Morningstar, Inc.
Form 10-Q
May 01, 2013

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED March 31, 2013
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File Number: 000-51280

MORNINGSTAR, INC.
(Exact Name of Registrant as Specified in its Charter)

Illinois	36-3297908
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)

22 West Washington Street	
Chicago, Illinois	60602
(Address of Principal Executive Offices)	(Zip Code)

(312) 696-6000
(Registrant’s Telephone Number, Including Area Code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer x	Accelerated filer o	Non-accelerated filer o	Smaller reporting company o
	(Do not check if a smaller reporting company)		

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

As of April 26, 2013, there were 46,499,799 shares of the Company’s common stock, no par value, outstanding.

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PART 1. FINANCIAL INFORMATION
Item 1. Financial Statements

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Morningstar, Inc. and Subsidiaries
Unaudited Condensed Consolidated Statements of Income

(in thousands except per share amounts)	Three months ended March 31 2013	2012
Revenue	$168,856	$160,759
Operating expense (1):		
Cost of goods sold	48,010	50,316
Development	13,640	13,365
Sales and marketing	27,980	28,326
General and administrative	27,327	28,178
Depreciation and amortization	11,339	10,175
Total operating expense	128,296	130,360
Operating income	40,560	30,399
Non-operating income (expense):		
Interest income, net	741	869
Gain (loss) on sale of investments, reclassified from other comprehensive income	725	(86)
Other income (expense), net	(521)	(124)
Non-operating income, net	945	659
Income before income taxes and equity in net income of unconsolidated entities	41,505	31,058
Income tax expense	12,427	11,511
Equity in net income of unconsolidated entities	497	566
Consolidated net income	29,575	20,113
Net loss attributable to the noncontrolling interest	43	24
Net income attributable to Morningstar, Inc.	$29,618	$20,137
Net income per share attributable to Morningstar, Inc.:		
Basic	$0.64	$0.40
Diluted	$0.63	$0.40
Dividends per common share:		
Dividends declared per common share	$0.13	$0.10
Dividends paid per common share	$—	$0.10
Weighted average shares outstanding:		
Basic	46,406	49,938
Diluted	46,814	50,758

Three months ended March 31

	2013	2012
(1) Includes stock-based compensation expense of:		
Cost of goods sold	$1,203	$1,089
Development	498	499
Sales and marketing	512	479
General and administrative	1,570	1,799
Total stock-based compensation expense	$3,783	$3,866

See notes to unaudited condensed consolidated financial statements.

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Morningstar, Inc. and Subsidiaries
Unaudited Condensed Consolidated Statements of Comprehensive Income

	Three months ended March 31	
(in thousands)	2013	2012
Consolidated net income	$29,575	$20,113
Other comprehensive income (loss), net of tax:		
Foreign currency translation adjustment	(9,071)	6,965
Unrealized gains on securities:		
Unrealized holding gains arising during period	1,166	909
Reclassification of (gains) losses included in net income	(463)	55
Other comprehensive income (loss)	(8,368)	7,929
Comprehensive income	21,207	28,042
Comprehensive loss attributable to noncontrolling interest	142	107
Comprehensive income attributable to Morningstar, Inc.	$21,349	$28,149

See notes to unaudited condensed consolidated financial statements.

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Morningstar, Inc. and Subsidiaries
Unaudited Condensed Consolidated Balance Sheets

(in thousands except share amounts)	As of March 31 2013	As of December 31 2012
Assets		
Current assets:		
Cash and cash equivalents	$224,892	$163,889
Investments	103,436	157,529
Accounts receivable, less allowance of $676 and $569, respectively	117,744	114,361
Deferred tax asset, net	3,343	3,741
Income tax receivable, net	2,672	14,267
Other	28,091	20,823
Total current assets	480,178	474,610
Property, equipment, and capitalized software, net	91,815	84,022
Investments in unconsolidated entities	35,635	35,305
Goodwill	315,784	320,845
Intangible assets, net	109,717	116,732
Other assets	12,420	10,438
Total assets	$1,045,549	$1,041,952
Liabilities and equity		
Current liabilities:		
Accounts payable and accrued liabilities	$44,777	$43,777
Accrued compensation	36,139	67,317
Deferred revenue	162,074	146,015
Other	242	256
Total current liabilities	243,232	257,365
Accrued compensation	8,569	8,281
Deferred tax liability, net	18,332	21,583
Deferred rent	15,046	15,368
Other long-term liabilities	21,248	12,460
Total liabilities	306,427	315,057
Equity:		
Morningstar, Inc. shareholders' equity:		
Common stock, no par value, 200,000,000 shares authorized, of which 46,487,512 and 46,541,571 shares were outstanding as of March 31, 2013 and December 31, 2012, respectively	5	5
Treasury stock at cost, 5,379,583 shares as of March 31, 2013 and 5,214,070 shares as of December 31, 2012	(312,412)	(301,839)
Additional paid-in capital	528,754	521,285
Retained earnings	520,096	496,354
Accumulated other comprehensive income (loss):		
Currency translation adjustment	(47)	8,925
Unrealized gain on available-for-sale investments	1,490	787
Total accumulated other comprehensive income	1,443	9,712
Total Morningstar, Inc. shareholders' equity	737,886	725,517
Noncontrolling interest	1,236	1,378

Total equity	739,122	726,895
Total liabilities and equity	$ 1,045,549	$ 1,041,952

See notes to unaudited condensed consolidated financial statements.

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Morningstar, Inc. and Subsidiaries
Unaudited Condensed Consolidated Statement of Equity
For the three months ended March 31, 2013

(in thousands, except share amounts)	Morningstar, Inc. Shareholders' Equity							
	Common Stock							
	Shares Outstanding	Par Value	Treasury Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Non Controlling Interests	Total Equity
Balance as of December 31, 2012	46,541,571	$5	$(301,839)	$521,285	$496,354	$9,712	$1,378	$726,895
Net income (loss)		—	—	—	29,618	—	(43)	29,575
Other comprehensive income (loss):								
Unrealized gain on available-for-sale investments, net of income tax of $398		—	—	—	—	1,166	—	1,166
Reclassification of adjustments for gains included in net income, net of income tax of $262		—	—	—	—	(463)	—	(463)
Foreign currency translation adjustment, net		—	—	—	—	(8,972)	(99)	(9,071)
Other comprehensive loss, net		—	—	—	—	(8,269)	(99)	(8,368)
Issuance of common stock related to stock-option exercises and vesting of restricted stock units, net	111,482	—	—	2,006	—	—	—	2,006
Stock-based compensation — restricted stock units		—	—	3,563	—	—	—	3,563
Stock-based compensation — restricted stock		—	—	97	—	—	—	97
Stock-based compensation — stock-options		—	—	123	—	—	—	123
Excess tax benefit derived from stock-option exercises and vesting of restricted stock units		—	—	1,587	—	—	—	1,587
Common shares repurchased	(165,541)	—	(10,573)	—	—	—	—	(10,573)
Dividends declared — common shares outstanding		—	—	—	(5,784)	—	—	(5,784)
Dividends declared — restricted stock units		—	—	93	(92)	—	—	1
Balance as of March 31, 2013	46,487,512	$5	$(312,412)	$528,754	$520,096	$1,443	$1,236	$739,122

See notes to unaudited condensed consolidated financial statements.

