
<th>Sep</th>
<th>Oct</th>
<th>Nov</th>
<th>Dec</th>
<th>Total</th>
<th>% Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>TV</td>
<td>$541</td>
<td>$342</td>
<td>$723</td>
<td>$471</td>
<td>$830</td>
<td>$893</td>
<td>$869</td>
<td>$963</td>
<td>$652</td>
<td>$491</td>
<td>$621</td>
<td>$1,253</td>
<td>$8,028</td>
<td>38%</td>
</tr>
<tr>
<td>Print</td>
<td>$709</td>
<td>$512</td>
<td>$598</td>
<td>$524</td>
<td>$561</td>
<td>$524</td>
<td>$550</td>
<td>$502</td>
<td>$546</td>
<td>$617</td>
<td>$722</td>
<td>$772</td>
<td>$7,137</td>
<td>33%</td>
</tr>
<tr>
<td>Radio</td>
<td>$230</td>
<td>$184</td>
<td>$196</td>
<td>$170</td>
<td>$199</td>
<td>$83</td>
<td>$69</td>
<td>$101</td>
<td>$131</td>
<td>$135</td>
<td>$104</td>
<td>$111</td>
<td>$1,057</td>
<td>5%</td>
</tr>
<tr>
<td>PPC</td>
<td>$83</td>
<td>$52</td>
<td>$49</td>
<td>$48</td>
<td>$71</td>
<td>$89</td>
<td>$101</td>
<td>$149</td>
<td>$113</td>
<td>$120</td>
<td>$137</td>
<td>$249</td>
<td>$1,503</td>
<td>7%</td>
</tr>
<tr>
<td>Affiliate</td>
<td>$85</td>
<td>$87</td>
<td>$114</td>
<td>$91</td>
<td>$109</td>
<td>$112</td>
<td>$137</td>
<td>$149</td>
<td>$113</td>
<td>$120</td>
<td>$137</td>
<td>$249</td>
<td>$1,503</td>
<td>7%</td>
</tr>
<tr>
<td>EM/DM</td>
<td>$ -</td>
<td>$22</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
<td>$13</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
<td>$69</td>
<td>$472</td>
<td>1%</td>
</tr>
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</table>

## Return on Media

<table>
<thead>
<tr>
<th></th>
<th>Jan</th>
<th>Feb</th>
<th>Mar</th>
<th>Apr</th>
<th>May</th>
<th>Jun</th>
<th>Jul</th>
<th>Aug</th>
<th>Sep</th>
<th>Oct</th>
<th>Nov</th>
<th>Dec</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>TV</td>
<td>1.6</td>
<td>1.5</td>
<td>1.1</td>
<td>1.3</td>
<td>0.7</td>
<td>1.1</td>
<td>1.2</td>
<td>1.4</td>
<td>1.3</td>
<td>1.3</td>
<td>1.1</td>
<td>1.2</td>
<td>1.19</td>
</tr>
<tr>
<td>Print</td>
<td>1.1</td>
<td>1.2</td>
<td>1.0</td>
<td>0.9</td>
<td>0.8</td>
<td>1.1</td>
<td>1.2</td>
<td>1.2</td>
<td>1.1</td>
<td>0.9</td>
<td>0.8</td>
<td>0.8</td>
<td>0.8</td>
</tr>
<tr>
<td>Radio</td>
<td>0.9</td>
<td>0.9</td>
<td>1.1</td>
<td>0.8</td>
<td>0.9</td>
<td>0.8</td>
<td>0.6</td>
<td>0.7</td>
<td>0.7</td>
<td>1.0</td>
<td>1.1</td>
<td>0.8</td>
<td>0.82</td>
</tr>
<tr>
<td>PPC</td>
<td>11.8</td>
<td>16.7</td>
<td>16.8</td>
<td>16.6</td>
<td>12.1</td>
<td>11.0</td>
<td>9.6</td>
<td>6.6</td>
<td>4.1</td>
<td>4.6</td>
<td>7.3</td>
<td>13.8</td>
<td>9.55</td>
</tr>
<tr>
<td>Affiliate</td>
<td>4.1</td>
<td>3.3</td>
<td>3.3</td>
<td>3.3</td>
<td>3.0</td>
<td>3.1</td>
<td>3.3</td>
<td>3.8</td>
<td>3.8</td>
<td>3.2</td>
<td>3.7</td>
<td>3.41</td>
<td></td>
</tr>
<tr>
<td>EM/DM</td>
<td>31.4</td>
<td>55.4</td>
<td>11.7</td>
<td>28.5</td>
<td>36.7</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
I. Short Form spending remains relatively flat Y/Y, as limitations with creative, offer and conversion are constraining.

