

Morningstar, Inc.  
Form 10-Q  
October 26, 2018

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 September 30, 2018

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 36-3297908

(State or Other Jurisdiction of (I.R.S. Employer

Incorporation or Organization) Identification Number)

22 West Washington Street

Chicago, Illinois 60602

(Address of Principal Executive Offices) (Zip Code)

(312) 696-6000

(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes  No

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

Large accelerated filer Accelerated Non-accelerated filer Smaller reporting Emerging growth  
 filer   company  company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Edgar Filing: Morningstar, Inc. - Form 10-Q

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 October 19, 2018, there were 42,660,038 shares of the Company's common stock, no par value, outstanding.

---

Table of Contents

MORNINGSTAR, INC. AND SUBSIDIARIES  
INDEX

<u>PART 1 FINANCIAL INFORMATION</u>	<u>3</u>
<u>Item 1. Financial Statements</u>	<u>3</u>
Unaudited Condensed Consolidated Statements of Income for the three and nine months ended September 30, 2018 and 2017	<u>4</u>
Unaudited Condensed Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2018 and 2017	<u>5</u>
Unaudited Condensed Consolidated Balance Sheets as of September 30, 2018 and December 31, 2017	<u>6</u>
Unaudited Condensed Consolidated Statement of Equity for the nine months ended September 30, 2018	<u>7</u>
Unaudited Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2018 and 2017	<u>8</u>
<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	<u>9</u>
<u>Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>26</u>
<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	<u>42</u>
<u>Item 4. Controls and Procedures</u>	<u>43</u>
<u>PART 2 OTHER INFORMATION</u>	<u>44</u>
<u>Item 1. Legal Proceedings</u>	<u>44</u>
<u>Item 1A. Risk Factors</u>	<u>44</u>
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>44</u>
<u>Item 6. Exhibits</u>	<u>45</u>
<u>SIGNATURE</u>	<u>46</u>

Table of Contents

PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

3

---

Table of Contents

and Subsidiaries

## Unaudited Condensed Consolidated Statements of Income

(in millions, except per share amounts)	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Revenue	\$261.3	\$229.9	\$757.2	\$668.6
Operating expense:				
Cost of revenue	100.0	90.9	302.2	283.2
Sales and marketing	35.8	31.1	113.7	100.2
General and administrative	35.4	33.3	103.6	93.2
Depreciation and amortization	24.7	21.8	71.2	64.8
Total operating expense	195.9	177.1	590.7	541.4
Operating income	65.4	52.8	166.5	127.2
Non-operating income (expense), net:				
Interest expense, net	(0.2 )	(0.9 )	(1.2 )	(2.6 )
Gain on sale of investments, reclassified from other comprehensive income	0.3	0.3	0.9	1.1
Gain on sale of business	—	—	—	17.5
Gain on sale of product line	—	—	10.5	—
Gain on sale of equity investments	5.6	—	5.6	—
Other income (expense), net	1.6	(1.4 )	2.2	(4.0 )
Non-operating income (expense), net	7.3	(2.0 )	18.0	12.0
Income before income taxes and equity in net income (loss) of unconsolidated entities	72.7	50.8	184.5	139.2
Equity in net income (loss) of unconsolidated entities	0.3	—	(1.6 )	(1.0 )
Income tax expense	16.1	16.9	42.3	40.2
Consolidated net income	\$56.9	\$33.9	\$140.6	\$98.0
Net income per share:				
Basic	\$1.33	\$0.80	\$3.30	\$2.29
Diluted	\$1.32	\$0.79	\$3.27	\$2.28
Dividends per common share:				
Dividends declared per common share	\$—	\$—	\$0.50	\$0.46
Dividends paid per common share	\$0.25	\$0.23	\$0.75	\$0.69
Weighted average shares outstanding:				
Basic	42.6	42.5	42.6	42.8
Diluted	43.1	42.8	43.0	43.1

See notes to unaudited condensed consolidated financial statements.

Table of Contents

## Morningstar, Inc. and Subsidiaries

## Unaudited Condensed Consolidated Statements of Comprehensive Income

(in millions)	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Consolidated net income	\$56.9	\$33.9	\$140.6	\$98.0
Other comprehensive (loss) income:				
Foreign currency translation adjustment	(6.1 )	10.0	(20.2 )	29.9
Unrealized gains (losses) on securities, net of tax:				
Unrealized holding gains arising during period	0.5	0.9	0.8	3.5
Reclassification gains included in net income	(0.2 )	(0.3 )	(0.7 )	(0.8 )
Other comprehensive (loss) income	(5.8 )	10.6	(20.1 )	32.6
Comprehensive income	\$51.1	\$44.5	\$120.5	\$130.6

See notes to unaudited condensed consolidated financial statements.