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Morningstar, Inc. and Subsidiaries
Unaudited Condensed Consolidated Statements of Cash Flows

(in thousands)	Three months ended March 31 2013	2012
Operating activities		
Consolidated net income	$29,575	$20,113
Adjustments to reconcile consolidated net income to net cash flows from operating activities:		
Depreciation and amortization	11,339	10,175
Deferred income taxes	(2,934)	(1,453)
Stock-based compensation expense	3,783	3,866
Provision for bad debt	175	525
Equity in net income of unconsolidated entities	(497)	(566)
Excess tax benefits from stock-option exercises and vesting of restricted stock units	(1,587)	(3,313)
Other, net	(632)	310
Changes in operating assets and liabilities, net of effects of acquisitions:		
Accounts receivable	(5,906)	(7,439)
Other assets	(6,575)	(3,758)
Accounts payable and accrued liabilities	400	703
Accrued compensation	(31,812)	(35,168)
Income taxes—current	14,487	7,369
Deferred revenue	17,769	14,165
Deferred rent	(461)	716
Other liabilities	(451)	(621)
Cash provided by operating activities	26,673	5,624
Investing activities		
Purchases of investments	(3,694)	(86,796)
Proceeds from maturities and sales of investments	61,152	80,551
Capital expenditures	(9,118)	(8,994)
Purchases of equity- and cost-method investments	—	(6,750)
Other, net	892	9
Cash provided by (used for) investing activities	49,232	(21,980)
Financing activities		
Proceeds from stock-option exercises, net	2,006	3,906
Excess tax benefits from stock-option exercises and vesting of restricted stock units	1,587	3,313
Common shares repurchased	(15,240)	(23,033)
Dividends paid	—	(5,012)
Other, net	(3)	(17)
Cash used for financing activities	(11,650)	(20,843)
Effect of exchange rate changes on cash and cash equivalents	(3,252)	2,110
Net increase (decrease) in cash and cash equivalents	61,003	(35,089)
Cash and cash equivalents—beginning of period	163,889	200,437
Cash and cash equivalents—end of period	$224,892	$165,348

Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$627	$5,553
Supplemental information of non-cash investing and financing activities:		
Unrealized gain on available-for-sale investments	$1,102	$1,498
Equipment obtained under long-term financing arrangement	$4,860	$—

See notes to unaudited condensed consolidated financial statements.

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MORNINGSTAR, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation of Interim Financial Information

The accompanying condensed consolidated financial statements of Morningstar, Inc. and subsidiaries (Morningstar, we, our, the Company) have been prepared to conform to the rules and regulations of the Securities and Exchange Commission (SEC). The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amount of assets, liabilities, revenue, and expenses. Actual results could differ from those estimates. In the opinion of management, the statements reflect all adjustments, which are of a normal recurring nature, necessary to present fairly our financial position, results of operations, equity, and cash flows. These financial statements and notes should be read in conjunction with our Consolidated Financial Statements and Notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2012, filed with the SEC on February 28, 2013.

The acronyms that appear in the Notes to our Unaudited Condensed Consolidated Financial Statements refer to the following:

ASC: Accounting Standards Codification
ASU: Accounting Standards Update
FASB: Financial Accounting Standards Board
SEC: Securities and Exchange Commission

2. Correction

In 2012, we identified errors related to purchases of investments and proceeds from maturities and sales of investments included on our Consolidated Statement of Cash Flows for the three months ended March 31, 2012 that had not been previously detected. We did not properly disclose the correct amounts for both categories by equal, but offsetting, amounts. The financial statements have been corrected to increase the purchases of investments and proceeds from maturities and sales of investments as shown in the table below. The error existed in the first quarter of 2012.

The following table shows our previously reported amounts, the correction, and our as corrected amounts:

	Three months ended March 31, 2012		
($000)	Previously Reported	Correction	As Corrected
Investing Activities			
Purchases of investments	$(344,391)	$257,595	$(86,796)
Proceeds from maturities and sales of investments	$338,146	$(257,595)	$80,551
Cash used for investing activities	$(21,980)	$—	$(21,980)

3. Summary of Significant Accounting Policies

We discuss our significant accounting policies in Note 3 of our Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2012, filed with the SEC on February 28, 2013.

In addition, effective January 1, 2013, we adopted FASB ASU No. 2013-2, Comprehensive Income (Topic 220). The amended guidance requires us to show the effects of items reclassified out of each component of accumulated other comprehensive income to net income on the face of the financial statement where net income is presented. The adoption of ASU No. 2013-2 did not have a material effect on our consolidated financial statements.

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4. Goodwill and Other Intangible Assets

Goodwill

The following table shows the changes in our goodwill balances from December 31, 2012 to March 31, 2013:

	($000)
Balance as of December 31, 2012	$320,845
Net change, currency translation	(5,061)
Balance as of March 31, 2013	$315,784

We did not record any significant impairment losses in the first three months of 2013 or 2012. We perform our annual impairment reviews in the fourth quarter.

Intangible Assets

The following table summarizes our intangible assets:

	As of March 31, 2013				As of December 31, 2012			
($000)	Gross	Accumulated Amortization	Net	Weighted Average Useful Life (years)	Gross	Accumulated Amortization	Net	Weighted Average Useful Life (years)
Intellectual property	$30,572	$ (22,132)	$8,440	9	$30,621	$ (21,527)	$9,094	9
Customer-related assets	130,833	(65,110)	65,723	12	132,798	(63,005)	69,793	12
Supplier relationships	240	(99)	141	20	240	(96)	144	20
Technology-based assets	80,644	(45,341)	35,303	9	81,333	(43,809)	37,524	9
Non-competition agreement	1,768	(1,658)	110	4	1,765	(1,588)	177	4
Total intangible assets	$244,057	$ (134,340)	$109,717	10	$246,757	$ (130,025)	$116,732	10

The following table summarizes our amortization expense related to intangible assets:

	Three months ended March 31	
($000)	2013	2012
Amortization expense	$5,625	$6,055

We amortize intangible assets using the straight-line method over their expected economic useful lives.

We expect intangible amortization expense for 2013 and subsequent years as follows:

	($000)
2013	$20,977
2014	19,759
2015	18,951

2016	14,360
2017	9,828
2018	7,875

Our estimates of future amortization expense for intangible assets may be affected by acquisitions, divestitures, changes in the estimated average useful life, and currency translations.