II. Very little spend on infomercial in 2007, with limited growth expected in 2008 (unless creative, call center improves).

III. Per Inquiry buying can also augment spend in 2008, resulting in an 18% increase in total spend.

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>Y/Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>SF Spend</td>
<td>$7,586,000</td>
<td>$8,025,000</td>
<td>106%</td>
</tr>
<tr>
<td>LF Spend</td>
<td>$442,000</td>
<td>$685,000</td>
<td>155%</td>
</tr>
<tr>
<td>PI Spend</td>
<td>-</td>
<td>$802,500</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$8,028,000</strong></td>
<td><strong>$9,512,500</strong></td>
<td><strong>118%</strong></td>
</tr>
</tbody>
</table>
I. We continue to be a top choice for **serious** language learners, along with Berlitz.

II. There are (and always will be) a number of competitors with cheap products (books, audio, non-interactive CDs)

III. Our goal is to continue to position ourselves as the **Best In Class Product** for a Reasonable Price. We may lose sales to those bottom feeders, but we should not lose sales to serious language learners.
I. We need improved promotional options to close and convert customers. Only having 10% off and Free Shipping is severely limiting us, and hurting our brand.

II. Don't get too aggressive and swim against the current. If the media is not there, don't dial up spend. This will only hurt ROM, and our ability to get good pricing next month. Increases must be methodical.

III. The untracked effect is still largely undetermined. During 2007, we saw a major (negative) correction in this assumption. Don't be too aggressive in this assumption until we really understand this.

IV. We must increase conversion, which is low versus the industry.

V. We need fresh/powerful new creative.
   I. Have not tested enough options
      I. Add more DR Sell elements
      II. Add more Closers
   II. Need an infomercial that works
   III. Must improve reporting systems
      I. Tracking sales
      II. Communicating actionable data
Overall: $76.3mil revenues on $25.6mil media + creative spend. ROM=2.98, Net Contribution of $34.8mil

Key Financial Assumptions:
I. Product/V3: 10% increase in AOV = $4mil
II. Web Site Conversion: 12% up in 08 (ranging 0-20%) = $4.7mil
III. Call Center Conversion: 14% up in 08 (ranging 2-25%) = $2.7mil
IV. Creative Improvements: 7% up in 08 (ranging 0-20%) = $2.8mil
V. Hispanic Entry: (begins July 08) = $600k
VI. EBay store: (begins February 08) = $1mil
I. Overview: Baseline plan performance metrics from 2007 will remain stable prior to 2008 improvement initiatives (call & Web conversion, AOV), with sales revenue gains derived from increased media spending.

II. Competition: Significant competitive threats will likely arise in Q3 timeframe. Will be a real impact to 2009 performance. We assume the need for a lower priced product(s), and a TV ad response fighting back this competition.

III. Clearance: We assume we will be able to clear the media we plan in this budget: $8.7mil in SF (8% over 07), $700k of LF

IV. Economy: There will be no recession to slow non-essential purchases.
I. Product/V3: We will continue to see a 10% increase in AOV from all V3 languages as they roll out.

II. Web Site: The site will continue to contribute 60% of DTC total revenues. Also, AOV will remain constant as conversion improves.

III. Call Center: Our 14% conversion will be derived, in part, from shifting the percentage of calls from external to internal handling. The internal team will add 15 heads by March 1st, and another 15 by September 1st. As well, we will replace Convergys with a facility that converts as well as Inpulse.

IV. Untracked: We will continue to see a 30% contribution of untracked sales on total DTC sales. TV untracked contribution specifically will be 1.7x tracked sales.

V. Returns/Renewals: We will continue to experience a 5% renewal rate, and a 7% return rate – on a monthly sales basis.

VI. Unit Growth: Assuming CD unit growth will be in line with revenue growth on a Y/Y basis (30%).

VII. Shipping Increase: 30% of sales come from Free 2-Day Shipping offer (through PPC, Affiliate). Also, assuming $7 premium on average.

