

Morningstar, Inc.  
Form 10-Q  
July 31, 2013

Table of Contents

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED June 30, 2013

OR

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

(State or Other Jurisdiction of  
Incorporation or Organization)

36-3297908

(I.R.S. Employer

Identification Number)

22 West Washington Street

Chicago, Illinois

(Address of Principal Executive Offices)

(312) 696-6000

60602

(Zip Code)

(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  No

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  No

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  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(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  No

As of July 26, 2013, there were 46,111,853 shares of the Company's common stock, no par value, outstanding.



Table of Contents

MORNINGSTAR, INC. AND SUBSIDIARIES  
INDEX

<u>PART 1</u>	<u>FINANCIAL INFORMATION</u>	<u>3</u>
<u>Item 1.</u>	<u>Financial Statements</u>	<u>3</u>
	Unaudited Condensed Consolidated Statements of Income for the three and six months ended June 30, 2013 and 2012	<u>4</u>
	<u>Unaudited Condensed Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2013 and 2012</u>	<u>5</u>
	Unaudited Condensed Consolidated Balance Sheets as of June 30, 2013 and December 31, 2012	<u>6</u>
	Unaudited Condensed Consolidated Statement of Equity for the six months ended June 30, 2013	<u>7</u>
	Unaudited Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2013 and 2012	<u>8</u>
	<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	<u>10</u>
<u>Item 2.</u>	<u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>30</u>
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	<u>49</u>
<u>Item 4.</u>	<u>Controls and Procedures</u>	<u>49</u>
<u>PART 2</u>	<u>OTHER INFORMATION</u>	<u>51</u>
<u>Item 1.</u>	<u>Legal Proceedings</u>	<u>51</u>
<u>Item 1A.</u>	<u>Risk Factors</u>	<u>51</u>
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>51</u>
<u>Item 6.</u>	<u>Exhibits</u>	<u>51</u>
	<u>SIGNATURE</u>	<u>52</u>
	<u>EXHIBIT INDEX</u>	<u>53</u>



Table of Contents

PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

3

---

Table of Contents

## Morningstar, Inc. and Subsidiaries

## Unaudited Condensed Consolidated Statements of Income

(in thousands except per share amounts)	Three months ended June 30		Six months ended June 30	
	2013	2012	2013	2012
Revenue	\$175,428	\$165,968	\$344,284	\$326,727
Operating expense (1):				
Cost of goods sold	50,273	49,452	98,283	99,768
Development	14,154	12,442	27,794	25,807
Sales and marketing	28,035	27,373	56,015	55,699
General and administrative	28,120	24,946	55,447	53,124
Depreciation and amortization	11,262	10,619	22,601	20,794
Total operating expense	131,844	124,832	260,140	255,192
Operating income	43,584	41,136	84,144	71,535
Non-operating income (expense):				
Interest income, net	664	1,260	1,405	2,129
Gain (loss) on sale of investments, reclassified from other comprehensive income	423	37	1,148	(49 )
Holding gain upon acquisition of additional ownership of equity method investments	3,713	—	3,713	—
Other expense, net	(1,689 )	(302 )	(2,210 )	(426 )
Non-operating income, net	3,111	995	4,056	1,654
Income before income taxes and equity in net income of unconsolidated entities	46,695	42,131	88,200	73,189
Income tax expense	15,955	14,744	28,382	26,255
Equity in net income of unconsolidated entities	360	497	857	1,063
Consolidated net income	31,100	27,884	60,675	47,997
Net loss attributable to the noncontrolling interest	21	4	64	28
Net income attributable to Morningstar, Inc.	\$31,121	\$27,888	\$60,739	\$48,025
Net income per share attributable to Morningstar, Inc.:				
Basic	\$0.67	\$0.57	\$1.31	\$0.97
Diluted	\$0.66	\$0.56	\$1.30	\$0.95
Dividends per common share:				
Dividends declared per common share	\$0.13	\$0.10	\$0.25	\$0.20
Dividends paid per common share	\$0.13	\$0.10	\$0.13	\$0.20

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Weighted average shares outstanding:

Basic	46,400	49,195	46,403	49,566
Diluted	46,853	49,856	46,756	50,296

	Three months ended June 30		Six months ended June 30	
	2013	2012	2013	2012
(1) Includes stock-based compensation expense of:				
Cost of goods sold	\$1,204	\$1,067	\$2,407	\$2,156
Development	487	465	985	964
Sales and marketing	522	461	1,034	940
General and administrative	1,741	1,741	3,311	3,540
Total stock-based compensation expense	\$3,954	\$3,734	\$7,737	\$7,600

See notes to unaudited condensed consolidated financial statements.

Table of Contents

## Morningstar, Inc. and Subsidiaries

## Unaudited Condensed Consolidated Statements of Comprehensive Income

(in thousands)	Three months ended June 30		Six months ended June 30	
	2013	2012	2013	2012
Consolidated net income	\$31,100	\$27,884	\$60,675	\$47,997
Other comprehensive income (loss):				
Foreign currency translation adjustment	(7,128	) (8,743	) (16,199	) (1,778
Unrealized gains on securities, net of tax:				
Unrealized holding gains arising during period	(166	) (541	) 1,000	368
Reclassification of gains included in net income	(271	) (22	) (734	) 33
Other comprehensive loss	(7,565	) (9,306	) (15,933	) (1,377
Comprehensive income	23,535	18,578	44,742	46,620
Comprehensive (income) loss attributable to noncontrolling interest	64	(46	) 206	61
Comprehensive income attributable to Morningstar, Inc.	\$23,599	\$18,532	\$44,948	\$46,681

See notes to unaudited condensed consolidated financial statements.

Table of Contents

## Morningstar, Inc. and Subsidiaries

## Unaudited Condensed Consolidated Balance Sheets

(in thousands except share amounts)	As of June 30 2013	As of December 31 2012
Assets		
Current assets:		
Cash and cash equivalents	\$ 169,810	\$ 163,889
Investments	144,973	157,529
Accounts receivable, less allowance of \$784 and \$569, respectively	110,646	114,361
Deferred tax asset, net	3,590	3,741
Income tax receivable, net	6,492	14,267
Other	26,874	20,823
Total current assets	462,385	474,610
Property, equipment, and capitalized software, net	95,550	84,022
Investments in unconsolidated entities	36,087	35,305
Goodwill	321,425	320,845
Intangible assets, net	112,073	116,732
Other assets	11,537	10,438
Total assets	\$ 1,039,057	\$ 1,041,952
Liabilities and equity		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 47,639	\$ 43,777
Accrued compensation	50,326	67,317
Deferred revenue	155,059	146,015
Other	272	256
Total current liabilities	253,296	257,365
Accrued compensation	8,144	8,281
Deferred tax liability, net	24,072	21,583
Deferred rent	14,457	15,368
Other long-term liabilities	21,812	12,460
Total liabilities	321,781	315,057
Equity:		
Morningstar, Inc. shareholders' equity:		
Common stock, no par value, 200,000,000 shares authorized, of which 46,131,688 and 46,541,571 shares were outstanding as of June 30, 2013 and December 31, 2012, respectively	5	5
Treasury stock at cost, 5,943,566 shares as of June 30, 2013 and 5,214,070 shares as of December 31, 2012	(352,503)	(301,839)
Additional paid-in capital	529,334	521,285
Retained earnings	545,347	496,354
Accumulated other comprehensive income (loss):		
Currency translation adjustment	(7,132)	) 8,925
Unrealized gain on available-for-sale investments	1,053	787
Total accumulated other comprehensive income	(6,079)	) 9,712
Total Morningstar, Inc. shareholders' equity	716,104	725,517
Noncontrolling interest	1,172	1,378

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Total equity	717,276	726,895
Total liabilities and equity	\$1,039,057	\$1,041,952

See notes to unaudited condensed consolidated financial statements.