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5. Income Per Share

The following table shows how we reconcile our net income and the number of shares used in computing basic and diluted income per share:

	Three months ended March 31	
(in thousands, except per share amounts)	2013	2012
Basic net income per share attributable to Morningstar, Inc.:		
Net income attributable to Morningstar, Inc.:	$29,618	$20,137
Less: Distributed earnings available to participating securities	(15)	(16)
Less: Undistributed earnings available to participating securities	(13)	(46)
Numerator for basic net income per share — undistributed and distributed earnings available to common shareholders	$29,590	$20,075
Weighted average common shares outstanding	46,406	49,938
Basic net income per share attributable to Morningstar, Inc.	$0.64	$0.40
Diluted net income per share attributable to Morningstar, Inc.:		
Numerator for basic net income per share — undistributed and distributed earnings available to common shareholders	$29,590	$20,075
Add: Undistributed earnings allocated to participating securities	13	46
Less: Undistributed earnings reallocated to participating securities	(13)	(45)
Numerator for diluted net income per share — undistributed and distributed earnings available to common shareholders	$29,590	$20,076
Weighted average common shares outstanding	46,406	49,938
Net effect of dilutive stock options and restricted stock units	408	820
Weighted average common shares outstanding for computing diluted income per share	46,814	50,758
Diluted net income per share attributable to Morningstar, Inc.	$0.63	$0.40

The following table shows the number of weighted average stock options, restricted stock units, and restricted stock excluded from our calculation of diluted earnings per share because their inclusion would have been anti-dilutive:

	Three months ended March 31	
(in thousands)	2013	2012
Weighted average stock options	—	14
Weighted average restricted stock units	9	—
Weighted average restricted stock	—	—
Total	9	14

These stock options and restricted stock units could be included in the calculation in the future.

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6. Segment and Geographical Area Information

Morningstar has two operating segments:

- Investment Information. The Investment Information segment includes all of our data, software, and research products and services. These products are typically sold through subscriptions or license agreements.

The largest products in this segment based on revenue are Morningstar Data, Morningstar Advisor Workstation (including Morningstar Office), Morningstar Direct, Morningstar.com, Morningstar Integrated Web Tools, Morningstar Structured Credit Ratings, and Morningstar Principia. Morningstar Data is a set of investment data spanning all of our investment databases, including real-time pricing and commodity data, and is available through electronic data feeds. Advisor Workstation is a web-based investment planning system for advisors that is available in two editions: Morningstar Office for independent financial advisors and an enterprise edition for financial advisors affiliated with larger firms. Morningstar Direct is a web-based institutional research platform. Morningstar.com includes both Premium Memberships and Internet advertising sales. Morningstar Integrated Web Tools is a set of services that helps institutional clients build customized websites or enhance their existing sites with Morningstar's online tools and components. Morningstar Structured Credit Ratings is provided by Morningstar Credit Ratings, LLC, a Nationally Recognized Statistical Rating Organization specializing in structured finance. Morningstar Principia is our CD-ROM-based investment research and planning software for advisors.

The Investment Information segment also includes Morningstar Equity Research and Morningstar Credit Ratings, LLC. We sell Morningstar Equity Research to companies that purchase our research for their own use or provide our research to their affiliated advisors or individual investor clients. Morningstar Credit Ratings, LLC offers Structured Credit Ratings as well as research, surveillance services, and data to help institutional investors identify risk in commercial mortgage-backed securities (CMBS).

We also offer a variety of financial communications and newsletters, other institutional and advisor software, and investment indexes.

- Investment Management. The Investment Management segment includes all of our asset management operations, which earn the majority of their revenue from asset-based fees.

The key products and services in this segment based on revenue are Investment Advisory Services, which focuses on investment monitoring and asset allocation for funds of funds, including mutual funds and variable annuities; Retirement Solutions, including the Morningstar Retirement Manager and Advice by Ibbotson platforms; and Morningstar Managed Portfolios, a fee-based discretionary asset management service that includes a series of mutual fund, exchange-traded fund, and stock portfolios tailored to meet a range of investment time horizons and risk levels that financial advisors can use for their clients' taxable and tax-deferred accounts. In addition, we offer Managed Portfolios through our subsidiary Ibbotson Associates Australia Limited which provides asset management services primarily to institutional clients and individual investors.

Our segment accounting policies are the same as those described in Note 3, except for the capitalization and amortization of internal product development costs, amortization of intangible assets, and costs related to corporate functions. We exclude these items from our operating segment results to provide our chief operating decision maker with a better indication of each segment's ability to generate cash flow. This information is one of the criteria used by our chief operating decision maker in determining how to allocate resources to each segment. We include capitalization and amortization of internal product development costs, amortization of intangible assets, and costs related to corporate functions in the Corporate Items category. Our segment disclosures are consistent with the business segment information provided to our chief operating decision maker on a recurring basis; for that reason, we don’t present balance sheet information by segment. We disclose goodwill by segment in accordance with the requirements of FASB ASC 350-20-50, Intangibles - Goodwill - Disclosure.

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The following tables present information about our operating segments and by geographical area:

($000)	Three months ended March 31, 2013 Investment Information	Investment Management	Corporate Items	Total
External revenue	$136,187	$32,669	$—	$168,856
Operating expense, excluding stock-based compensation expense, depreciation, and amortization	89,869	15,619	7,686	113,174
Stock-based compensation expense	2,499	592	692	3,783
Depreciation and amortization	2,352	24	8,963	11,339
Operating income (loss)	$41,467	$16,434	$(17,341)	$40,560
U.S. capital expenditures				$8,009
Non-U.S. capital expenditures				$1,109

($000)	Three months ended March 31, 2012 Investment Information	Investment Management	Corporate Items	Total
External revenue	$126,925	$33,834	$—	$160,759
Operating expense, excluding stock-based compensation expense, depreciation, and amortization	93,438	15,953	6,928	116,319
Stock-based compensation expense	2,559	551	756	3,866
Depreciation and amortization	2,244	39	7,892	10,175
Operating income (loss)	$28,684	$17,291	$(15,576)	$30,399
U.S. capital expenditures				$7,397
Non-U.S. capital expenditures				$1,597

($000)	As of March 31, 2013 Investment Information	Investment Management	Corporate Items	Total
Goodwill	$274,631	$41,153	$—	$315,784

($000)	As of December 31, 2012 Investment Information	Investment Management	Corporate Items	Total
Goodwill	$279,164	$41,681	$ —	$320,845

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External revenue by geographical area

	Three months ended March 31	
($000)	2013	2012
United States	$121,413	$114,469
United Kingdom	13,153	13,736
Europe, excluding the United Kingdom	13,167	12,055
Australia	9,352	9,348
Canada	7,736	7,350
Asia, excluding Japan	2,595	2,369
Japan	829	979
Other	611	453
Total Non-U.S.	47,443	46,290
Total	$168,856	$160,759

Long-lived assets by geographical area

	As of March 31	As of December 31
($000)	2013	2012
United States	$69,664	$60,371
United Kingdom	6,517	7,435
Europe, excluding the United Kingdom	2,116	2,356
Australia	1,374	1,402
Canada	1,641	1,773
Asia, excluding Japan	10,291	10,445
Japan	58	84
Other	154	156
Total Non-U.S.	22,151	23,651
Total	$91,815	$84,022