VIII. Lead Sourcing: We will resume collecting demo request email addresses early in 08, as they drive the database marketing efforts.
I. Shipping price increase: +$1.1mil in Rev & Net. More if we charge $16.95 or $19.95

II. Ebay could see +$1mil over forecast if we launch in Feb, but may also see some cannibalization of the base business.

III. Booking more LF could yield +$700k

IV. Partnerships could yield +$1mil

V. Hispanic could generate +$1mil

VI. New Radio buyer could improve spend and ROM for +$400k

VII. Could see +$400k from internal call center conversion rise

VIII. If focused on, could see +$700k from external call centers

IX. Big Internet initiative could improve sales, margin - and strengthen our under 35 demographic. +$500k upside.

X. Canadian market could generate gains of +$500k
I. Call center could continue to struggle, taking longer than planned to improve -$1.4mil

II. Clearance on TV may be challenging with the elections this year - $1.8mil

III. Cleaning up data situation (print performance, etc.) may take longer than hoped. That would leave us with no good way to assess print performance, and thus make improvements -$1.6mil

IV. Developing good new creative may take longer than expected -$800k

V. Alternative promotions (other than 10%, Shipping) may not become available or may not be effective -$3.5mil

VI. Resource constrains may keep DTC team from completing all planned initiatives -$3mil

VII. Steep & sudden falloff of performance in Print, TV due to creative fatigue could occur with very old creative out there -$2mil

VIII. Recession worries could ring true for 2008

IX. Competitive threat(s) could emerge
I. Strong growth on the top line and bottom line

II. Online vehicles are scaling better than offline, which have been in use longer and seem to have plateaued in their current state (without creative, offer, call center improvements)

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total DTC Revenues</td>
<td>$40.0</td>
<td>$59.3</td>
<td>$76.3</td>
</tr>
<tr>
<td>TV</td>
<td>$6.2</td>
<td>$9.5</td>
<td>$9.9</td>
</tr>
<tr>
<td>Print</td>
<td>$7.5</td>
<td>$7.2</td>
<td>$8.0</td>
</tr>
<tr>
<td>Radio</td>
<td>$2.0</td>
<td>$2.8</td>
<td>$2.5</td>
</tr>
<tr>
<td>PPC</td>
<td>$8.2</td>
<td>$10.1</td>
<td>$11.5</td>
</tr>
<tr>
<td>Affiliate</td>
<td>$2.3</td>
<td>$5.1</td>
<td>$5.4</td>
</tr>
<tr>
<td>dB Marketing</td>
<td>$2.2</td>
<td>$6.3</td>
<td>$7.5</td>
</tr>
<tr>
<td>Untracked</td>
<td>$11.0</td>
<td>$18.9</td>
<td>$22.1</td>
</tr>
<tr>
<td>New Initiatives</td>
<td></td>
<td></td>
<td>$9.4</td>
</tr>
<tr>
<td>Total DTC Net</td>
<td>$16.4</td>
<td>$28.5</td>
<td>$34.8</td>
</tr>
</tbody>
</table>
I. Revenue growth for 2008 is forecast to be 30%. By quarter it is as follows:

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Revenue</th>
<th>Y/Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q107</td>
<td>$13,045,683</td>
<td>164%</td>
</tr>
<tr>
<td>Q207</td>
<td>$12,421,753</td>
<td>141%</td>
</tr>
<tr>
<td>Q307</td>
<td>$14,132,098</td>
<td>139%</td>
</tr>
<tr>
<td>Q407</td>
<td>$19,731,921</td>
<td>151%</td>
</tr>
<tr>
<td>Q108</td>
<td>$16,213,619</td>
<td>124%</td>
</tr>
<tr>
<td>Q208</td>
<td>$15,900,000</td>
<td>128%</td>
</tr>
<tr>
<td>Q308</td>
<td>$18,400,000</td>
<td>130%</td>
</tr>
<tr>
<td>Q408</td>
<td>$25,800,000</td>
<td>131%</td>
</tr>
</tbody>
</table>
I. The Rosetta Stone brand and position we have as the premium product
   I. Brand image
   II. Awareness
   III. Marketing Approach
II. The size of Rosetta Stone, and momentum we have
III. Our rich margins
IV. Our product superiority: a complete solution to language learning, versus the many partial solutions available. As well, the reasonable cost of this total solution
V. Our base of strong, compelling testimonials
VI. Our strong guarantee and what it projects to consumers
VII. Our key kiosk locations, and the lift they give us in awareness and brand strength
I. Our claim of "fastest" may be used by others

II. Limited product offerings hurt promotional options, upsell revenue, follow-on sales, and new customers that low entry price points deliver

