

Morningstar, Inc.
Form 10-Q
May 02, 2012

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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 March 31, 2012

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)

60602

(Zip Code)

(312) 696-6000

(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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

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As of April 27, 2012, there were 49,594,723 shares of the Company's common stock, no par value, outstanding.

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PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

Morningstar, Inc. and Subsidiaries

Unaudited Condensed Consolidated Statements of Income

(in thousands except per share amounts)	Three months ended March 31	
	2012	2011
Revenue	\$160,759	\$151,767
Operating expense (1):		
Cost of goods sold	50,316	40,669
Development	13,365	11,988
Sales and marketing	28,326	26,482
General and administrative	28,178	30,617
Depreciation and amortization	10,175	10,202
Total operating expense	130,360	119,958
Operating income	30,399	31,809
Non-operating income (expense):		
Interest income, net	869	524
Other income (expense), net	(210)	) 250
Non-operating income, net	659	774
Income before income taxes and equity in net income of unconsolidated entities	31,058	32,583
Income tax expense	11,511	10,518
Equity in net income of unconsolidated entities	566	374
Consolidated net income	20,113	22,439
Net loss attributable to the noncontrolling interest	24	98
Net income attributable to Morningstar, Inc.	\$20,137	\$22,537
Net income per share attributable to Morningstar, Inc.:		
Basic	\$0.40	\$0.45
Diluted	\$0.40	\$0.44
Dividends per common share:		
Dividends declared per common share	\$0.10	\$0.05
Dividends paid per common share	\$0.10	\$0.05
Weighted average shares outstanding:		
Basic	49,938	49,800
Diluted	50,758	50,953

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	Three months ended March 31	
	2012	2011
(1) Includes stock-based compensation expense of:		
Cost of goods sold	\$1,089	\$879
Development	499	471
Sales and marketing	479	422
General and administrative	1,799	1,877
Total stock-based compensation expense	\$3,866	\$3,649

See notes to unaudited condensed consolidated financial statements.
Morningstar, Inc. and Subsidiaries
Unaudited Condensed Consolidated Statements of Comprehensive Income

(in thousands)	Three months ended March 31	
	2012	2011
Consolidated net income	\$20,113	\$22,439
Other comprehensive income (loss), net of tax:		
Foreign currency translation adjustment	6,965	9,302
Unrealized gains (losses) on securities:		
Unrealized holding gains arising during period	909	438
Reclassification of (gains) losses included in net income	55	(41)
Other comprehensive income	7,929	9,699
Comprehensive income	28,042	32,138
Comprehensive loss attributable to noncontrolling interest	107	112
Comprehensive income attributable to Morningstar, Inc.	\$28,149	\$32,250

See notes to unaudited condensed consolidated financial statements.

Morningstar, Inc. and Subsidiaries
Unaudited Condensed Consolidated Balance Sheets

(in thousands except share amounts)	As of March 31 2012	As of December 31 2011
Assets		
Current assets:		
Cash and cash equivalents	\$165,348	\$200,437
Investments	278,298	269,755
Accounts receivable, less allowance of \$951 and \$835, respectively	121,396	113,312
Deferred tax asset, net	4,570	5,104
Income tax receivable, net	3,554	7,445
Other	20,864	15,980
Total current assets	594,030	612,033
Property, equipment, and capitalized software, net	73,576	68,196
Investments in unconsolidated entities	34,943	27,642
Goodwill	322,016	318,492
Intangible assets, net	134,994	139,809
Other assets	6,826	5,912
Total assets	\$1,166,385	\$1,172,084

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Liabilities and equity

Current liabilities:

Accounts payable and accrued liabilities	\$46,032	\$41,403
Accrued compensation	39,951	73,124
Deferred revenue	171,013	155,494
Other	370	612
Total current liabilities	257,366	270,633
Accrued compensation	6,171	5,724
Deferred tax liability, net	14,556	15,940
Deferred rent	15,613	14,604
Other long-term liabilities	8,413	8,167
Total liabilities	302,119	315,068

Equity:

Morningstar, Inc. shareholders' equity:

Common stock, no par value, 200,000,000 shares authorized, of which 49,895,998 and 50,083,940 shares were outstanding as of March 31, 2012 and December 31, 2011, respectively	5	5
Treasury stock at cost, 1,419,936 shares as of March 31, 2012 and 980,177 shares as of December 31, 2011	(73,476)	(46,701)
Additional paid-in capital	502,488	491,432
Retained earnings	424,086	409,022
Accumulated other comprehensive income (loss):		
Currency translation adjustment	8,984	1,936
Unrealized gain (loss) on available-for-sale investments	640	(324)
Total accumulated other comprehensive income	9,624	1,612
Total Morningstar, Inc. shareholders' equity	862,727	855,370
Noncontrolling interest	1,539	1,646
Total equity	864,266	857,016
Total liabilities and equity	\$1,166,385	\$1,172,084

See notes to unaudited condensed consolidated financial statements.