Table of ContentsMorningstar, Inc. and Subsidiaries  
Condensed Consolidated Balance Sheets

(in millions, except share amounts)	As of September 30, 2018 (unaudited)	As of December 31, 2017
Assets		
Current assets:		
Cash and cash equivalents	\$ 323.0	\$ 308.2
Investments	43.7	45.1
Accounts receivable, less allowance of \$4.5 and \$3.2, respectively	172.4	148.2
Income tax receivable	7.8	—
Deferred commissions	14.2	—
Other current assets	22.8	28.3
Total current assets	583.9	529.8
Property, equipment, and capitalized software, less accumulated depreciation and amortization of \$333.1 and \$284.7, respectively	144.5	147.4
Investments in unconsolidated entities	58.4	62.0
Goodwill	559.2	564.9
Intangible assets, net	79.3	95.4
Deferred commissions, non-current	9.8	—
Other assets	4.4	6.2
Total assets	\$ 1,439.5	\$ 1,405.7
Liabilities and equity		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 42.5	\$ 49.2
Accrued compensation	85.6	92.0
Deferred revenue	189.0	171.3
Other current liabilities	4.2	10.7
Total current liabilities	321.3	323.2
Accrued compensation	11.9	11.7
Deferred tax liability, net	30.2	23.6
Long-term debt	90.0	180.0
Deferred rent	25.3	26.9
Deferred revenue, non-current	14.6	14.2
Other long-term liabilities	18.6	21.2
Total liabilities	511.9	600.8
Equity:		
Morningstar, Inc. shareholders' equity:		
Common stock, no par value, 200,000,000 shares authorized, of which 42,670,728 and 42,547,707 shares were outstanding as of September 30, 2018 and December 31, 2017, respectively	—	—
Treasury stock at cost, 10,728,410 and 10,633,637 shares as of September 30, 2018 and December 31, 2017, respectively	(717.0	) (708.2 )
Additional paid-in capital	616.3	601.0

Edgar Filing: Morningstar, Inc. - Form 10-Q

Retained earnings	1,095.0	958.7
Accumulated other comprehensive loss:		
Currency translation adjustment	(68.1 )	(47.9 )
Unrealized gain on available-for-sale investments	1.4	1.3
Total accumulated other comprehensive loss	(66.7 )	(46.6 )
Total equity	927.6	804.9
Total liabilities and equity	\$ 1,439.5	\$ 1,405.7

See notes to unaudited condensed consolidated financial statements.

6

---

Table of Contents

Morningstar, Inc. and Subsidiaries  
 Unaudited Condensed Consolidated Statement of Equity  
 For the nine months ended September 30, 2018

(in millions, except share amounts)	Morningstar, Inc. Shareholders' Equity					Accumulated	Total
	Common Stock Shares Outstanding	Par Value	Treasury Stock	Additional Paid-in Capital	Retained Earnings	Other Comprehensive Loss	
Balance as of December 31, 2017	42,547,707	\$ —	\$(708.2)	\$ 601.0	\$ 958.7	\$ (46.6 )	\$ 804.9
Cumulative effect of accounting change related to the adoption of ASU No. 2014-09					17.0		17.0
Net income		—	—	—	140.6	—	140.6
Other comprehensive income (loss):							
Unrealized gain on available-for-sale investments, net of income tax of \$0.1		—	—	—	—	0.8	0.8
Reclassification of adjustments for gain included in net income, net of income tax of \$0.2		—	—	—	—	(0.7 )	(0.7 )
Foreign currency translation adjustment, net		—	—	—	—	(20.2 )	(20.2 )
Other comprehensive income (loss)		—	—	—	—	(20.1 )	(20.1 )
Issuance of common stock related to option exercises and vesting of restricted stock units, net of shares withheld for taxes on settlements of restricted stock units	232,310	—	1.7	(13.1 )	—	—	(11.4 )
Reclassification of awards previously liability-classified that were converted to equity		—	—	4.5	—	—	4.5
Stock-based compensation		—	—	23.9	—	—	23.9
Common shares repurchased	(109,289 )	—	(10.5 )	—	—	—	(10.5 )
Dividends declared		—	—	—	(21.3 )	—	(21.3 )
Balance as of September 30, 2018	42,670,728	\$ —	\$(717.0)	\$ 616.3	\$ 1,095.0	\$ (66.7 )	\$ 927.6

See notes to unaudited condensed consolidated financial statements.

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

(in millions)	Nine months ended September 30,	
	2018	2017
<b>Operating activities</b>		
Consolidated net income	\$140.6	\$98.0
Adjustments to reconcile consolidated net income to net cash flows from operating activities:		
Depreciation and amortization	71.2	64.8
Deferred income taxes	6.5	1.0
Stock-based compensation expense	23.9	16.5
Provision for bad debt	2.6	1.3
Equity in net loss of unconsolidated entities	1.6	1.0
Gain on sale of business	—	(17.5 )
Gain on sale of product line	(10.5 )	—
Gain on sale of equity investments	(5.6 )	—
Other, net	(3.3 )	2.9
Changes in operating assets and liabilities:		
Accounts receivable	(29.1 )	(0.3 )
Other assets	8.8	(3.0 )
Deferred commissions	24.0	—
Accounts payable and accrued liabilities	5.9	(4.3 )
Accrued compensation	(31.6 )	0.2
Income taxes, current	(13.7 )	1.6
Deferred revenue	21.0	6.2
Deferred rent	(1.4 )	(1.1 )
Other liabilities	(1.4 )	(2.6 )
Cash provided by operating activities	209.5	164.7
<b>Investing activities</b>		
Purchases of investments	(23.7 )	(22.7 )
Proceeds from maturities and sales of investments	22.3	20.6
Capital expenditures	(55.2 )	(46.4 )
Acquisitions, net of cash acquired	—	(1.0 )
Proceeds from sale of a business	—	23.7
Proceeds from sale of a product line	10.5	—
Proceeds from sale of equity investments	7.9	—
Purchases of equity investments	(0.5 )	(24.3 )
Other, net	(0.3 )	0.6
Cash used for investing activities	(39.0 )	(49.5 )
<b>Financing activities</b>		
Common shares repurchased	(10.8 )	(41.3 )
Dividends paid	(31.9 )	(29.6 )
Repayment of long-term debt	(90.0 )	(45.0 )