6

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Table of Contents

Morningstar, Inc. and Subsidiaries  
 Unaudited Condensed Consolidated Statement of Equity  
 For the six months ended June 30, 2013

(in thousands, except share amounts)	Morningstar, Inc. Shareholders' Equity					Accumulated Other Comprehensive Income (Loss)	Non Controlling Interests	Total Equity
	Common Stock Shares Outstanding	Par Value Treasury Stock	Treasury Stock	Additional Paid-in Capital	Retained Earnings			
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)		—	—	—	60,739	—	(64)	60,675
Other comprehensive income (loss):								
Unrealized gain on available-for-sale investments, net of income tax of \$151		—	—	—	—	1,000	—	1,000
Reclassification of adjustments for gains included in net income, net of income tax of \$414		—	—	—	—	(734)	—	(734)
Foreign currency translation adjustment, net		—	—	—	—	(16,057)	(142)	(16,199)
Other comprehensive loss, net		—	—	—	—	(15,791)	(142)	(15,933)
Issuance of common stock related to stock-option exercises and vesting of 337,886 restricted stock units, net	337,886	—	1,286	(3,633)	—	—	—	(2,347)
Stock-based compensation — restricted stock units		—	—	7,297	—	—	—	7,297
Stock-based compensation — restricted stock		—	—	194	—	—	—	194
Stock-based compensation — stock-options		—	—	246	—	—	—	246
Excess tax benefit derived from stock-option exercises and vesting of restricted stock units		—	—	3,842	—	—	—	3,842
Common shares repurchased (747,769)	(747,769)	—	(51,950)	—	—	—	—	(51,950)
Dividends declared — common shares outstanding		—	—	—	(11,563)	—	—	(11,563)
Dividends declared — restricted stock units		—	—	103	(183)	—	—	(80)
Balance as of June 30, 2013	46,131,688	\$5	\$(352,503)	\$529,334	\$545,347	\$(6,079)	\$1,172	\$717,276

See notes to unaudited condensed consolidated financial statements.



Table of Contents

## Morningstar, Inc. and Subsidiaries

## Unaudited Condensed Consolidated Statements of Cash Flows

(in thousands)	Six months ended June 30	
	2013	2012
Operating activities		
Consolidated net income	\$60,675	\$47,997
Adjustments to reconcile consolidated net income to net cash flows from operating activities:		
Depreciation and amortization	22,601	20,794
Deferred income taxes	(38	) 299
Stock-based compensation expense	7,737	7,600
Provision for bad debts	461	717
Equity in net income of unconsolidated entities	(857	) (1,063
Excess tax benefits from stock-option exercises and vesting of restricted stock units	(3,842	) (4,548
Holding gain upon acquisition of additional ownership of equity method investments	(3,713	) —
Other, net	688	745
Changes in operating assets and liabilities, net of effects of acquisitions:		
Accounts receivable	524	(4,394
Other assets	(3,465	) (3,640
Accounts payable and accrued liabilities	638	652
Accrued compensation	(19,581	) (26,920
Income taxes—current	13,693	4,525
Deferred revenue	11,023	12,333
Deferred rent	(872	) 468
Other liabilities	(537	) (776
Cash provided by operating activities	85,135	54,789
Investing activities		
Purchases of investments	(82,299	) (133,888
Proceeds from maturities and sales of investments	96,128	161,523
Capital expenditures	(18,881	) (17,922
Acquisitions, net of cash acquired	(11,125	) —
Proceeds from sale of a business	957	—
Purchases of equity- and cost-method investments	(909	) (6,750
Other, net	436	—
Cash provided by (used for) investing activities	(15,693	) 2,963
Financing activities		
Proceeds from stock-option exercises	2,810	4,474
Employee taxes withheld for restricted stock units	(5,157	) (3,693
Excess tax benefits from stock-option exercises and vesting of restricted stock units	3,842	4,548
Common shares repurchased	(53,937	) (105,439
Dividends paid	(5,889	) (10,004
Other, net	(50	) (20
Cash used for financing activities	(58,381	) (110,134
Effect of exchange rate changes on cash and cash equivalents	(5,140	) (556

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Net increase (decrease) in cash and cash equivalents	5,921	(52,938 )
Cash and cash equivalents—beginning of period	163,889	200,437
Cash and cash equivalents—end of period	\$169,810	\$147,499
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	\$14,511	\$21,405

8

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Table of Contents

Supplemental information of non-cash investing and financing activities:

Unrealized gain on available-for-sale investments	\$418	\$606
Equipment obtained under long-term financing arrangement	\$4,860	\$—

See notes to unaudited condensed consolidated financial statements.

9

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Table of Contents

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. 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.

Table of Contents

## 3. Acquisitions, Goodwill and Other Intangible Assets

## Acquisitions

## Increased Ownership Interest in Morningstar Sweden AB

In May 2013, we acquired an additional 76% interest in Morningstar Sweden AB (Morningstar Sweden), increasing our ownership to 100% from 24%. Morningstar's main offerings in Sweden include Morningstar Direct, Morningstar Data, Integrated Web Tools, and Morningstar.se, an investment information website for individual investors that provides fund and ETF data, portfolio tools, and market analysis. We began consolidating the financial results of this acquisition in our Consolidated Financial Statements on May 2, 2013.

Morningstar Sweden's total preliminary estimated fair value of \$18,783,000 includes \$14,748,000 in cash paid to acquire the remaining 76% interest in Morningstar Sweden and \$4,035,000 related to the 24% of Morningstar Sweden we previously held. We determined the preliminary fair value of the previously held 24% investment independent of the acquired controlling interest by applying a minority interest discount based on analysis of comparable transactions. Accordingly, we recorded a preliminary non-cash holding gain of \$3,713,000. The gain is included in non-operating income in our Unaudited Condensed Consolidated Statement of Income. The gain is preliminary pending receipt of the final valuation of our previously held investment.

The following table summarizes our preliminary allocation of the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition, all of which are preliminary pending receipt of the final valuation:

	(\$000)	
Cash and cash equivalents	\$3,472	
Accounts receivable and other current assets	519	
Other non-current assets	244	
Intangible assets	9,000	
Goodwill	9,940	
Deferred revenue	(1,191	)
Deferred tax liability	(2,118	)
Other current and non-current liabilities	(1,083	)
Total fair value of Morningstar Sweden	\$18,783	

The preliminary allocation includes \$9,000,000 of acquired intangible assets, as follows:

	(\$000)	Weighted Average Useful Life (years)
Customer-related assets	\$9,000	14
Total intangible assets	\$9,000	14

We recognized a preliminary deferred tax liability of \$2,118,000 mainly because the amortization expense related to certain intangible assets is not deductible for income tax purposes. The fair value of the acquired intangible assets and the deferred tax liability are preliminary pending receipt of the final valuation for these intangible assets.

Preliminary goodwill of \$9,940,000 represents the premium over the fair value of the net tangible and intangible assets acquired with this acquisition. We paid this premium for a number of reasons, including the opportunity to offer Morningstar's full suite of products and services to investors in Sweden and further leverage Morningstar's global reach, investment databases, and technology expertise.



Table of Contents

## Goodwill

The following table shows the changes in our goodwill balances from December 31, 2012 to June 30, 2013:

	(\$000)
Balance as of December 31, 2012	\$320,845
Acquisition of remaining ownership in Morningstar Sweden	9,940
Other, primarily foreign currency translation	(9,360 )
Balance as of June 30, 2013	\$321,425

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

## Intangible Assets

The following table summarizes our intangible assets:

(\$000)	As of June 30, 2013			Weighted Average Useful Life (years)	As of December 31, 2012			Weighted Average Useful Life (years)
	Gross	Accumulated Amortization	Net		Gross	Accumulated Amortization	Net	
Intellectual property	\$29,577	\$ (22,012 )	\$7,565	9	\$30,621	\$ (21,527 )	\$9,094	9
Customer-related assets	138,673	(67,508 )	71,165	12	132,798	(63,005 )	69,793	12
Supplier relationships	240	(102 )	138	20	240	(96 )	144	20
Technology-based assets	79,720	(46,618 )	33,102	9	81,333	(43,809 )	37,524	9
Non-competition agreement	1,680	(1,577 )	103	4	1,765	(1,588 )	177	4
Total intangible assets	\$249,890	\$ (137,817 )	\$112,073	10	\$246,757	\$ (130,025 )	\$116,732	10

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

(\$000)	Three months ended June 30		Six months ended June 30	
	2013	2012	2013	2012
Amortization expense	\$5,337	\$5,976	\$10,962	\$12,031

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	\$21,155
2014	20,174
2015	19,367
2016	14,821

2017	10,362
2018	8,411

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

12

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Table of Contents

## 4. 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:

(in thousands, except per share amounts)	Three months ended June 30		Six months ended June 30	
	2013	2012	2013	2012
Basic net income per share attributable to Morningstar, Inc.:				
Net income attributable to Morningstar, Inc.:	\$31,121	\$27,888	\$60,739	\$48,025
Less: Distributed earnings available to participating securities	(2	) (12	) (5	) (27
Less: Undistributed earnings available to participating securities	(9	) (53	) (18	) (88
Numerator for basic net income per share — undistributed and distributed earnings available to common shareholders	\$31,110	\$27,823	\$60,716	\$47,910
Weighted average common shares outstanding	46,400	49,195	46,403	49,566
Basic net income per share attributable to Morningstar, Inc.	\$0.67	\$0.57	\$1.31	\$0.97
Diluted net income per share attributable to Morningstar, Inc.:				
Numerator for basic net income per share — undistributed and distributed earnings available to common shareholders	\$31,110	\$27,823	\$60,716	\$47,910
Add: Undistributed earnings allocated to participating securities	9	53	18	88
Less: Undistributed earnings reallocated to participating securities	(9	) (53	) (17	) (87
Numerator for diluted net income per share — undistributed and distributed earnings available to common shareholders	\$31,110	\$27,823	\$60,717	\$47,911
Weighted average common shares outstanding	46,400	49,195	46,403	49,566
Net effect of dilutive stock options and restricted stock units	453	661	353	730
Weighted average common shares outstanding for computing diluted income per share	46,853	49,856	46,756	50,296
Diluted net income per share attributable to Morningstar, Inc.	\$0.66	\$0.56	\$1.30	\$0.95