7. Investments and Fair Value Measurements

We account for our investments in accordance with FASB ASC 320, Investments—Debt and Equity Securities. We classify our investments in three categories: available-for-sale, held-to-maturity, and trading. We monitor the concentration, diversification, maturity, and liquidity of our investment portfolio, which is primarily invested in fixed-income securities, and classify our investment portfolio as shown below:

	As of March 31	As of December 31
($000)	2013	2012
Available-for-sale	$70,193	$125,786
Held-to-maturity	26,408	26,357
Trading securities	6,835	5,386
Total	$103,436	$157,529

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The following table shows the cost, unrealized gains (losses), and fair values related to investments classified as available-for-sale and held-to-maturity:

($000)	As of March 31, 2013 Cost	Unrealized Gain	Unrealized Loss	Fair Value	As of December 31, 2012 Cost	Unrealized Gain	Unrealized Loss	Fair Value
Available-for-sale:								
Government obligations	$17,384	$27	$(108)	$17,303	$40,669	$29	$(608)	$40,090
Corporate bonds	30,171	18	(186)	30,003	49,339	36	(292)	49,083
Foreign obligations	2,433	1	(30)	2,404	2,437	1	(19)	2,419
Commercial paper	—	—	—	—	2,000	—	—	2,000
Equity securities and exchange-traded funds	7,351	943	(164)	8,130	19,613	1,359	(323)	20,649
Mutual funds	10,523	1,956	(126)	12,353	10,499	1,092	(46)	11,545
Total	$67,862	$2,945	$(614)	$70,193	$124,557	$2,517	$(1,288)	$125,786
Held-to-maturity:								
Certificates of deposit	$26,408	$—	$—	$26,408	$26,357	$—	$—	$26,357

As of March 31, 2013 and December 31, 2012, investments with unrealized losses for greater than a 12-month period were not material to the Condensed Consolidated Balance Sheets and were not deemed to have other than temporary declines in value.

The table below shows the cost and fair value of investments classified as available-for-sale and held-to-maturity based on their contractual maturities as of March 31, 2013 and December 31, 2012. The expected maturities of certain fixed-income securities may differ from their contractual maturities because some of these holdings have call features that allow the issuers the right to prepay obligations without penalties.

($000)	As of March 31, 2013 Cost	Fair Value	As of December 31, 2012 Cost	Fair Value
Available-for-sale:				
Due in one year or less	$49,988	$49,710	$87,599	$86,784
Due in one to two years	—	—	6,846	6,808
Equity securities, exchange-traded funds, and mutual funds	17,874	20,483	30,112	32,194
Total	$67,862	$70,193	$124,557	$125,786
Held-to-maturity:				
Due in one year or less	$26,403	$26,403	$26,352	$26,352
Due in one to three years	5	5	5	5
Total	$26,408	$26,408	$26,357	$26,357

As of March 31, 2013 and December 31, 2012, held-to-maturity investments included a $1,500,000 certificate of deposit held primarily as collateral against bank guarantees for our office leases, primarily in Australia.

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The following table shows the realized gains and losses arising from sales of our investments classified as available-for-sale recorded in our Condensed Consolidated Statements of Income:

	Three months ended March 31	
($000)	2013	2012
Realized gains	$1,564	$212
Realized losses	(839)	(298)
Realized gains (losses), net	$725	$(86)

We determine realized gains and losses using the specific identification method.

The following table shows the net unrealized gains (losses) on trading securities as recorded in our Condensed Consolidated Statements of Income:

	Three months ended March 31	
($000)	2013	2012
Unrealized gains, net	$318	$428

The fair value of our assets subject to fair value measurements and that are measured at fair value on a recurring basis using the fair value hierarchy and the necessary disclosures under FASB ASC 820, Fair Value Measurement, are as follows:

	Fair Value as of	Fair Value Measurements as of March 31, 2013 Using Fair Value Hierarchy		
($000)	March 31, 2013	Level 1	Level 2	Level 3
Available-for-sale investments:				
Government obligations	$17,303	$—	$17,303	$—
Corporate bonds	30,003	—	30,003	—
Foreign obligations	2,404	—	2,404	—
Equity securities and exchange-traded funds	8,130	8,130	—	—
Mutual funds	12,353	12,353	—	—
Trading securities	6,835	6,835	—	—
Cash equivalents	9,285	9,285	—	—
Total	$86,313	$36,603	$49,710	$—

	Fair Value as of	Fair Value Measurements as of December 31, 2012 Using Fair Value Hierarchy		
($000)	December 31, 2012	Level 1	Level 2	Level 3
Available-for-sale investments:				
Government obligations	$40,090	$—	$40,090	$—
Corporate bonds	49,083	—	49,083	—
Foreign obligations	2,419	—	2,419	—
Commercial paper	2,000	—	2,000	—
Equity securities and exchange-traded funds	20,649	20,649	—	—
Mutual funds	11,545	11,545	—	—
Trading securities	5,386	5,386	—	—

Cash equivalents	398	398	—	—
Total	$131,570	$37,978	$93,592	$—

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Level 1: Valuations based on quoted prices in active markets for identical assets or liabilities that we have the ability to access.
Level 2: Valuations based on quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.
Level 3: Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

Based on our analysis of the nature and risks of our investments in equity securities and mutual funds, we have determined that presenting each of these investment categories in the aggregate is appropriate.

We measure the fair value of money market funds, mutual funds, equity securities, and exchange-traded funds based on quoted prices in active markets for identical assets or liabilities. All other financial instruments were valued either based on recent trades of securities in inactive markets or based on quoted market prices of similar instruments and other significant inputs derived from observable market data. We did not hold any securities categorized as Level 3 as of March 31, 2013 and December 31, 2012.

8. Investments in Unconsolidated Entities

Our investments in unconsolidated entities consist primarily of the following:

	As of March 31	As of December 31
($000)	2013	2012
Investment in MJKK	$21,152	$20,540
Other equity method investments	6,019	6,288
Investments accounted for using the cost method	8,464	8,477
Total investments in unconsolidated entities	$35,635	$35,305

Morningstar Japan K.K. Morningstar Japan K.K. (MJKK) develops and markets products and services customized for the Japanese market. MJKK’s shares are traded on the Osaka Stock Exchange “Hercules Market” under the ticker 4765. We account for our investment in MJKK using the equity method. The following table summarizes our ownership percentage in MJKK and the market value of this investment based on MJKK’s publicly quoted share price:

	As of March 31	As of December 31
	2013	2012
Morningstar’s approximate ownership of MJKK	34 %	34 %
Approximate market value of Morningstar’s ownership in MJKK:		
Japanese yen (¥000)	¥5,054,213	¥3,109,579
Equivalent U.S. dollars ($000)	$53,676	$36,227

Other Equity Method Investments. As of March 31, 2013 and December 31, 2012, other equity method investments consist of our investment in Morningstar Sweden AB (Morningstar Sweden), YCharts, Inc. (YCharts), and Inquiry Financial Europe AB (Inquiry Financial). Morningstar Sweden develops and markets products and services customized for investors in Sweden. Our ownership interest in Morningstar Sweden was approximately 24% as of March 31, 2013 and December 31, 2012. YCharts is a technology company that provides stock research and analysis. Our ownership interest in YCharts was approximately 22% as of March 31, 2013 and December 31, 2012. Inquiry Financial is a provider of sell-side consensus estimate data. Our ownership interest in Inquiry Financial was approximately 34% as of March 31, 2013 and December 31, 2012.