III. We have slow time to market with fresh products and competition blockers

IV. We lack comprehensive and accurate data on our business, which would help us optimize

V. Our largely homogenous customer base (older, educated & affluent), and the perception that we are skewed this way
I. TV
   I. Fresh new creative (3 agencies, 2 approaches each)
   II. New Infomercial
   III. Greater variety of spots (120, 60, 30?, more LF)
   IV. Test different offers (stronger closers, 'buy now', etc)
   V. Aggressive buying. Perhaps a new agency

II. Print
   I. Clean up data/measurement issues
   II. Fresh creative (3 agencies, 6 approaches each)
   III. More variety of creative, cycling them regularly
   IV. Expansion into new categories of publications
   V. More testing

III. Online
   I. Engage in robust online programs, more than just PPC/Affiliate. This will not only increase the largest revenue source (Web), but will broaden the demographic to younger.
      I. Display placements with new networks, more targeting partners like Travelocity/Expedia
      II. Text ads on key portals like Yahoo
      III. Placements on shopping sites like Yahoo Shopping and MSN Shopping
   IV. Social Media Initiatives like Facebook, perhaps a YouTube video contest

IV. Set Up EBay Store

V. Conversion
   I. Call Center: take more calls inhouse, improve routing in cloud, new call center, better scripts
   II. Web: LPs, checkout, user experience

VI. Partnerships with key companies (hotels, airlines, credit cards, travel sites)

VII. Overhaul Analytics
   I. Robust forecasting (bottom up, top down), call forecasts
   II. Daily/Weekly reporting
   III. Build data warehouse
   IV. Better TV/Print/Radio metrics
   V. Fix Print data sourcing

VIII. Hispanic
I. Set up two tier affiliate program
II. Discover new opportunities online as yet unidentified
III. New DB Marketing initiatives (partner/external lists, sending more DM to demo inquirers, co-reg, outbound calling, segmentation)
IV. Establish a referral program
V. Print inserts
VI. Hispanic market test
I. Web Optimization
   I. Landing Page Optimization
      I. Develop full test plan, running one test every week
   II. Pay Per Click
      I. Source Bid-Management software
      II. Ongoing Ad copy testing
      III. Quantification of 'Assist' keywords
   III. Affiliate Program
      I. Commission structure optimization
      II. Explore other adv opps like paid placements
      III. Join another affiliate network

II. Demo Conversion
   I. Re-Institute email form on site?
   II. Test creative piece, offer sticker
   III. Continue optimization of cadence/creative/offer

III. Print
   I. Improve analytics
   II. Use much more variety in creative
   III. BW, Duotone
   IV. More 1/2, 1/4 pages
   V. Catalog sized space ads
   VI. Classifieds
<table>
<thead>
<tr>
<th>SP</th>
<th>Jan</th>
<th>Feb</th>
<th>Mar</th>
<th>Apr</th>
<th>May</th>
<th>Jun</th>
<th>Jul</th>
<th>Aug</th>
<th>Sep</th>
<th>Oct</th>
<th>Nov</th>
<th>Dec</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Creative</td>
<td>2 New Creatives</td>
<td>2 New Creatives</td>
<td>2 New Creatives</td>
<td>1 New Creatives</td>
<td>Holiday Message</td>
<td></td>
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</tr>
</tbody>
</table>
| Offer/CTA | 2 New Options | 2 New Options | 2 New Options | 2 New Options | 2 New Options | 2 New Options | 2 New Options | 2 New Options | 2 New Options | 2 New Options | 2 New Options | Ideas:  
- "Call to Order", not to Demo  
- Free Trial for $14.95 (shipin)  
- Payment Plan testing |
| LF       | Creative | 1 New Creative | 1 New Creative | 1 New Creative | Holiday Message |
| Categories | 1 New Category | 1 New Category | 1 New Category | 1 New Category | 1 New Category | 1 New Category | 1 New Category | 1 New Category | 1 New Category | 1 New Category | 1 New Category | 1 New Category |
| DBC      | Creative | 2 New Creatives (Intermedia) | 2 New Creatives (Intermedia) | 2 New Creatives (Intermedia) | 2 New Creatives (Intermedia) | 2 New Creatives (Intermedia) | 2 New Creatives (Intermedia) | 2 New Creatives (Intermedia) | 2 New Creatives (Intermedia) | 2 New Creatives (Intermedia) | 2 New Creatives (Intermedia) | 2 New Creatives (Intermedia) | 2 New Creatives (Intermedia) |