Table of Contents

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:

(in thousands)	Three months ended June 30		Six months ended June 30	
	2013	2012	2013	2012
Weighted average stock options	—	13	—	13
Weighted average restricted stock units	2	—	22	—
Weighted average restricted stock	—	—	—	—
Total	2	13	22	13

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

## 5. Segment and Geographical Area Information

As of June 30, 2013, Morningstar had 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, Morningstar Equity Research, 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 Equity Research is sold to companies that purchase our research for their own use or provide our research to their affiliated advisors or individual investor clients. Morningstar Principia is our CD-ROM-based investment research and planning software for advisors.

The Investment Information segment also includes Morningstar Credit Ratings, LLC. 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.

Table of Contents

Our segment accounting policies are the same as those described in Note 2, 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.

Table of Contents

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

(\$000)	Three months ended June 30, 2013			Total
	Investment Information	Investment Management	Corporate Items	
External revenue	\$141,426	\$34,002	\$ —	\$175,428
Operating expense, excluding stock-based compensation expense, depreciation, and amortization	91,751	16,856	8,021	116,628
Stock-based compensation expense	2,483	611	860	3,954
Depreciation and amortization	2,343	19	8,900	11,262
Operating income (loss)	\$44,849	\$16,516	\$(17,781)	\$43,584
U.S. capital expenditures				\$8,241
Non-U.S. capital expenditures				\$1,522

(\$000)	Three months ended June 30, 2012			Total
	Investment Information	Investment Management	Corporate Items	
External revenue	\$134,749	\$31,219	\$ —	\$165,968
Operating expense, excluding stock-based compensation expense, depreciation, and amortization	86,915	17,179	6,385	110,479
Stock-based compensation expense	2,531	529	674	3,734
Depreciation and amortization	2,300	38	8,281	10,619
Operating income (loss)	\$43,003	\$13,473	\$(15,340)	\$41,136
U.S. capital expenditures				\$6,818
Non-U.S. capital expenditures				\$2,110

(\$000)	Six months ended June 30, 2013			Total
	Investment Information	Investment Management	Corporate Items	
External revenue	\$277,613	\$66,671	\$ —	\$344,284
Operating expense, excluding stock-based compensation expense, depreciation, and amortization	181,620	32,475	15,707	229,802
Stock-based compensation expense	4,982	1,203	1,552	7,737
Depreciation and amortization	4,695	43	17,863	22,601
Operating income (loss)	\$86,316	\$32,950	\$(35,122)	\$84,144
U.S. capital expenditures				\$16,250
Non-U.S. capital expenditures				\$2,631



Table of Contents

(\$000)	Six months ended June 30, 2012			
	Investment Information	Investment Management	Corporate Items	Total
External revenue	\$261,674	\$65,053	\$ —	\$326,727
Operating expense, excluding stock-based compensation expense, depreciation, and amortization	180,353	33,132	13,313	226,798
Stock-based compensation expense	5,090	1,080	1,430	7,600
Depreciation and amortization	4,544	77	16,173	20,794
Operating income (loss)	\$71,687	\$30,764	\$(30,916)	\$71,535
U.S. capital expenditures				\$14,215
Non-U.S. capital expenditures				\$3,707

(\$000)	As of June 30, 2013			
	Investment Information	Investment Management	Corporate Items	Total
Goodwill	\$280,252	\$41,173	\$ —	\$321,425

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

(\$000)	Three months ended June 30		Six months ended June 30	
	2013	2012	2013	2012
External revenue by geographical area				
United States	\$126,335	\$117,952	\$247,748	\$232,421
United Kingdom	14,015	14,714	27,168	28,450
Europe, excluding the United Kingdom	13,993	12,281	27,160	24,336
Australia	9,176	9,791	18,528	19,139
Canada	7,812	7,397	15,548	14,747
Asia, excluding Japan	2,661	2,366	5,256	4,735
Japan	788	986	1,617	1,965
Other	648	481	1,259	934
Total Non-U.S.	49,093	48,016	96,536	94,306
Total	\$175,428	\$165,968	\$344,284	\$326,727

Table of Contents

## Long-lived assets by geographical area

	As of June 30	As of December 31
(\$000)	2013	2012
United States	\$74,154	\$60,371
United Kingdom	6,318	7,435
Europe, excluding the United Kingdom	2,169	2,356
Australia	1,114	1,402
Canada	1,484	1,773
Asia, excluding Japan	10,121	10,445
Japan	51	84
Other	139	156
Total Non-U.S.	21,396	23,651
Total	\$95,550	\$84,022

## 6. 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 June 30	As of December 31
(\$000)	2013	2012
Available-for-sale	\$109,687	\$125,786
Held-to-maturity	28,343	26,357
Trading securities	6,943	5,386
Total	\$144,973	\$157,529

Table of Contents

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 June 30, 2013				As of December 31, 2012			
	Cost	Unrealized Gain	Unrealized Loss	Fair Value	Cost	Unrealized Gain	Unrealized Loss	Fair Value
Available-for-sale:								
Government obligations	\$25,277	\$11	\$(61)	\$25,227	\$40,669	\$29	\$(608)	\$40,090
Corporate bonds	54,189	8	(302)	53,895	49,339	36	(292)	49,083
Foreign obligations	2,437	—	(41)	2,396	2,437	1	(19)	2,419
Commercial paper	7,484	—	(2)	7,482	2,000	—	—	2,000
Equity securities and exchange-traded funds	8,038	515	(220)	8,333	19,613	1,359	(323)	20,649
Mutual funds	10,615	1,838	(99)	12,354	10,499	1,092	(46)	11,545
Total	\$108,040	\$2,372	\$(725)	\$109,687	\$124,557	\$2,517	\$(1,288)	\$125,786
Held-to-maturity:								
Certificates of deposit	\$28,343	\$—	\$—	\$28,343	\$26,357	\$—	\$—	\$26,357

As of June 30, 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 June 30, 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 June 30, 2013		As of December 31, 2012	
	Cost	Fair Value	Cost	Fair Value
Available-for-sale:				
Due in one year or less	\$49,646	\$49,421	\$87,599	\$86,784
Due in one to two years	39,741	39,579	6,846	6,808
Equity securities, exchange-traded funds, and mutual funds	18,653	20,687	30,112	32,194
Total	\$108,040	\$109,687	\$124,557	\$125,786
Held-to-maturity:				
Due in one year or less	\$28,339	\$28,339	\$26,352	\$26,352
Due in one to three years	4	4	5	5
Total	\$28,343	\$28,343	\$26,357	\$26,357

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As of June 30, 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.

Table of Contents

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:

(\$000)	Six months ended June 30	
	2013	2012
Realized gains	\$2,226	\$470
Realized losses	(1,078	) (519
Realized gains (losses), net	\$1,148	\$(49

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:

(\$000)	Six months ended June 30	
	2013	2012
Unrealized gains, net	\$273	\$156

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:

(\$000)	Fair Value as of June 30, 2013	Fair Value Measurements as of June 30, 2013 Using Fair Value Hierarchy		
		Level 1	Level 2	Level 3
Available-for-sale investments:				
Government obligations	\$25,227	\$—	\$25,227	\$—
Corporate bonds	53,895	—	53,895	—
Foreign obligations	2,396	—	2,396	—
Equity securities and exchange-traded funds	8,333	8,333	—	—
Mutual funds	12,354	12,354	—	—
Trading securities	6,943	6,943	—	—
Cash equivalents	9,489	9,489	—	—
Total	\$118,637	\$37,119	\$81,518	\$—

(\$000)	Fair Value as of December 31, 2012	Fair Value Measurements as of December 31, 2012 Using Fair Value Hierarchy		
		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	—	—

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

20

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Table of Contents

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 June 30, 2013 and December 31, 2012.