We did not record any impairment losses on our equity method investments in the first three months of 2013 or 2012.

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Cost Method Investments. As of March 31, 2013 and December 31, 2012, our cost method investments consist of minority investments in Pitchbook Data, Inc. (Pitchbook) and HelloWallet LLC (HelloWallet). Pitchbook offers detailed data and information about private equity transactions, investors, companies, limited partners, and service providers. HelloWallet is a provider of personalized financial guidance to employees of Fortune 1000 companies.

We did not record any impairment losses on our cost method investments in the first three months of 2013 or 2012.

9. Stock-Based Compensation

Stock-Based Compensation Plans

Our shareholders approved the Morningstar 2011 Stock Incentive Plan (the 2011 Plan) on May 17, 2011. As of that date, we stopped granting awards under the Morningstar 2004 Stock Incentive Plan (the 2004 Plan). The 2004 Plan amended and restated the Morningstar 1993 Stock Option Plan, the Morningstar 2000 Stock Option Plan, and the Morningstar 2001 Stock Option Plan.

The 2011 Plan provides for a variety of stock-based awards, including, among other things, stock options, restricted stock units, and restricted stock. We granted stock options, restricted stock units, and restricted stock under the 2004 Plan.

All of our employees and our non-employee directors are eligible for awards under the 2011 Plan.

Grants awarded under the 2011 Plan or the 2004 Plan that are forfeited, canceled, settled, or otherwise terminated without a distribution of shares, or shares withheld by us in connection with the exercise of options, will be available for awards under the 2011 Plan. Any shares subject to awards under the 2011 Plan, but not under the 2004 Plan, that are withheld by us in connection with the payment of any required income tax withholding will be available for awards under the 2011 Plan.

The following table summarizes the number of shares available for future grants under our 2011 Plan:

	As of March 31
(000)	2013
Shares available for future grants	4,741

Accounting for Stock-Based Compensation Awards

The following table summarizes our stock-based compensation expense and the related income tax benefit we recorded in the three months ended March 31, 2013 and March 31, 2012:

	Three months ended March 31	
($000)	2013	2012
Restricted stock units	$3,563	$3,278
Restricted stock	97	444
Stock options	123	144
Total stock-based compensation expense	$3,783	$3,866
Income tax benefit related to the stock-based compensation expense	$1,030	$930

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The following table summarizes the amount of unrecognized stock-based compensation expense as of March 31, 2013 and the expected number of months over which the expense will be recognized:

	Unrecognized stock-based compensation expense ($000)	Expected amortization period (months)
Restricted stock units	$26,014	31
Restricted stock	808	25
Stock options	955	25
Total unrecognized stock-based compensation expense	$27,777	30

In accordance with FASB ASC 718, Compensation—Stock Compensation, we estimate forfeitures of employee stock-based awards and recognize compensation cost only for those awards expected to vest. Our largest annual equity grants typically have vesting dates in the second quarter. We adjust the stock-based compensation expense during the third quarter to reflect those awards that ultimately vested and update our estimate of the forfeiture rate that will be applied to awards not yet vested.

Restricted Stock Units

Restricted stock units represent the right to receive a share of Morningstar common stock when that unit vests. Restricted stock units to employees vest ratably over a four-year period. Restricted stock units granted to non-employee directors vest ratably over a three-year period. For restricted stock units granted through December 31, 2008, employees could elect to defer receipt of the Morningstar common stock issued upon vesting of the restricted stock unit.

We measure the fair value of our restricted stock units on the date of grant based on the closing market price of the underlying common stock on the day prior to grant. We amortize that value to stock-based compensation expense, net of estimated forfeitures, ratably over the vesting period.

The following table summarizes restricted stock unit activity during the first three months of 2013:

Restricted Stock Units (RSUs)	Unvested	Vested but Deferred	Total	Weighted Average Grant Date Value per RSU
RSUs outstanding—December 31, 2012	727,145	18,782	745,927	$ 53.37
Granted	—	—	—	—
Dividend equivalents	—	—	—	—
Vested	(2,586)	—	(2,586)	35.83
Vested but deferred	—	—	—	—
Issued	—	—	—	—
Forfeited	(9,500)	—	(9,500)	53.25
RSUs outstanding—March 31, 2013	715,059	18,782	733,841	53.87

Restricted Stock

In conjunction with our acquisition of Realpoint in May 2010, we issued 199,174 shares of restricted stock to the selling employee-shareholders under the 2004 Stock Incentive Plan. The restricted stock vests ratably over a five-year period from the acquisition date and may be subject to forfeiture if the holder terminates his or her employment during the vesting period.

Because of the terms of the restricted stock agreements prepared in conjunction with the Realpoint acquisition, we account for the grant of restricted stock as stock-based compensation expense and not as part of the acquisition consideration.

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We measured the fair value of the restricted stock on the date of grant based on the closing market price of our common stock on the day prior to the grant. We amortize the fair value of $9,363,000 to stock-based compensation expense over the vesting period. We have assumed that all of the remaining restricted stock will ultimately vest, and therefore have not incorporated a forfeiture rate for purposes of determining the stock-based compensation expense.

Stock Options

Stock options granted to employees vest ratably over a four-year period. Grants to our non-employee directors vest ratably over a three-year period. All grants expire 10 years after the date of grant. Almost all of the options granted under the 2004 Stock Incentive Plan have a premium feature in which the exercise price increases over the term of the option at a rate equal to the 10-year Treasury bond yield as of the date of grant. Options granted under the 2011 Plan have an exercise price equal to the fair market value on the grant date.

In May 2011, we granted 86,106 stock options under the 2004 Stock Incentive Plan. In November 2011, we granted 6,095 stock options under the 2011 Plan. We estimated the fair value of the options on the date of grant using a Black-Scholes option-pricing model. The weighted average fair value of options granted during 2011 was $23.81 per share, based on the following assumptions:

Assumptions for Black-Scholes Option Pricing Model		
Expected life (years):	7.4	
Volatility factor:	35.10	%
Dividend yield:	0.35	%
Interest rate:	2.87	%

The following tables summarize stock option activity in the first three months of 2013 for our various stock option grants. The first table includes activity for options granted at an exercise price below the fair value per share of our common stock on the grant date; the second table includes activity for all other option grants.

