Rosetta Stone Inc.: Pricing the 2009 IPO

Group 102
Executive Summary

Rosetta Stone Inc., formerly known as Fairfield Language Company, is an education technology software company that develops language and literacy software. Products include self-study language learning solutions in 31 languages, which is used by individuals, educational institutions, government agencies and corporations around the world.

Rosetta Stone has successfully developed a strong brand and its aggressive revenue growth has acquired private investment from ABS Capital Partners and Norwest Equity Partners. The company is planning to expand their product line by introducing Rosetta Studio and Rosetta World, products that connect a virtual community of language learners together to practice their skills through dynamic learning opportunities. With this novel learning technology in development, Rosetta Stone sets their sights on expanding their geographic reach.

In order for Rosetta Stone to reach their goals, we advise bringing the company public and raise capital more efficiently from a wider range of audiences.

Rosetta Stone’s sources of capital have always been very limited. The company was only able to attract investments from private equities in 2006. Up until now there is no other major loan or investment available to Rosetta Stone, which hinders their aggressive growth. We believe an initial public offering is their best source of financing at this time, depicted below are advantages and disadvantages of going public and staying private.

Advantages of IPO

- Rosetta Stone would be able to reach a larger number of investors relatively quickly to raise capital
- They would generate analyst coverage from the investment bank underwriting it, as well as the general public, thus increasing business awareness and opportunities
- By issuing an initial public offering, Rosetta Stone would be able to compensate employees and attract new talent with stock options

Disadvantages of IPO

- Initial public offering tend to be a costly process with financial service and underwriter fees, as well as filing fees with the SEC
- An Initial public offering would likely take anywhere from three to nine months, the majority of the time Rosetta Stone’s management team would likely focus on the deal rather than creating new opportunities and value for the company
- Due to SEC regulations, going public would require Rosetta Stone to be subject to a new wave of reporting and disclosure requirements
- Greater scrutiny from investors and analysts which may cause them to sacrifice long-term growth for short term profits.
- Loss of control, when a company goes public, its sole responsibility is to the stockholders, and in some cases when shareholder gain significant control they can override management’s decisions or vote to get rid of them entirely

Although IPO underpricing is a common phenomenon, we encourage Rosetta to price their IPO in our calculated price range because it faithfully represents Rosetta’s current financial performance and realistic assumptions of their future earnings and growth. We recommend Rosetta Stone’s IPO to be priced at the range of $17.8 to $21.17 per share, which is later discussed in our analysis. This would imply an Enterprise Value of $396.5 million with 23.44 million fully diluted shares outstanding. We believe the pricing of this offering is fair given that Rosetta Stone acquires 95% share of the U.S. total language and learning market, and an aggressive revenue expansion despite poor economic conditions, increased profit margins, and superior management team.

Due to the above reasons, we believe Rosetta Stone’s best course of action is an initial public offering to provide capital for their continued growth.
**Comparable Company Analysis**

When selecting comparable companies, we looked into the For-Profit Education sector, the sector that is very similar to Rosetta Stone Inc.’s core business of language learning software business. Within the For-Profit Education sector, we selected 4 companies, which resemble closest to Rosetta Stone Inc. based on their revenue and income growth percentage. The average revenue growth rate for Rosetta Stone is estimated to be 15% which is very close to that of the 4 companies we selected (Table 1). All these companies also have a high income growth rate, similar to that of Rosetta Stone Inc. Moreover, Debt-to-Equity ratio is also a very important metric that we looked for, because the majority of Rosetta Stone’s Capital came from equity. The average D/E ratio of these 4 firms is 1.67%. We then average the levered beta of these 4 companies, and unlevered the mean beta by their average D/E ratio and get a 0.62 unlevered beta. The average EV/EBITDA multiple for these 4 companies is 8.0 times (Table 1).

**Discounted Cash Flow Analysis**

Assumptions played a big role in our case, we wanted to represent Rosetta Stone Inc. in the most realistic way possible. Therefore, our discounted cash flow analysis is based on information provided by management and analyst’s estimates at the time, as well as minor assumptions we made as a group. Most notably includes: a 10 year declining revenue growth rate with an average revenue growth rate of 16% (Table 2), cost of equity of 8.09%, after tax cost of debt of 4.65%, D/E ratio of 12.53% (Table 3), WACC of 7.71% (Table 4), and an 8X EV/EBITDA multiple (Table 1).

We did a discounted cash flow analysis based on a 10 year projection for Rosetta Stone’s key financials. We projected Rosetta Stone’s 10 year average growth rate to be around 16%, with a declining growth rate each year starting from 35% in 2009 and decrease to a steady long term growth rate of 3% from 2017 onwards (Table 2).