## 7. Investments in Unconsolidated Entities

Our investments in unconsolidated entities consist primarily of the following:

	As of June 30	As of December 31
(\$000)	2013	2012
Investment in MJKK	\$20,900	\$20,540
Other equity method investments	6,366	6,288
Investments accounted for using the cost method	8,821	8,477
Total investments in unconsolidated entities	\$36,087	\$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 Tokyo Stock Exchange under the ticker 47650. 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 June 30	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)	¥9,218,664	¥3,109,579
Equivalent U.S. dollars (\$000)	\$93,016	\$36,227

Other Equity Method Investments. As of June 30, 2013 and December 31, 2012, other equity method investments consist of our investment in YCharts, Inc. (YCharts), and Inquiry Financial Europe AB (Inquiry Financial). YCharts is a technology company that provides stock research and analysis. Our ownership interest in YCharts was approximately 22% as of June 30, 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 June 30, 2013 and December 31, 2012.



Table of Contents

As of December 31, 2012, other equity-method investments also included our investment in Morningstar Sweden. Our ownership interest and profit-and-loss sharing interest in Morningstar Sweden was 24% at that date. In May 2013, we acquired an additional 76% ownership interest in Morningstar Sweden, increasing our ownership interest to 100%. Upon acquiring the majority ownership, we recorded a non-cash gain of \$3,713,000. This gain represents the difference between the estimated fair value and the book value of our investment in Morningstar Sweden at the date of acquisition. Because Morningstar Sweden is now a wholly owned subsidiary, we no longer account for our investment using the equity method. Beginning in May 2013, we consolidate the assets, liabilities, and results of operations of Morningstar Sweden in our Unaudited Condensed Consolidated Financial Statements. See Note 3 for additional information concerning our acquisition of Morningstar Sweden.

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

Cost Method Investments. As of June 30, 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 six months of 2013 or 2012.

## 8. 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 June 30
(in thousands)	2013
Shares available for future grants	4,521



Table of Contents

## 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 six months ended June 30, 2013 and June 30, 2012:

(\$000)	Three months ended June 30		Six months ended June 30	
	2013	2012	2013	2012
Restricted stock units	\$3,734	\$3,270	\$7,297	\$6,548
Restricted stock	97	444	194	888
Stock options	123	20	246	164
Total stock-based compensation expense	\$3,954	\$3,734	\$7,737	\$7,600
Income tax benefit related to the stock-based compensation expense	\$1,068	\$882	\$2,098	\$1,804

The following table summarizes the amount of unrecognized stock-based compensation expense as of June 30, 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	\$38,079	36
Restricted stock	711	22
Stock options	831	22
Total unrecognized stock-based compensation expense	\$39,621	35

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.



Table of Contents

The following table summarizes restricted stock unit activity during the first six 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	244,364	—	244,364	69.99
Dividend equivalents	1,357	36	1,393	54.85
Vested	(251,514)	) —	(251,514)	) 49.88
Vested but deferred	—	—	—	—
Issued	—	(2,257)	) (2,257)	) 49.40
Forfeited	(23,605)	) —	(23,605)	) 55.01
RSUs outstanding—June 30, 2013	697,747	16,561	714,308	60.29

## 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.

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.

The following tables summarize stock option activity in the first six 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	(250)	) 21.04

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Exercised	(33,972	) 20.82
Options outstanding—June 30, 2013	248,473	21.01
Options exercisable—June 30, 2013	248,473	\$21.01

24

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Table of Contents

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	(1,252	) 13.71
Exercised	(125,159	) 15.89
Options outstanding—June 30, 2013	265,373	35.69
Options exercisable—June 30, 2013	229,326	\$32.25

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:

(\$000)	Six months ended June 30	
	2013	2012
Intrinsic value of options exercised	\$8,170	\$14,531

The table below shows additional information for options outstanding and exercisable as of June 30, 2013:

Range of Exercise Prices	Options Outstanding			Options Exercisable				
	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	735	0.78	\$10.95	\$49	735	0.78	\$10.95	\$49
\$20.96 - \$47.86	441,436	1.65	23.93	23,683	441,436	1.65	23.93	23,683
\$57.28 - \$59.35	71,675	8.03	57.46	1,442	35,628	8.01	57.37	692
\$8.57 - \$59.35	513,846	2.54	28.59	\$25,174	477,799	2.12	26.40	\$24,424
Vested or Expected to Vest								
\$8.57 - \$59.35	513,846	2.54	\$28.59	\$25,174				

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 June 30, 2013. The intrinsic value is based on our closing stock price of \$77.58 on that date.

Table of Contents

## 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 six months ended June 30, 2013 and June 30, 2012:

(\$000)	Three months ended June 30		Six months ended June 30	
	2013	2012	2013	2012
Excess tax benefits related to stock-based compensation	\$2,255	\$1,235	\$3,842	\$4,548

Table of Contents

## 9. Income Taxes

## Effective Tax Rate

The following table shows our effective income tax rate for the three and six months ended June 30, 2013 and June 30, 2012:

(\$000)	Three months ended June 30		Six months ended June 30		
	2013	2012	2013	2012	
Income before income taxes and equity in net income of unconsolidated entities	\$46,695	\$42,131	\$88,200	\$73,189	
Equity in net income of unconsolidated entities	360	497	857	1,063	
Net loss attributable to the noncontrolling interest	21	4	64	28	
Total	\$47,076	\$42,632	\$89,121	\$74,280	
Income tax expense	\$15,955	\$14,744	\$28,382	\$26,255	
Effective tax rate	33.9	% 34.6	% 31.8	% 35.3	%

Our effective tax rate in the second quarter of 2013 was 33.9%, a decrease of 0.7 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 June 30, 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.

(\$000)	As of June 30	As of December 31
	2013	2012
Gross unrecognized tax benefits	\$14,332	\$12,699
Gross unrecognized tax benefits that would affect income tax expense	\$14,332	\$12,699
Decrease in income tax expense upon recognition of gross unrecognized tax benefits	\$11,877	\$10,446

In the first six months of 2013, we recorded a net increase of \$1,633,000 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.

Liabilities for Unrecognized Tax Benefits (\$000)	As of June 30	As of December 31
	2013	2012
Current liability	\$6,604	\$6,568
Non-current liability	7,367	5,659
Total liability for unrecognized tax benefits	\$13,971	\$12,227

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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.

## Table of Contents

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.

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.

## 10. 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. We have not provided an estimate of loss or range of loss in connection with this matter because no such estimate can reasonably be made.



Table of Contents

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, compensatory damages, punitive damages, attorneys' fees, and injunctive relief. Ibbotson and Morningstar answered the complaint, and Ibbotson asserted a counterclaim against Business Logic alleging trade secret misappropriation and breach of contract, also seeking damages and injunctive relief. Business Logic filed a motion for summary judgment on its breach of contract claim, which is pending but has not yet been decided by the Circuit Court.

As noted above, Business Logic's complaint seeks, among other things, compensatory damages, punitive damages, attorneys' fees, and injunctive relief. With regard to compensatory damages, based on the analysis of Ibbotson's retained damages expert (who has assumed, solely for purposes of his analysis, that Business Logic will prevail with regard to the issue of liability), and recognizing the uncertainty inherent in litigation and our intention to continue to vigorously defend the claims made by Business Logic, our best estimate of the range of possible loss is between \$0 and \$5.4 million, excluding punitive damages or attorneys' fees, both of which are recoverable in certain circumstances under the Illinois Trade Secrets Act. Business Logic's retained damages expert (who has also assumed for purposes of her estimate that Business Logic will prevail with regard to the issue of liability) has, however, estimated compensatory damages of \$84 million, excluding punitive damages or attorneys' fees. We dispute the conclusions reached and the methods employed by Business Logic's expert.

With regard to Business Logic's claim for injunctive relief, no reasonable estimate of loss or range of loss is possible. Morningstar and Ibbotson continue to vigorously contest all the claims against them in this matter. We cannot, however, predict the outcome of the proceeding.

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.

11. 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 June 30, 2013, we had repurchased a total of 5,804,364 shares for \$352,886,000 under this authorization.

## Table of Contents

### 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." They 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.

As of the second quarter of 2013, we currently have 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.

Beginning in the third quarter of 2013, we will begin reporting based on one operating segment to reflect our shift to a more centralized organizational structure. We will continue to report revenue for our two main product groups: Information Products and Investment Management.

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. During the second quarter of 2013, we also acquired the remaining ownership interest in Morningstar Sweden AB to become the sole owner.

Table of Contents

Industry Overview

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

Market volatility increased during the second quarter of 2013 as fears about central-bank actions across the globe made investors increasingly cautious. After strong gains in the first quarter, the Morningstar U.S. Market Index, a broad market benchmark, was up a more modest 2.7% in the second quarter of 2013. The Global Ex-U.S. Index was down 3.1%.