Options Granted At an Exercise Price Below the Fair Value Per Share on the Grant Date	Underlying Shares		Weighted Average Exercise Price
Options outstanding—December 31, 2012	282,695		$20.55
Granted	—		—
Canceled	—		—
Exercised	(21,410	)	20.74
Options outstanding—March 31, 2013	261,285		20.78
Options exercisable—March 31, 2013	261,285		$20.78

All Other Option Grants, Excluding Activity Shown Above	Underlying Shares		Weighted Average Exercise Price
Options outstanding—December 31, 2012	391,784		$28.98
Granted	—		—
Canceled	(525	)	17.73
Exercised	(88,672	)	17.11
Options outstanding—March 31, 2013	302,587		32.69

Options exercisable—March 31, 2013	248,487	$27.29

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The following table summarizes the total intrinsic value (difference between the market value of our stock on the date of exercise and the exercise price of the option) of options exercised:

	Three months ended March 31	
($000)	2013	2012
Intrinsic value of options exercised	$5,588	$10,905

The table below shows additional information for options outstanding and exercisable as of March 31, 2013:

	Options Outstanding				Options Exercisable			
Range of Exercise Prices	Number of Options	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Aggregate Intrinsic Value ($000)	Exercisable Shares	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Aggregate Intrinsic Value ($000)
$8.57 - $14.70	29,582	0.11	$8.63	$1,813	29,582	0.11	$8.63	$1,813
$20.74- $47.32	462,615	1.90	23.66	21,400	462,615	1.90	23.66	21,400
$57.28 - $59.35	71,675	8.29	57.46	893	17,575	8.29	57.46	203
$8.57 - $59.35	563,872	4.29	27.17	$24,106	509,772	2.02	23.95	$23,416
Vested or Expected to Vest								
$8.57 - $59.35	563,872	2.62	$27.17	$24,106				

The aggregate intrinsic value in the table above represents the total pretax intrinsic value all option holders would have received if they had exercised all outstanding options on March 31, 2013. The intrinsic value is based on our closing stock price of $69.92 on that date.

Excess Tax Benefits Related to Stock-Based Compensation

FASB ASC 718, Compensation—Stock Compensation, requires that we classify the cash flows that result from excess tax benefits as financing cash flows. Excess tax benefits correspond to the portion of the tax deduction taken on our income tax return that exceeds the amount of tax benefit related to the compensation cost recognized in our Statement of Income. The following table summarizes our excess tax benefits for the three months ended March 31, 2013 and March 31, 2012:

	Three months ended March 31	
($000)	2013	2012
Excess tax benefits related to stock-based compensation	$1,587	$3,313

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10. Income Taxes

Effective Tax Rate

The following table shows our effective income tax rate for the three months ended March 31, 2013 and March 31, 2012:

	Three months ended March 31	
($000)	2013	2012
Income before income taxes and equity in net income of unconsolidated entities	$41,505	$31,058
Equity in net income of unconsolidated entities	497	566
Net loss attributable to the noncontrolling interest	43	24
Total	$42,045	$31,648
Income tax expense	$12,427	$11,511
Effective tax rate	29.6 %	36.4 %

Our effective tax rate in the first quarter of 2013 was 29.6%, a decrease of 6.8 percentage points compared with the prior-year period. The effective tax rate decrease primarily reflects adjustments to certain deferred income tax benefits and reductions in valuation allowances.

Unrecognized Tax Benefits

The table below provides information concerning our gross unrecognized tax benefits as of March 31, 2013 and December 31, 2012. The table also provides the effect these gross unrecognized tax benefits would have on our income tax expense, if they were recognized.

	As of March 31	As of December 31
($000)	2013	2012
Gross unrecognized tax benefits	$13,746	$12,699
Gross unrecognized tax benefits that would affect income tax expense	$13,746	$12,699
Decrease in income tax expense upon recognition of gross unrecognized tax benefits	$11,389	$10,446

In the first quarter of 2013, we recorded a net increase of $1,047,000 of gross tax benefits.

Our Condensed Consolidated Balance Sheets include the following liabilities for unrecognized tax benefits. These amounts include interest and penalties, less any associated tax benefits.

	As of March 31	As of December 31
Liabilities for Unrecognized Tax Benefits ($000)	2013	2012
Current liability	$6,576	$6,568
Non-current liability	6,799	5,659
Total liability for unrecognized tax benefits	$13,375	$12,227

We conduct business globally and as a result, we file income tax returns in U.S. federal, state, local, and foreign jurisdictions. In the normal course of business, we are subject to examination by tax authorities throughout the world.

The open tax years for our U.S. federal tax returns and most state tax returns include the years 2008 to the present. In non-U.S. jurisdictions, the statute of limitations generally extends to years prior to 2005.

We are currently under audit by the U.S. federal and various state and local tax authorities in the United States, as well as tax authorities in certain non-U.S. jurisdictions. It is possible, though not likely, that the examination phase of some of these audits will conclude in 2013. It is not possible to estimate the effect of current audits on previously recorded unrecognized tax benefits.

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Our effective tax rate reflects the fact that we are not recording an income tax benefit related to losses recorded by certain of our non-U.S. operations. The net operating losses (NOLs) may become deductible in certain non-U.S. tax jurisdictions to the extent these non-U.S. operations become profitable. In the year certain non-U.S. entities record a loss, we do not record a corresponding tax benefit, thus increasing our effective tax rate. For each of our operations, we evaluate whether it is more likely than not that the tax benefits related to NOLs will be realized. As part of this evaluation, we consider evidence such as tax planning strategies, historical operating results, forecasted taxable income, and recent financial performance. Upon determining that it is more likely than not that the NOLs will be realized, we reduce the tax valuation allowances related to these NOLs, which results in a reduction to our income tax expense and our effective tax rate in the period.

11. Contingencies

Life's Good S.T.A.B.L. Hedge Fund

In September 2011, three individual investors in Life's Good S.T.A.B.L. Mortgage hedge fund (LG), Marta Klass, Gregory Martin, and Richard Roellig, filed a complaint in the United States District Court for the Eastern District of Pennsylvania against LG, its principal Robert Stinson, and several other parties, including Morningstar, Inc. (the Klass Matter). The plaintiffs claim that Morningstar committed fraud and aided and abetted the other defendants' breach of fiduciary duty through the 5-star rating LG obtained from Morningstar. The plaintiffs seek unspecified damages. Hedge fund managers self-report their performance data to Morningstar.

More than a year before the Klass Matter, in June 2010, the SEC filed suit against LG and other entities claiming they were part of a Ponzi scheme operated by Stinson. As a result, LG and the other entities were placed in court-appointed receivership. Morningstar was not part of the SEC suit or receivership. Since that time, the Receiver, as part of his duties, has been investigating whether to assert claims against third parties. Morningstar is aware of 14 lawsuits filed by the Receiver seeking to recover money for the fund.

In November 2011, Morningstar filed a motion to dismiss the Klass Matter. On behalf of the entities in receivership, the Receiver filed a motion to stay the proceedings because the Receivership Order does not permit suits against the entities in receivership without court permission. The court granted the Receiver's motion and stayed the Klass Matter. In April 2012, the Receiver filed a complaint against Morningstar, in which the Receiver claims that Morningstar is liable for contribution and aiding and abetting Stinson's breach of fiduciary duty and fraud through the 5-star rating LG obtained from Morningstar. The Receiver seeks unspecified damages. The same day the Receiver filed his complaint, Morningstar sought leave from the court to file a counter suit against Stinson and two of his entities-Keystone State Capital Corporation and LG-for, among other things, fraud, misrepresentation, and breach of user agreements. In June 2012, the court denied Morningstar's motion for leave to file suit. The court took no position on the merits of Morningstar's claims, and did not preclude us from renewing our motion to file a complaint at a later time, but deferred to the Receiver's request not to subject the receivership estate to additional litigation at this early point in the receivership. In August 2012, the court denied Morningstar's motion to dismiss the Receiver's complaint.