Morningstar, Inc. and Subsidiaries

Unaudited Condensed Consolidated Statement of Equity

For the three months ended March 31, 2012

(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	Additional Paid-in Capital	Retained Earnings			
Balance as of December 31, 2011	50,083,940	\$5	\$(46,701)	\$491,432	\$409,022	\$1,612	\$1,646	\$857,016
Net income (loss)		—	—	—	20,137	—	(24)	20,113
Other comprehensive income (loss):								
Unrealized gain on available-for-sale investments, net of income tax of \$503		—	—	—	—	909	—	909
		—	—	—	—	55	—	55

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Reclassification of adjustments for losses included in net income, net of income tax of \$31									
Foreign currency translation adjustment, net	—	—	—	—	7,048	(83	)	6,965
Other comprehensive income (loss), net	—	—	—	—	8,012	(83	)	7,929
Issuance of common stock related to stock-option exercises and vesting of 253,963 restricted stock units, net	—	103	3,803	—	—	—		3,906	
Stock-based compensation — restricted stock units	—	—	3,278	—	—	—		3,278	
Stock-based compensation — restricted stock	—	—	444	—	—	—		444	
Stock-based compensation — stock-options	—	—	144	—	—	—		144	
Excess tax benefit derived from stock-option exercises and vesting of restricted stock units	—	—	3,313	—	—	—		3,313	
Common shares repurchased	(441,905)	—	(26,878)	—		(26,878)
Dividends declared — common shares outstanding	—	—	—	(4,998)	—		(4,998)
Dividends declared — restricted stock units	—	—	74	(75)	—		(1)
Balance as of March 31, 2012	49,895,998	\$5	\$(73,476)	\$502,488	\$424,086	\$9,624	\$1,539	\$864,266	

See notes to unaudited condensed consolidated financial statements.

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Unaudited Condensed Consolidated Statements of Cash Flows

(in thousands)	Three months ended March 31	
	2012	2011
Operating activities		
Consolidated net income	\$20,113	\$22,439
Adjustments to reconcile consolidated net income to net cash flows from operating activities:		
Depreciation and amortization	10,175	10,202
Deferred income taxes	(1,453	) (677
Stock-based compensation expense	3,866	3,649
Provision for bad debt	525	285
Equity in net income of unconsolidated entities	(566	) (374
Excess tax benefits from stock-option exercises and vesting of restricted stock units	(3,313	) (4,122
Other, net	310	(512
Changes in operating assets and liabilities, net of effects of acquisitions:		
Accounts receivable	(7,439	) (3,357
Other assets	(3,758	) 1,453
Accounts payable and accrued liabilities	703	(2,600
Accrued compensation	(35,168	) (26,876
Income taxes—current	7,369	5,297
Deferred revenue	14,165	9,847
Deferred rent	716	(399
Other liabilities	(621	) 91
Cash provided by operating activities	5,624	14,346
Investing activities		
Purchases of investments	(344,391	) (67,352
Proceeds from maturities and sales of investments	338,146	62,359
Capital expenditures	(8,994	) (5,037
Purchases of cost method investments	(6,750) —
Other, net	9	(14
Cash used for investing activities	(21,980	) (10,044
Financing activities		
Proceeds from stock-option exercises, net	3,906	4,921
Excess tax benefits from stock-option exercises and vesting of restricted stock units	3,313	4,122
Common shares repurchased	(23,033) —
Dividends paid	(5,012	) (2,494
Other, net	(17	) (214
Cash provided by (used for) financing activities	(20,843	) 6,335
Effect of exchange rate changes on cash and cash equivalents	2,110	2,561
Net increase (decrease) in cash and cash equivalents	(35,089	) 13,198
Cash and cash equivalents—beginning of period	200,437	180,176
Cash and cash equivalents—end of period	\$165,348	\$193,374

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Supplemental disclosure of cash flow information:

Cash paid for income taxes	\$5,553	\$6,962
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Supplemental information of non-cash investing and financing activities:

Unrealized gain on available-for-sale investments	\$1,498	\$609
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See notes to unaudited condensed consolidated financial statements.

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

1. Basis of Presentation of Interim Financial Information

The accompanying condensed consolidated financial statements of Morningstar, Inc. and subsidiaries (Morningstar, we, our, the Company) have been prepared to conform to the rules and regulations of the Securities and Exchange Commission (SEC). The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amount of assets, liabilities, revenue, and expenses. Actual results could differ from those estimates. In the opinion of management, the statements reflect all adjustments, which are of a normal recurring nature, necessary to present fairly our financial position, results of operations, equity, and cash flows. These financial statements and notes should be read in conjunction with our Consolidated Financial Statements and Notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2011, filed with the SEC on February 24, 2012.

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 2 of our Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2011, filed with the SEC on February 24, 2012.

In addition, effective January 1, 2012, we adopted FASB ASU No. 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. ASU No. 2011-04 clarifies existing fair value measurement and disclosure requirements, amends certain fair value measurement principles, and requires additional disclosures about fair value measurements. The adoption of ASU No. 2011-04 did not have a material impact on our Consolidated Financial Statements.