U.S. mutual fund assets stood at \$13.9 trillion as of May 31, 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 withdrew \$47 billion from long-term open-end funds in June 2013, driven entirely by heavy outflows from taxable and municipal bond funds. For the second quarter overall, investors added about \$27 billion to long-term open-end funds, down from \$184 billion in the first quarter.

Assets in exchange-traded funds (ETFs) rose to \$1.5 trillion as of May 31, 2013, compared with \$1.1 trillion as of May 31, 2012, based on data from the ICI.

For the first half of 2013, new issuance of commercial mortgage-backed securities (CMBS) totaled \$50.6 billion, compared with \$65.0 billion for full-year 2012. Morningstar Credit Ratings, a Nationally Recognized Statistical Rating Organization and the structured credit research and ratings subsidiary of Morningstar, Inc. was engaged to provide ratings on 20 new-issue rating deals for the year to date through June 30, 2013, with a rated balance of \$12.5 billion.

In July 2013, the United States Department of Labor (DOL) revised the definition of "Rating Agency" in its amended requirements for the Exemption From Certain Prohibited Transaction Restrictions of the Employee Retirement Income Security Act of 1974 (ERISA), commonly referred to as the "Underwriter Exemptions", to eliminate any specific reference to a particular credit rating agency. The amended exemption increases the ability of employee benefit plans to invest in structured credit securities that carry ratings issued by Morningstar Credit Ratings.

While economic growth has generally improved 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.

Table of Contents

Three and Six Months Ended June 30, 2013 vs. Three and Six Months Ended June 30, 2012

## Consolidated Results

Key Metrics (\$000)	Three months ended June 30				Six months ended June 30			
	2013	2012	Change		2013	2012	Change	
Revenue	\$175,428	\$165,968	5.7	%	\$344,284	\$326,727	5.4	%
Operating income	\$43,584	\$41,136	6.0	%	\$84,144	\$71,535	17.6	%
Operating margin	24.8	% 24.8	%	—	24.4	% 21.9	%	2.5 pp
Cash provided by (used for) investing activities	\$(64,925 )	\$24,943	NMF		\$(15,693 )	\$2,963	NMF	
Cash used for financing activities	\$(46,731 )	\$(89,291 )	(47.7 )%		\$(58,381 )	\$(110,134 )	(47.0 )%	
Cash provided by operating activities	\$58,462	\$49,165	18.9	%	\$85,135	\$54,789	55.4	%
Capital expenditures	(9,763 )	(8,928 )	9.4	%	(18,881 )	(17,922 )	5.4	%
Free cash flow	\$48,699	\$40,237	21.0	%	\$66,254	\$36,867	79.7	%

pp — percentage points

NMF — Not meaningful

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 second quarter of 2013, our consolidated revenue increased 5.7% to \$175.4 million, compared with \$166.0 million in the second quarter of 2012. Currency movements had a slightly negative effect in the quarter, lowering revenue by approximately \$0.7 million. We had \$0.9 million of revenue during 2013 from acquisitions. Our 2012 results included revenue of \$1.5 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 \$10.8 million, or 6.6%, in the second quarter of 2013. Leading the growth were Morningstar Direct, Morningstar Managed Portfolios, Retirement Solutions, and Morningstar Data.

Revenue for the first half of the year increased 5.4% to \$344.3 million. Currency movements had a slightly negative effect in the first half, lowering revenue by approximately \$1.2 million. We had \$0.9 million of revenue during the first half of 2013 from acquisitions. Our 2012 results included revenue of \$2.7 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 \$20.5 million, or 6.3%, in the first half of 2013. Leading the growth were Morningstar Direct, Morningstar Data, Morningstar Managed Portfolios, and Retirement Solutions.

The positive product trends mentioned above for both the second quarter and first half of 2013 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 \$0.6 million and \$3.8 million in revenue in the second quarter and first half of 2012, respectively, associated with our work on these portfolios.

Table of Contents

To make it easier for investors to compare our results in different periods, we provide information on organic revenue, which reflects our underlying business excluding acquisitions, divestitures, and the effect of foreign currency translations, and revenue from divestitures and acquisitions. We had one acquisition during the six months ended June 30, 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):

(\$000)	Three months ended June 30			Six months ended June 30		
	2013	2012	Change	2013	2012	Change
Consolidated revenue	\$175,428	\$165,968	5.7 %	\$344,284	\$326,727	5.4 %
Less: acquisitions	(867 )	—	NMF	(867 )	—	NMF
Less: divestitures	—	(1,500 )	NMF	—	(2,663 )	NMF
Unfavorable effect of foreign currency translations	749	—	NMF	1,189	—	NMF
Organic revenue	\$175,310	\$164,468	6.6 %	\$344,606	\$324,064	6.3 %

NMF - not meaningful

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 about 28% of our consolidated revenue in the second quarter and first half of 2013, compared with about 29% in the second quarter and first half 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 \$1.1 million, or 2.2%, to \$49.1 million for the second quarter of 2013 compared to \$48.0 in the second quarter of 2012. Revenue from international operations rose \$2.2 million, or 2.4%, to \$96.5 million in the first half of 2013 compared to \$94.3 million in the first half of 2012.

Foreign currency translations had a slightly negative effect on our international revenue. We had \$0.9 million in incremental revenue during the second quarter and first half of 2013 from acquisitions. Our second quarter and first six months of 2012 international results included revenue of \$1.4 million and \$2.5 million, respectively, 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 5.0% in the second quarter and 5.5% in the first half of 2013, reflecting stronger product sales in most regions.

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.

Table of Contents

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):

(\$000)	Three months ended June 30			Six months ended June 30		
	2013	2012	Change	2013	2012	Change
International revenue	\$49,093	\$48,016	2.2 %	\$96,536	\$94,306	2.4 %
Less: acquisitions	(867 )	—	NMF	(867 )	—	NMF
Less: divestitures	—	(1,385 )	NMF	—	(2,461 )	NMF
Unfavorable effect of foreign currency translations	749	—	NMF	1,189	—	NMF
International organic revenue	\$48,975	\$46,631	5.0 %	\$96,858	\$91,845	5.5 %

## Consolidated Operating Expense

(\$000)	Three months ended June 30			Six months ended June 30		
	2013	2012	Change	2013	2012	Change
Operating expense	\$131,844	\$124,832	5.6 %	\$260,140	\$255,192	1.9 %
% of revenue	75.2 %	75.2 %	—	75.6 %	78.1 %	(2.5 ) pp

In the second quarter of 2013, our consolidated operating expense increased \$7.0 million, or 5.6%. For the first six months of 2013, operating expense increased \$4.9 million, or 1.9%. Higher salary expense of \$2.8 million and \$2.3 million was the primary driver of the increase in total operating expense in the quarter and first half of 2013, respectively. Of the increase in salary expense, approximately \$1.5 million resulted from moving up the timing of annual salary increases this year to April from July. Salary increases made in July 2012 also contributed to the higher salary expense. Higher bonus expense of \$2.2 million and \$1.4 million also contributed to the increase in both the second quarter and first half of 2013, respectively. The bonus expense increase mainly reflects the comparison from unusually low expense in the second quarter of 2012. We review and update our estimates and the bonus pool size quarterly, primarily based on our expectations for full-year revenue and operating income metrics relative to internal targets.

We had approximately 3,425 employees worldwide as of June 30, 2013, compared with 3,495 as of December 31, 2012 and 3,490 as of June 30, 2012.

Intangible amortization expense decreased \$0.6 million in the quarter and \$1.1 million in the first half of the year, primarily because certain intangible assets from some of our earlier acquisitions are now fully amortized. However, depreciation expense rose \$1.3 million in the second quarter and \$2.9 million in the first half of the year, primarily driven by amortization of software development costs and higher capital expenditures for computer software in the United States.

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

## Cost of Goods Sold

(\$000)	Three months ended June 30			Six months ended June 30		
	2013	2012	Change	2013	2012	Change

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Cost of goods sold	\$50,273	\$49,452	1.7	%	\$98,283	\$99,768	(1.5	)%
% of revenue	28.7	% 29.8	% (1.1	) pp	28.5	% 30.5	% (2.0	) pp
Gross profit	\$125,155	\$116,516	7.4	%	\$246,001	\$226,959	8.4	%
Gross margin	71.3	% 70.2	% 1.1	pp	71.5	% 69.5	% 2.0	pp

34

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Table of Contents

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.

Cost of goods sold increased \$0.8 million in the second quarter of 2013 and decreased \$1.5 million in the first half of 2013. Higher salary expense was the primary contributor to the increase in the second quarter.