We believe the allegations against Morningstar by the Klass plaintiffs and the Receiver have no legal or factual basis and we plan to vigorously contest the claims. We also intend to refile our affirmative claims against Stinson, Keystone, and LG at a later time consistent with the court's order. We cannot predict the outcome of the proceedings.

Business Logic Holding Corporation

In November 2009, Business Logic Holding Corporation filed a complaint in the Circuit Court of Cook County, Illinois against Ibbotson Associates, Inc. and Morningstar, Inc. relating to Ibbotson's prior commercial relationship with Business Logic. Business Logic is alleging breach of contract and trade secret misappropriation in connection with Ibbotson's development of a proprietary web-service software and user interface that connects plan participant data with the Ibbotson Wealth Forecasting Engine. Business Logic seeks, among other things, injunctive relief and unspecified damages. Ibbotson and Morningstar answered the complaint, and Ibbotson asserted a counterclaim against Business Logic alleging trade secret misappropriation and breach of contract, seeking damages and injunctive relief. While Morningstar and Ibbotson are vigorously contesting the claims against them, we cannot predict the outcome of the proceeding.

We have not provided an estimate of loss or range of loss in connection with the matters described above because no such estimate can reasonably be made.

In addition to these proceedings, we are involved in legal proceedings and litigation that have arisen in the normal course of our business. Although the outcome of a particular proceeding can never be predicted, we do not believe that the result of any of these other matters will have a material adverse effect on our business, operating results, or financial position.

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12. Share Repurchase Program

In September 2010, the board of directors approved a share repurchase program that authorizes the repurchase of up to $100 million in shares of our outstanding common stock. In December 2011, the board approved an increase to the $100 million share repurchase program it announced in 2010. The board approval authorized the company to repurchase up to an additional $200 million in shares of our outstanding common stock. In December 2012, the board authorized the company to repurchase an additional $200 million in shares of our outstanding common stock, increasing the repurchase program from $300 million to $500 million with a revised expiration date of December 31, 2014. We may repurchase shares from time to time at prevailing market prices on the open market or in private transactions at our discretion. As of March 31, 2013, we had repurchased a total of 5,222,136 shares for $311,510,000 under this authorization.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

The discussion included in this section, as well as other sections of this Quarterly Report on Form 10-Q, contains forward-looking statements as that term is used in the Private Securities Litigation Reform Act of 1995. These statements are based on our current expectations about future events or future financial performance. Forward-looking statements by their nature address matters that are, to different degrees, uncertain, and often contain words such as “may,” “could,” “expect,” “intend,” “plan,” “seek,” “anticipate,” “believe,” “estimate,” “predict,” “potential,” or “continue.” T involve known and unknown risks and uncertainties that may cause the events we discuss not to occur or to differ significantly from what we expect. For us, these risks and uncertainties include, among others:

- general industry conditions and competition, including current global financial uncertainty;
- the impact of market volatility on revenue from asset-based fees;
- damage to our reputation resulting from claims made about possible conflicts of interest;
- liability for any losses that result from an actual or claimed breach of our fiduciary duties;
- financial services industry consolidation;
- liability related to the storage of personal information about our users;
- a prolonged outage of our database and network facilities;
- challenges faced by our non-U.S. operations;
- the availability of free or low-cost investment information; and
- liability and/or damage to our reputation as a result of some of our currently pending litigation.

A more complete description of these risks and uncertainties can be found in our other filings with the Securities and Exchange Commission (SEC), including our Annual Report on Form 10-K for the year ended December 31, 2012. If any of these risks and uncertainties materialize, our actual future results may vary significantly from what we expect. We do not undertake to update our forward-looking statements as a result of new information or future events.

All dollar and percentage comparisons, which are often accompanied by words such as “increase,” “decrease,” “grew,” “declined,” “was up,” “was down,” “was flat,” or “was similar” refer to a comparison with the same period in the prior year unless otherwise stated.

Understanding our Company

Our Business

Our mission is to create great products that help investors reach their financial goals. We offer an extensive line of data, software, and research products for individual investors, financial advisors, and institutional clients. We also offer investment management services for advisors, institutions, and retirement plan participants. Many of our products are sold through subscriptions or license agreements. As a result, we typically generate recurring revenue.

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Our company has two operating segments: The Investment Information segment includes all of our data, software, and research products and services. These products and services are typically sold through subscriptions or license agreements. The Investment Management segment includes all of our asset management operations, which are registered investment advisors and earn more than half of their revenue from asset-based fees.

Over our 29-year history, we have focused primarily on organic growth by introducing new products and services and expanding our existing products. From 2006 through 2010, we also completed 24 acquisitions to support our growth strategies.

Industry Overview

We monitor developments in the economic and financial information industry to help inform our company strategy, product development plans, and marketing initiatives.

As the economy continued showing signs of improvement and tax fears abated, equity markets were off to a strong start in 2013, particularly in the United States. The Morningstar U.S. Market Index, a broad market benchmark, gained 11.0% in the quarter. The Global Ex-U.S. Index was up a more modest 3.7%.

U.S. mutual fund assets stood at $13.5 trillion as of February 28, 2013, based on data from the Investment Company Institute (ICI), compared with $13.0 trillion as of December 31, 2012. Based on Morningstar's estimated asset flow data, investors added $184 billion to long-term open-end funds during the first quarter and pulled $93 billion from money market funds. While taxable-bond funds continued to garner healthy asset flows, equity funds focusing on U.S. stocks had their first quarter of positive net inflows since the beginning of 2011.

Assets in exchange-traded funds (ETFs) rose to $1.4 trillion as of February 28, 2013, compared with $1.2 trillion as of February 28, 2012, based on data from the ICI.

While we've seen positive momentum in the markets and continued signs of economic growth so far in 2013, we believe the business environment for the financial services industry remains challenging. Firms continue to be cautious about spending against a backdrop of low interest rates, client risk aversion, and increased regulation. Further, the historically low interest-rate environment has put significant pressure on the margins of many firms, most notably those in the variable annuity space. As a result, we expect there will be further pressure on revenue from clients in this area.