3. Goodwill and Other Intangible Assets

Goodwill

The following table shows the changes in our goodwill balances from December 31, 2011 to March 31, 2012:

	(\$000)
Balance as of December 31, 2011	\$318,492
Net change, primarily currency translation	3,524
Balance as of March 31, 2012	\$322,016

We did not record any significant impairment losses in the first quarter of 2012 or 2011. We perform our annual impairment reviews in the fourth quarter.

Intangible Assets

The following table summarizes our intangible assets:

(\$000)	As of March 31, 2012			Weighted Average Useful Life (years)	As of December 31, 2011			Weighted Average Useful Life (years)
	Gross	Accumulated Amortization	Net		Gross	Accumulated Amortization	Net	
Intellectual property	\$32,331	\$ (21,214)	\$11,117	9	\$32,293	\$ (20,455)	\$11,838	9
Customer-related assets	135,888	(56,268)	79,620	12	134,396	(52,611)	81,785	12
Supplier relationships	240	(87)	153	20	240	(84)	156	20
Technology-based assets	81,240	(37,523)	43,717	9	80,694	(35,130)	45,564	9
Non-competition agreement	1,766	(1,379)	387	4	1,751	(1,285)	466	4
Total intangible assets	\$251,465	\$ (116,471)	\$134,994	10	\$249,374	\$ (109,565)	\$139,809	10

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

(\$000)	Three months ended March 31	
	2012	2011
Amortization expense	\$6,055	\$6,513

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

We expect intangible amortization expense for 2012 and subsequent years as follows:

	(\$000)
2012	\$24,040
2013	21,319
2014	20,064
2015	19,192
2016	14,570
2017	9,967

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

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:

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(in thousands, except per share amounts)	Three months ended March 31	
	2012	2011
Basic net income per share attributable to Morningstar, Inc.:		
Net income attributable to Morningstar, Inc.:	\$20,137	\$22,537
Less: Distributed earnings available to participating securities	(16	) (10
Less: Undistributed earnings available to participating securities	(46	) (79
Numerator for basic net income per share — undistributed and distributed earnings available to common shareholders	\$20,075	\$22,448
Weighted average common shares outstanding	49,938	49,800
Basic net income per share attributable to Morningstar, Inc.	\$0.40	\$0.45
Diluted net income per share attributable to Morningstar, Inc.:		
Numerator for basic net income per share — undistributed and distributed earnings available to common shareholders	\$20,075	\$22,448
Add: Undistributed earnings allocated to participating securities	46	79
Less: Undistributed earnings reallocated to participating securities	(45	) (78
Numerator for diluted net income per share — undistributed and distributed earnings available to common shareholders	\$20,076	\$22,449
Weighted average common shares outstanding	49,938	49,800
Net effect of dilutive stock options and restricted stock units	820	1,153
Weighted average common shares outstanding for computing diluted income per share	50,758	50,953
Diluted net income per share attributable to Morningstar, Inc.	\$0.40	\$0.44

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5. Segment and Geographical Area Information

Morningstar has two operating segments:

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

The largest products in this segment based on revenue are Morningstar Data (formerly Licensed Data), Morningstar Advisor Workstation (including Morningstar Office), Morningstar Direct, Morningstar.com, Morningstar Integrated Web Tools, 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. Advisor Workstation 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. Principia is our CD-ROM-based investment research and planning software for advisors.

The Investment Information segment also includes Morningstar Equity Research, which we distribute through several channels. We sell Morningstar Equity Research to companies that purchase our research for their own use or provide our research to their affiliated advisors or individual investor clients.

The Investment Information segment also includes Morningstar Credit Research and Morningstar Structured Credit Ratings. Morningstar Structured Credit Ratings is provided by Morningstar Credit Ratings, LLC, a Nationally Recognized Statistical Rating Organization specializing in structured finance. It offers securities ratings, research, surveillance services, and data to help institutional investors identify risk in commercial mortgage-backed securities (CMBS) and residential mortgage-backed securities (RMBS).

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 (formerly Investment Consulting), 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 Australia which provides asset management services primarily to institutional clients and individual investors.

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

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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.

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

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

(\$000)	Three months ended March 31, 2011			
	Investment Information	Investment Management	Corporate Items	Total
External revenue	\$120,399	\$31,368	\$—	\$151,767
Operating expense, excluding stock-based compensation expense, depreciation, and amortization	83,763	13,838	8,506	106,107
Stock-based compensation expense	2,470	442	737	3,649
Depreciation and amortization	1,859	42	8,301	10,202
Operating income (loss)	\$32,307	\$17,046	\$(17,544)	\$31,809
U.S. capital expenditures				\$1,930
Non-U.S. capital expenditures				\$3,107

(\$000)	As of March 31, 2012			
	Investment Information	Investment Management	Corporate Items	Total
Goodwill	\$280,320	\$41,696	\$—	\$322,016

(\$000)	As of December 31, 2011			
	Investment Information	Investment Management	Corporate Items	Total
Goodwill	\$277,059	\$41,433	\$—	\$318,492