Our gross margin improved 1.1 percentage points in the second quarter and 2.0 percentage points in the first half of the year as revenue increased faster than our cost basis in this category.

## Development Expense

(\$000)	Three months ended June 30			Six months ended June 30		
	2013	2012	Change	2013	2012	Change
Development expense	\$14,154	\$12,442	13.8 %	\$27,794	\$25,807	7.7 %
% of revenue	8.1	% 7.5	% 0.6 pp	8.1	% 7.9	% 0.2 pp

Development expense increased \$1.7 million in the second quarter of 2013 and \$2.0 million in the first six months of 2013. We capitalized \$2.2 million and \$3.8 million of software development expense in the second quarter and first half of 2013, respectively, reducing the expense that we would otherwise report in this category. In comparison, we capitalized \$2.4 million and \$4.1 million in the second quarter and first six months of 2012, respectively. Higher salary expense of \$0.9 million in the second quarter of 2013 and \$1.0 million in the first half of the year was the primary driver of the increase. Higher bonus expense also contributed to the increase, although to a lesser extent.

As a percentage of revenue, development expense was 0.6 percentage points higher in the second quarter of 2013 and 0.2 percentage points higher in the first half of 2013.

## Sales and Marketing Expense

(\$000)	Three months ended June 30			Six months ended June 30		
	2013	2012	Change	2013	2012	Change
Sales and marketing expense	\$28,035	\$27,373	2.4 %	\$56,015	\$55,699	0.6 %
% of revenue	16.0	% 16.5	% (0.5 ) pp	16.3	% 17.0	% (0.7 ) pp

Sales and marketing expense increased \$0.7 million in the second quarter of 2013 and \$0.3 million in the first half of 2013. Higher commissions of \$1.0 million and \$1.9 million in the second quarter and first half of 2013, respectively, contributed to the increase. Lower bonus expense, advertising and marketing expense, and travel expense partially offset the increase in operating expense in the first half of the year.

As a percentage of revenue, sales and marketing expense was down 0.5 percentage points in the second quarter and 0.7 percentage points for the first half of 2013, primarily reflecting lower bonus expense as a percentage of revenue.

## General and Administrative Expense

(\$000)	Three months ended June 30			Six months ended June 30		
	2013	2012	Change	2013	2012	Change

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General and administrative expense	\$28,120	\$24,946	12.7	%	\$55,447	\$53,124	4.4	%
% of revenue	16.0	% 15.0	% 1.0	pp	16.1	% 16.3	% (0.2)	) pp

35

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Table of Contents

G&A expense increased \$3.2 million in the second quarter of 2013 and \$2.3 million in the first half of 2013. Higher professional fees, rent expense, bonus expense, and salary expense contributed to the increase in the second quarter and first half of 2013. G&A expense in the first half of 2012 included about \$1.6 million of expense for an impairment charge for one of our smaller products and a litigation settlement. These expenses did not recur in 2013.

Bonus expense was up \$0.9 million in the first half of 2013. However, in the first quarter of 2013, we paid a greater portion of the 2012 bonus to employees in this category compared with our initial estimate, contributing \$0.5 million to the bonus expense recorded in the first half of 2013.

As a percentage of revenue, G&A expense increased 1.0 percentage points in the second quarter of 2013. As a percentage of revenue, G&A expense declined 0.2 percentage points in the first half of 2013, primarily reflecting the unfavorable effect of the \$1.6 million non-recurring expense on our 2012 results.

## Depreciation and Amortization Expense

(\$000)	Three months ended June 30			Six months ended June 30			
	2013	2012	Change	2013	2012	Change	
Depreciation expense	\$5,925	\$4,643	27.6 %	\$11,639	\$8,763	32.8 %	
Amortization expense	5,337	5,976	(10.7 )%	10,962	12,031	(8.9 )%	
Total depreciation and amortization expense	\$11,262	\$10,619	6.1 %	\$22,601	\$20,794	8.7 %	
% of revenue	6.4	% 6.4	% —	6.6	% 6.4	% 0.2	pp

Depreciation expense rose \$1.3 million in the second quarter of 2013 and \$2.9 million in the first half of the year, primarily related to amortization of software development costs and increased capital expenditures for computer software for our operations in the United States. Amortization expense decreased \$0.6 million in the second quarter of 2013 and \$1.1 million in the first half of 2013, primarily because certain intangible assets from some of our earlier acquisitions are now fully amortized.

We expect that amortization of intangible assets will be an ongoing cost for the remaining lives of the assets. We estimate that aggregate amortization expense for intangible assets will be approximately \$21.2 million in 2013 and \$20.2 million in 2014. Our estimates of future amortization expense for intangible assets may be affected by additional acquisitions, dispositions, changes in the estimated average useful lives, and currency translations.

As a percentage of revenue, depreciation and amortization expense was unchanged in the second quarter and up slightly in the first half of 2013.

## Stock-Based Compensation Expense

(\$000)	Three months ended June 30			Six months ended June 30			
	2013	2012	Change	2013	2012	Change	
Total stock-based compensation expense	\$3,954	\$3,734	5.9 %	\$7,737	\$7,600	1.8 %	
% of revenue	2.3	% 2.2	% 0.1	pp 2.2	% 2.3	% (0.1 )	pp

Our stock-based compensation expense relates to grants of restricted stock units (RSUs), restricted stock, and stock options. We include this cost in each of our operating expense categories. Stock-based compensation expense increased \$0.1 million in the first six months of 2013, and was down slightly as a percentage of revenue compared

with the same period in 2012.

We describe our stock-based compensation in more detail in Note 8 of the Notes to our Unaudited Condensed Consolidated Financial Statements.

36

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Table of Contents

Based on grants of RSUs, stock options, and restricted stock made through June 30, 2013, we anticipate that stock-based compensation expense will be approximately \$16.0 million in 2013. This amount is subject to change based on additional equity grants or changes in our estimated forfeiture rate related to these grants.

## Bonus Expense

The amount of bonus expense is not a fixed cost. We review and update our estimates and the bonus pool size quarterly, primarily based on our expectations for full-year revenue and operating income metrics relative to internal targets. We record bonus expense throughout the year and pay annual bonuses to employees in the first quarter of the following year.

(\$000)	Three months ended June 30			Six months ended June 30			
	2013	2012	Change	2013	2012	Change	
Bonus expense	\$9,628	\$7,398	30.1 %	\$20,154	\$18,718	7.7 %	
% of revenue	5.5	% 4.5	% 1.0	pp 5.9	% 5.7	% 0.2	pp

Bonus expense, which we include in each of our operating expense categories, increased \$2.2 million in the second quarter of 2013 and \$1.4 million in the first half of 2013. The increase mainly reflects the comparison from unusually low expense in the second quarter of 2012. Bonus expense as a percentage of revenue increased about 1.0 percentage points in the second quarter of 2013 and 0.2 percentage points in the first half of 2013.

## Consolidated Operating Income

(\$000)	Three months ended June 30			Six months ended June 30			
	2013	2012	Change	2013	2012	Change	
Operating income	\$43,584	\$41,136	6.0 %	\$84,144	\$71,535	17.6 %	
% of revenue	24.8	% 24.8	% —	24.4	% 21.9	% 2.5	pp

Consolidated operating income increased \$2.4 million in the second quarter of 2013 as our operating costs increased \$7.0 million and revenue increased \$9.5 million. Our operating margin was 24.8%, unchanged compared with the second quarter of 2012.

Consolidated operating income increased \$12.6 million in the first six months of 2013 as our operating costs grew \$4.9 million and revenue increased \$17.6 million. Our operating margin was 24.4%, an increase of 2.5 percentage points compared with the first six months of 2012.

Lower salary expense as a percentage of revenue contributed approximately 1.2 percentage points to the margin improvement in the first half of 2013. In addition, the \$1.6 million of expense recorded in the first quarter of 2012 related to an impairment charge for one of our smaller products and a litigation settlement lowered our 2012 margin by approximately 0.5 percentage points, favorably affecting the current-year comparison.

## Consolidated Free Cash Flow

As described in more detail above, we define free cash flow as cash provided by or used for operating activities less capital expenditures.

(\$000)	Three months ended June 30			Six months ended June 30		
	2013	2012	Change	2013	2012	Change
	\$58,462	\$49,165	18.9 %	\$85,135	\$54,789	55.4 %

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Cash provided by operating activities

Capital expenditures	(9,763	)	(8,928	)	9.4	%	(18,881	)	(17,922	)	5.4	%
Free cash flow	\$48,699		\$40,237		21.0	%	\$66,254		\$36,867		79.7	%

We generated positive free cash flow of \$48.7 million in the second quarter of 2013, an increase of \$8.5 million compared with free cash flow of \$40.2 million in the second quarter of 2012. We generated positive free cash flow of \$66.3 million in the first half of 2013, an increase of \$29.4 million compared with free cash flow of \$36.9 million in the first half of 2012.