Three Months Ended March 31, 2013 vs. Three Months Ended March 31, 2012

Consolidated Results

	Three months ended March 31		
Key Metrics ($000)	2013	2012	Change
Revenue	$168,856	$160,759	5.0 %
Operating income	$40,560	$30,399	33.4 %
Operating margin	24.0 %	18.9 %	5.1 pp
Cash provided by (used for) investing activities	$49,232	$(21,980)	NMF
Cash used for financing activities	$(11,650)	$(20,843)	(44.1)%
Cash provided by operating activities	$26,673	$5,624	374.3 %

Capital expenditures	(9,118)	(8,994)	1.4 %
Free cash flow	$17,555	$(3,370)	NMF

pp — percentage points
NMF — Not meaningful

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We define free cash flow as cash provided by or used for operating activities less capital expenditures. We present free cash flow solely as supplemental disclosure to help investors better understand how much cash is available after we spend money to operate our business. Our management team uses free cash flow to evaluate our business. Free cash flow is not equivalent to any measure required to be reported under U.S. generally accepted accounting principles (GAAP). Also, the free cash flow definition we use may not be comparable to similarly titled measures used by other companies.

Consolidated Revenue

In the first quarter of 2013, our consolidated revenue increased 5.0% to $168.9 million, compared with $160.8 million in the first quarter of 2012. Currency movements had a slightly negative effect in the quarter, lowering revenue by approximately $0.4 million. We had no incremental revenue during 2013 from acquisitions. Our 2012 results included revenue of $1.2 million from businesses that we sold in 2012 and that did not recur in 2013.

Excluding acquisitions, divestitures, and the effect of foreign currency translations, our consolidated revenue rose $9.7 million, or 6.1%, in the first quarter of 2013. Leading the growth were Morningstar Direct, Morningstar Data, and Structured Credit Ratings. Retirement Solutions and Morningstar Managed Portfolios also contributed to the organic revenue increase, although to a lesser extent. These positive factors helped offset the loss of business from our largest client in the Investment Management segment. As previously announced, a large Investment Advisory Services client moved to in-house management of several fund-of-funds portfolios in April 2012. We recognized about $3.2 million in associated revenue in the first quarter of 2012.

To make it easier for investors to compare our results in different periods, we provide information on both organic revenue, which reflects our underlying business excluding acquisitions, divestitures, and the effect of foreign currency translations, and revenue from divestitures and acquisitions. We did not complete any acquisitions during the three months ended March 31, 2013. We had two divestitures in the fourth quarter of 2012. We include a divested operation as part of revenue from divestitures for 12 months after we complete the divestiture.

The table below reconciles consolidated revenue with organic revenue (revenue excluding acquisitions, divestitures, and the effect of foreign currency translations):

	Three months ended March 31		
($000)	2013	2012	Change
Consolidated revenue	$168,856	$160,759	5.0 %
Less: acquisitions	—	—	n/a
Less: divestitures	—	(1,163)	NMF
Unfavorable effect of foreign currency translations	440	—	NMF
Organic revenue	$169,296	$159,596	6.1 %

n/a — not applicable

Organic revenue (revenue excluding acquisitions, divestitures, and the effect of foreign currency translations) is considered a non-GAAP financial measure. The definition of organic revenue we use may not be the same as similarly titled measures used by other companies. Organic revenue should not be considered an alternative to any measure of performance as promulgated under GAAP.

International revenue made up 28.1% of our consolidated revenue in the first quarter of 2013, compared with 28.8% in the first quarter of 2012. More than half of our international revenue is from Europe, with most of the remainder from

Australia and Canada. Revenue from international operations was up $1.2 million, or 2.5%, to $47.4 million for the first quarter of 2013.

Foreign currency translations had a slightly negative effect on our international revenue. We had no incremental revenue during 2013 from acquisitions. Our 2012 international results included revenue of $1.1 million from businesses that we sold in 2012 and that did not recur in 2013. Excluding acquisitions, divestitures, and the effect of foreign currency translations, international revenue rose 5.9% in the first quarter, reflecting stronger product sales in most regions.

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International organic revenue (international revenue excluding acquisitions, divestitures, and the effect of foreign currency translations) is considered a non-GAAP financial measure. The definition of international organic revenue we use may not be the same as similarly titled measures used by other companies. International organic revenue should not be considered an alternative to any measure of performance as promulgated under GAAP.

The tables below present a reconciliation from international revenue to international organic revenue (international revenue excluding acquisitions, divestitures, and the effect of foreign currency translations):

	Three months ended March 31		
($000)	2013	2012	Change
International revenue	$47,443	$46,290	2.5 %
Less: acquisitions	—	—	n/a
Less: divestitures	—	(1,076)	NMF
Unfavorable effect of foreign currency translations	440	—	NMF
International organic revenue	$47,883	$45,214	5.9 %

Consolidated Operating Expense

	Three months ended March 31		
($000)	2013	2012	Change
Operating expense	$128,296	$130,360	(1.6)%
% of revenue	76.0 %	81.1 %	(5.1) pp

In the first quarter of 2013, our consolidated operating expense decreased $2.1 million, or 1.6%.

General and administrative (G&A) expense in the first three months of 2012 included $1.6 million for an impairment charge for one of our smaller products and a litigation settlement. These expenses did not recur in 2013.

Lower bonus expense of $0.8 million in the first quarter also contributed to the decline in operating expense.

We had approximately 3,445 employees worldwide as of March 31, 2013, compared with 3,495 as of December 31, 2012 and 3,520 as of March 31, 2012. Headcount was down because we closed our Delhi office and consolidated our Indian operations in Mumbai in the first quarter of 2013. In addition, we continue to be cautious about filling open positions, primarily in the United States and Europe.

Intangible amortization expense decreased $0.4 million in the quarter, primarily because certain intangible assets from some of our earlier acquisitions are now fully amortized. However, depreciation expense rose $1.6 million in the quarter.

Cost of Goods Sold

	Three months ended March 31		
($000)	2013	2012	Change
Cost of goods sold	$48,010	$50,316	(4.6)%
% of revenue	28.4 %	31.3 %	(2.9) pp
Gross profit	$120,846	$110,443	9.4 %
Gross margin	71.6 %	68.7 %	2.9 pp

Cost of goods sold is our largest category of operating expense, representing more than one-third of our total operating expense. Our business relies heavily on human capital, and cost of goods sold includes the compensation expense for employees who produce our products and services. Compensation expense for approximately half of our employees is included in this category.

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Cost of goods sold decreased $2.3 million in the first quarter of 2013. Lower compensation expense, including bonus, salaries, and employee benefit costs, contributed $1.5 million to the decrease.

Our gross margin improved 2.9 percentage points in the first quarter of the year as costs in this category decreased and revenue increased.

Development Expense

	Three months ended March 31		
($000)	2013	2012	Change
Development expense	$13,640	$13,365	2.1 %
% of revenue	8.1 %	8.3 %	(0.2) pp

Development expense increased $0.3 million in the first quarter of 2013. We capitalized $1.6 million and $1.7 million of software development expense in the first quarter of 2013 and 2012, respectively, reducing the expense that we would otherwise report in this category. Higher bonus expense of $0.5 million in the first quarter of 2013 was the primary driver of the increase. In 2012, bonus expense of $2.1 million was offset by a $1.0 million reduction in bonus expense related to the prior-year bonus because we paid a smaller portion of the 2011 bonus to employees in this category than we originally estimated.

As a percentage of revenue, development expense was 0.2 percentage points lower in the first three months of 2013.

Sales and Marketing Expense

Three months ended March 31