Using the estimates given by management and analysts in exhibit 7, we are able to calculate the gross profit with the projected percentage margin (% Margin). EBITDA is calculated by subtracting the forecasted Selling, General and Administrative expenses (SG&A) and Research and Development expense (R&D) from exhibit 7. Further subtracting projected Depreciation and Amortization expense (D&A) obtained from exhibit 7 from EBITDA gives us the EBIT. Assuming constant 38% corporate tax rate, we are subtracting that from EBIT, and obtained the EBIT for Rosetta Stone. The amount of capital expenditure (CapEx) and changes in net-working capital (ΔNWC) is calculated based on the projections in exhibit 7. Adding back our D&A, while subtracting our CapEx and ΔNWC, we are able to project the 10 year free cash flow (FCF) of Rosetta Stone Inc. Discounting our projected FCF by our discount factor obtained by 1/(1+WACC)^Discount Period, we then have our FCF in present value (Table 2).

**WACC Calculation**

In order for us to discount our projected FCF back to present value, we must first calculate our weighted-average-cost-of-capital (WACC), which will be used to calculate our discount factor. We used Rosetta Stone Inc.’s prevailing borrowing rate of 7.5% as our cost-of-debt percentage. Since Rosetta Stone Inc. has a corporate tax rate of 38%, we calculated the after-tax cost of debt of 4.65%. The 30 year U.S. yield data as of 4/9/2009 is 3.76% (Exhibit 4), which is the basis of our risk-free rate, and the average market risk premium during 2008 is 6.5% (Graph 1), the levered beta for Rosetta Stone Inc. is 0.67 (Table 4), which is obtained by re-levering our comparable company’s beta with Rosetta Stone Inc.’s current D/E ratio and tax rate of 12.53% and 38% (Table 3) respectively (0.62*(1+12.53%)*1-38%). The WACC is then calculated by multiplying the after tax cost of debt and cost of equity by their respective weights of 11.14% and 88.86%, which results in 7.71% (Table 4).

We did the above calculation based on book value of equity and debt, although we can calculate the market value of equity based on estimated share price given, we were unable to calculate the market value of debt therefore we settled for capital structure in book value.
Our analysis indicated an Enterprise Value of 396.5 million with an intrinsic share price range of $17.8 to $21.17. Provided Rosetta Stone does go through with an IPO, this would provide them with significant funding to source their growth (Table 6, 9).

The best estimate of true intrinsic value would be the $17.8 to $21.17 price range from both the EMM method and PGM method, which is calculated by analysis depicted below.

**Enterprise Value (Exit Multiple Method)**

Taking our 2018E EBITA (65,266K) as our terminal value and multiple by the average 8.0X EV/EBITDA multiple we obtained from comparable company analysis and discount (0.49 Discount Factor) back to present value, we achieved a present value of our terminal value (25,7840K). The enterprise value is then the sum of cumulative PV of FCF and PV of TV, which results in 396.5M (Table 5).

**Implied Share Price**

From that, we subtract our current total debt (9,910K) and add back cash and cash equivalent (30,660K) to arrive at our implied equity value of 417.2M. Dividing our implied equity value by the number of fully diluted shares outstanding gives us a share price of $24.26 (Table 6).

If we take the discounted enterprise value and compare it with our 2008 EBITDA, we can calculate the implied EV/EBITDA multiple, which is approximately 10.4x (Table 7).

**Enterprise Value (Perpetuity Growth Method)**

If we take a look at the perpetuity growth method by applying the long term growth rate estimated of 3%, we can multiply that to the terminal year 2018E FCF of 31,195K and arrive at our terminal value of 662.3M(31,195/(WACC - growth rate), Graph 9). Discounted back to present terminal value of 336.8M. Summing up our cumulative present value FCF and our present terminal value gives us our enterprise value of 475.5M (Table 8).

**Implied Share Price**

Subtracting our total debt of 9,910K and adding back our cash and cash equivalent of 30,660K to enterprise value gives us the implied equity value of 496.2M. Dividing our implied EV by fully diluted shares outstanding of 23.44M, we get a share price of $21.17 (Table 9).

Taking the discounted enterprise value from our perpetuity growth method and compare it with our 2008 EBITDA, we can calculate the implied EV/EBITDA multiple, which is approximately 12.5x (Table 10).

**Summary**

An initial public offering would give Rosetta Stone $111.5 to $132.3 million in financing net any fees they incurred throughout the IPO process. Based on the $17.8 to $21.17 price range and 30% equity stake in the company or 6.25 million shares it was authorized to sell. This cash injection would allow Rosetta Stone to finance their growth not only in the U.S., but also abroad where the worldwide language learning industry is estimated to be more than $83 billion. Furthermore, as Rosetta Stone continues to show increased operating margins and expands it revenue, the incentive for competition will only intensify. Although the inherent nature of an initial public offering changes the capital structure, responsibility of the company, and creates additional risks. We believe Rosetta Stone will only be able to grow if they acquire a significant source of financing.