Table of Contents

To provide investors with additional insight into our financial results, we provide a comparison between the change in consolidated net income and the change in operating cash flow:

(\$000)	Three months ended June 30			Six months ended June 30		
	2013	2012	Change	2013	2012	Change
Consolidated net income	\$31,100	\$27,884	\$3,216	\$60,675	\$47,997	\$12,678
Adjustments to reconcile consolidated net income to net cash flows from operating activities:						
Excess tax benefits from stock-option exercises and vesting of restricted stock units	(2,255 )	(1,235 )	(1,020 )	(3,842 )	(4,548 )	706
Depreciation and amortization expense	11,262	10,619	643	22,601	20,794	1,807
Stock-based compensation expense	3,954	3,734	220	7,737	7,600	137
Holding gain upon acquisition of additional ownership of equity method investment	(3,713 )	—	(3,713 )	(3,713 )	—	(3,713 )
All other non-cash items included in net income	4,142	1,882	2,260	254	698	(444 )
Changes in operating assets and liabilities, net of effects of acquisitions:						
Cash paid for bonuses	—	—	—	(36,568 )	(42,820 )	6,252
Cash paid for income taxes	(13,867 )	(16,485 )	2,618	(14,511 )	(21,405 )	6,894
Cash paid for separation agreements	—	—	—	—	(137 )	137
Accounts receivable	6,430	3,045	3,385	524	(4,394 )	4,918
Deferred revenue	(6,746 )	(1,832 )	(4,914 )	11,023	12,333	(1,310 )
Income taxes — current	13,073	13,641	(568 )	28,204	25,930	2,274
Accrued compensation	12,231	8,248	3,983	16,987	16,037	950
Other assets	3,110	118	2,992	(3,465 )	(3,640 )	175
Accounts payable and accrued liabilities	238	(51 )	289	638	652	(14 )
All other	(497 )	(403 )	(94 )	(1,409 )	(308 )	(1,101 )
Cash provided by operating activities	\$58,462	\$49,165	\$9,297	\$85,135	\$54,789	\$30,346

In the second quarter of 2013, cash provided by operations increased more than the increase in net income adjusted for non-cash items, primarily because of the positive cash flow effect of operating assets and liabilities and the timing of income tax payments.

In the first half of 2013, cash provided by operations increased more than the increase in net income adjusted for non-cash items, primarily because of the lower cash paid for bonuses and the timing of income tax payments.

FASB ASC 718, Compensation—Stock Compensation, requires that we classify excess tax benefits as a financing activity, which contributes to the difference between net income and cash from operations. In the first six months of 2013 and 2012, we classified \$3.8 million and \$4.5 million, respectively, of excess tax benefits as financing activities. We describe these excess tax benefits in the Liquidity and Capital Resources section.

Capital expenditures: We spent \$9.8 million for capital expenditures in the second quarter of 2013 and \$18.9 million in the first six months of 2013, primarily for computer hardware and software and internally developed capitalized software. In the first six months of 2013, capital expenditures increased \$1.0 million compared with the prior-year period.

Table of Contents

## Segment Results

Key Metrics (\$000)	Three months ended June 30			Six months ended June 30				
	2013	2012	Change	2013	2012	Change		
Revenue								
Investment Information	\$ 141,426	\$ 134,749	5.0	%	\$ 277,613	\$ 261,674	6.1	%
Investment Management	34,002	31,219	8.9	%	66,671	65,053	2.5	%
Consolidated revenue	\$ 175,428	\$ 165,968	5.7	%	\$ 344,284	\$ 326,727	5.4	%
Operating income (loss)								
Investment Information	\$ 44,849	\$ 43,003	4.3	%	\$ 86,316	\$ 71,687	20.4	%
Investment Management	16,516	13,473	22.6	%	32,950	30,764	7.1	%
Intangible amortization and corporate depreciation expense	(8,900 )	(8,281 )	7.5	%	(17,863 )	(16,173 )	10.4	%
Corporate unallocated	(8,881 )	(7,059 )	25.8	%	(17,259 )	(14,743 )	17.1	%
Consolidated operating income	\$ 43,584	\$ 41,136	6.0	%	\$ 84,144	\$ 71,535	17.6	%
Operating margin								
Investment Information	31.7	% 31.9	% (0.2 )	pp	31.1	% 27.4	% 3.7	pp
Investment Management	48.6	% 43.2	% 5.4	pp	49.4	% 47.3	% 2.1	pp
Consolidated operating margin	24.8	% 24.8	% —		24.4	% 21.9	% 2.5	pp

## Investment Information Segment

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, Morningstar Equity Research, 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 help institutional clients build customized websites or enhance their existing sites with our 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 Equity Research is sold to companies that purchase our research for their own use or provide our research to their affiliated advisors or individual investor clients. Morningstar Principia is our CD-ROM-based investment research and planning software for advisors.

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The Investment Information segment also includes Morningstar Credit Ratings, LLC. 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.

In the first six months of 2013 and 2012, this segment represented approximately 80% of our consolidated revenue.

Table of Contents

Key Metrics (\$000)	Three months ended June 30				Six months ended June 30			
	2013	2012	Change		2013	2012	Change	
Revenue	\$141,426	\$134,749	5.0	%	\$277,613	\$261,674	6.1	%
Operating income	\$44,849	\$43,003	4.3	%	\$86,316	\$71,687	20.4	%
Operating margin (%)	31.7	% 31.9	% (0.2	) pp	31.1	% 27.4	% 3.7	pp

## Revenue

In the second quarter of 2013, Investment Information segment revenue increased \$6.7 million, or 5.0%, to \$141.4 million. Morningstar Direct was the main contributor to revenue growth in the second quarter. Morningstar Data, Advisor Workstation, and Morningstar.com also contributed to the revenue growth, although to a lesser extent.

In the first half of 2013, Investment Information segment revenue increased \$15.9 million, or 6.1%, to \$277.6 million. Morningstar Direct and Morningstar Data were the main contributors to revenue growth. Morningstar Advisor Workstation, Structured Credit Ratings, and Morningstar Integrated Web Tools also contributed to the revenue growth, although to a lesser extent.

Morningstar Direct contributed approximately 46% and 41% of the organic revenue growth for the segment in the second quarter of and first half of 2013, respectively. The number of licenses for Morningstar Direct increased to 8,055 worldwide as of June 30, 2013, compared with 6,771 as of June 30, 2012, with strong growth globally. The growth reflects additional licenses for both new and existing clients, and, to a lesser extent, client migrations from both Institutional Workstation and Morningstar EnCorr.

Morningstar Data was the second-largest contributor to the increase in segment revenue in the second quarter and first half of 2013. Morningstar Data's revenue growth reflects strong renewal rates for managed product data as well as new contracts signed in 2012. Morningstar Data gives institutions access to a full range of proprietary investment data spanning numerous investment databases, including real-time pricing data and commodity data. The data packages we offer include proprietary statistics, such as the Morningstar Style Box and Morningstar Rating, and a wide range of other information on investment performance, risk, portfolios, operations data, fees and expenses, cash flows, and ownership.

Higher revenue from Morningstar Advisor Workstation (mainly Morningstar Office) and Morningstar Integrated Web Tools also contributed to the revenue growth, although to a lesser extent. The number of U.S. licenses for Morningstar Advisor Workstation rose slightly to 164,923 as of June 30, 2013 compared with 162,904 as of December 31, 2012 and 160,145 as of June 30, 2012. Lower revenue for Principia partially offset the higher revenue from these two products. Principia subscriptions totaled 22,464 as of June 30, 2013, down from 26,807 as of December 31, 2012 and 28,599 as of June 30, 2012. During the first quarter of 2013, we announced that we are no longer selling new subscriptions to Principia, and we've begun migrating Principia clients to Morningstar Advisor Workstation and other Morningstar products that meet their needs. We expect to continue supporting clients on Principia until the end of 2014.

Revenue for Morningstar.com was up in both periods of 2013 because of higher advertising sales during the second quarter of 2013, mainly in the United States. Premium subscriptions for the U.S. version of Morningstar.com declined to 123,881 as of June 30, 2013, compared with 126,410 as of June 30, 2012, and 123,899 as of December 31, 2012. Consistent with the trend over the past few years, we moderately increased subscription prices for U.S. Premium Membership in both January 2013 and 2012, which offset the revenue decline associated with the lower subscription levels.

Higher revenue for Morningstar Structured Credit Ratings also contributed to the growth in revenue in the first half of the year, primarily because of a significant increase in new-issue ratings compared with the prior-year period. We completed 20 new-issue CMBS ratings in the first six months of 2013, compared with eight in the first six months of 2012.

## Table of Contents

### Operating Income

In the second quarter of 2013, operating income for the Investment Information segment increased \$1.8 million, or 4.3%. Operating expense was up \$4.8 million in the second quarter of 2013, mainly because of higher bonus and salary expense.

In the first half of 2013, operating income for the Investment Information segment increased \$14.6 million, or 20.4%. Operating expense was up \$1.3 million, or 0.7% in the first half of 2013.

The Investment Information segment's operating margin decreased 0.2 percentage points in the second quarter and increased 3.7 percentage points in the first half of the year. The margin improvement in the first half of the year reflects the higher revenue base as well as lower salary expense as a percentage of revenue. Lower salary expense contributed approximately 2.1 percentage points to the margin improvement in the first half of the year.

### Investment Management Segment

The Investment Management segment includes all of our asset management operations, which earn more than half 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, ETF, and stock portfolios tailored to meet a range of investment time horizons, risk levels, and investment strategies that financial advisors can use for their clients' taxable and tax-deferred accounts.

Our Investment Advisory Services business has multiple fee structures, which vary by client. In general, we seek to receive asset-based fees for any work we perform that involves managing investments or acting as a subadvisor to investment portfolios. For any individual contract, we may receive flat fees, variable asset-based fees, or a combination of the two. Some of our contracts include minimum fee levels that provide us with a flat payment up to a specified asset level, above which we also receive variable asset-based fees. In the majority of our contracts that include variable asset-based fees, we bill clients quarterly in arrears based on average assets for the quarter. The method of calculation varies by client; some contracts include provisions for calculating average assets based on daily data, while others use weekly or monthly data. Other contracts may include provisions for monthly billing or billing based on assets as of the last day of the billing period rather than on average assets.

In our Retirement Solutions business, our contracts may include one-time setup fees, technology licensing fees, asset-based fees for managed retirement accounts, fixed and variable fees for advice and guidance, or a combination of these fee structures. Our Retirement Solutions business also includes plan sponsor and custom target-date consulting arrangements. Fees for these services may be based on the level of assets under advisement in these arrangements.

We do not disclose a fee range for our Investment Advisory Services and Retirement Solutions businesses because our fee structures vary by client. In addition, we believe disclosing a fee range would be detrimental from a competitive standpoint. We disclose changes in the nature of the underlying services we provide or their associated fee structures (for example, a change from flat fees to asset-based fees) in our periodic filings to the extent that they are material to our financial results.

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For Morningstar Managed Portfolios, we charge asset-based fees, that are based on a tiered schedule that depends on the client's account balance. Fees for our mutual fund and ETF portfolios generally range from 30 to 40 basis points. We charge fees of 55 basis points for our customized stock portfolios.

In addition, we offer Managed Portfolios through our subsidiary Ibbotson Associates Australia Limited (Ibbotson Australia), which provides asset management services primarily to institutional clients and individual investors.

In the first six months of 2013 and 2012, this segment represented approximately 20% of our consolidated revenue.

Table of Contents

Key Metrics (\$000)	Three months ended June 30			Six months ended June 30			
	2013	2012	Change	2013	2012	Change	
Revenue	\$34,002	\$31,219	8.9 %	\$66,671	\$65,053	2.5 %	
Operating income	\$16,516	\$13,473	22.6 %	\$32,950	\$30,764	7.1 %	
Operating margin (%)	48.6	% 43.2	% 5.4	pp 49.4	% 47.3	% 2.1	pp

## Revenue

Investment Management segment revenue increased \$2.8 million, or 8.9%, in the second quarter of 2013 and \$1.6 million, or 2.5%, in the first half of 2013, driven by higher revenue for Managed Portfolios and Retirement Solutions.

These positive product trends were partially offset by lower revenue for Investment Advisory Services, which was driven by 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 \$0.6 million and \$3.8 million in associated revenue in the second quarter and first half of 2012, respectively.

The variable annuity industry, which accounted for approximately 10% of Investment Management segment revenue in the first half of 2013 and 15% of 2012 full-year revenue, continues to face challenges. Accordingly, we expect that there will be further pressure on revenue from clients in the variable annuity industry.

We had approximately \$22.8 million in revenue from asset-based fees in the second quarter of 2013, an increase of \$4.3 million compared with \$18.5 million in the second quarter of 2012. Within the Investment Management segment, revenue from asset-based fees made up about 67% and 59% of segment revenue in the second quarter of 2013 and 2012, respectively.

Total assets under advisement and management were \$166.1 billion as of June 30, 2013, a decrease of \$20.6 billion from \$186.7 billion as of June 30, 2012. A change in the scope of services we provide to an existing client during the fourth quarter of 2012 lowered our assets by about \$45.9 billion.

The asset totals as of the end of each period don't fully reflect the change in average asset levels during the quarter. The asset-based fees we earn are primarily based on average asset levels during each quarter. Average assets under advisement and management (calculated based on available quarterly data) were approximately \$161.6 billion in the second quarter of 2013, down 14.9% from approximately \$189.9 billion in the second quarter of 2012.

## Assets under Advisement and Management for Investment Advisory Services

(\$ billions)	As of June 30	
	2013	2012
Assets under advisement – U.S.	\$95.6	\$133.8
Assets under advisement – International	5.8	4.3
Total	\$101.4	\$138.1

We provided Investment Advisory Services on approximately \$101.4 billion in assets as of June 30, 2013 compared with approximately \$94.3 billion as of December 31, 2012 and approximately \$138.1 billion as of June 30, 2012.

These assets include relationships for which we receive basis-point fees, including consulting arrangements and other agreements where we act as a portfolio construction manager for a mutual fund or variable annuity. We also provide

Investment Advisory Services for some assets for which we receive a flat fee; we do not include these assets in the total reported above. Excluding changes related to new contracts and cancellations, changes in the value of assets under advisement can come from two primary sources: gains or losses related to overall trends in market performance, and net inflows or outflows caused when investors add to or redeem shares from these portfolios.

Table of Contents

Assets under advisement and management decreased about \$36.7 billion, or 26.6%, compared with June 30, 2012. A change in the scope of services we provide to an existing client during the fourth quarter of 2012 lowered our assets by about \$45.9 billion. This portfolio represented 33.2% of our Investment Advisory Services assets under advisement and management as of June 30, 2012.

We cannot quantify cash inflows and outflows for these portfolios because we do not have custody of the assets in the majority of our investment management businesses. The information we receive from many of our clients does not separately identify the effect of cash inflows and outflows on asset balances for each period. We also cannot precisely quantify the effect of market appreciation or depreciation because the majority of our clients have discretionary authority to implement their own portfolio allocations.

## Assets under Advisement and Management for Retirement Solutions

(\$ billions)	As of June 30	
	2013	2012
Assets under management	\$27.9	\$22.4
Assets under advisement	28.0	19.3
Total	\$55.9	\$41.7

Assets under management for managed retirement accounts increased to \$27.9 billion as of June 30, 2013, compared with \$25.1 billion as of December 31, 2012 and \$22.4 billion as of June 30, 2012. Assets under advisement for plan sponsor and custom target-date arrangements increased to \$28.0 billion as of June 30, 2013, compared with \$22.1 billion as of December 31, 2012 and \$19.3 billion as of June 30, 2012.

We cannot quantify all of the factors affecting assets under management for our managed retirement accounts. These factors primarily consist of employer and employee contributions, plan administrative fees, market movements, and participant loans and hardship withdrawals. We cannot quantify the impact of these other factors because the information we receive from the plan providers does not separately identify these transactions or the changes in balances caused by market movement.

## Morningstar Managed Portfolios

Revenue for Morningstar Managed Portfolios increased \$1.8 million in the second quarter of 2013 and \$3.2 million in the first half of the year. This growth mainly reflects higher average asset levels during the first six months of 2013 compared with the same period in 2012. Assets under management and advisement for Morningstar Managed Portfolios rose to \$5.9 billion as of June 30, 2013, up from \$4.7 billion as of December 31, 2012 and \$3.9 billion as of June 30, 2012, reflecting strong net inflows and positive market performance.

## Ibbotson Australia Managed Portfolios

Revenue for Ibbotson Australia Managed Portfolios increased about \$0.8 million in the first six months of 2013. Assets under management for Ibbotson Australia totaled \$2.9 billion as of June 30, 2013, down slightly from \$3.3 billion as of December 31, 2012 and \$3.0 billion as of June 30, 2012. The decline is due to a weaker Australian dollar vs. the U.S. dollar.

## Operating Income

Operating income for the Investment Management segment increased