Edgar Filing: Morningstar, Inc. - Form 10-Q

Proceeds from stock-option exercises	0.1	0.2
Employee taxes paid from withholding of restricted stock units	(11.5 )	(3.4 )
Other, net	(1.1 )	(0.4 )
Cash used for financing activities	(145.2 )	(119.5 )
Effect of exchange rate changes on cash and cash equivalents	(10.5 )	15.5
Net increase in cash and cash equivalents	14.8	11.2
Cash and cash equivalents—beginning of period	308.2	259.1
Cash and cash equivalents—end of period	\$323.0	\$270.3
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	\$55.3	\$37.5
Cash paid for interest	\$2.7	\$3.8
Supplemental information of non-cash investing and financing activities:		
Unrealized (loss) gain on available-for-sale investments	\$(0.2 )	\$3.5
Software and equipment obtained under long-term financing arrangement	\$—	\$3.1

See notes to unaudited condensed consolidated financial statements.

Table of Contents

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

1. Basis of Presentation of Interim Financial Information

The accompanying unaudited 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 (U.S. GAAP) 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 are unaudited and should be read in conjunction with our Audited Consolidated Financial Statements and Notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2017, filed with the SEC on March 1, 2018 (our Annual Report).

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  
SAB: Staff Accounting Bulletin

2. Summary of Significant Accounting Policies

Significant changes to our accounting policies as a result of adopting ASU 2014-09, Revenue from Contracts with Customers, are discussed below. We discuss our other significant accounting policies in Note 2 of our Audited Consolidated Financial Statements included in our Annual Report.

Recently adopted accounting pronouncements

Revenue Recognition: On May 28, 2014, the FASB issued ASU No. 2014-09 (Topic 606), Revenue from Contracts with Customers, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The original effective date for ASU 2014-09 would have required us to adopt it beginning on January 1, 2017. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers—Deferral of the Effective Date, which deferred the effective date of ASU 2014-09 for one year and permitted early adoption as early as the original effective date. We elected the deferral, and the new standard was effective for us on January 1, 2018. We also adopted ASU No. 2016-08, ASU No. 2016-10, ASU No. 2016-11, ASU No. 2016-12, and ASU No. 2016-20 on January 1, 2018.

We adopted Topic 606 using the modified retrospective transition method applied to those contracts which were not completed as of January 1, 2018. Upon adoption, we recognized the cumulative effect of adopting this guidance as an adjustment to our opening balance of retained earnings. Prior periods were not retrospectively adjusted.

The impact to revenue as a result of applying Topic 606 was an increase of \$1.7 million and \$5.0 million for the three and nine months ended September 30, 2018, respectively, and relates to a change in presentation of revenue and costs associated with third-party content and data. Such revenue and costs were presented on a net basis prior to the

adoption of Topic 606 and are now presented on a gross basis.

We also changed our accounting for expenses related to our sales commission plans as a result of adopting Topic 606. Due to our method of adoption, we recorded a deferred commission asset, and related deferred tax liability, as of January 1, 2018 for sales commissions that were expensed in prior periods. This change resulted in an opening net adjustment to retained earnings of \$17.0 million, with an offsetting increase to our deferred commissions and deferred income tax liabilities relating to prior periods.

Table of Contents

The following table summarizes the cumulative effect of the changes to our unaudited condensed consolidated balance sheet as of January 1, 2018 from the adoption of Topic 606:

(in millions)	Balance at December 31, 2017	Adjustments due to Topic 606	Balance at January 1, 2018
<b>Assets:</b>			
Deferred commissions, current and non-current	\$	—\$ 22.7	\$ 22.7
<b>Liabilities:</b>			
Deferred income tax liability	\$	—\$ 5.7	\$ 5.7
<b>Equity:</b>			
Retained earnings	\$	—\$ 17.0	\$ 17.0

The following table illustrates the impact that adopting Topic 606 has had on our reported results in the unaudited condensed consolidated balance sheet as of September 30, 2018 and the unaudited condensed consolidated statements of income for the three and nine months ended September 30, 2018:

(in millions)	As of September 30, 2018		As of September 30, 2018		As of September 30, 2018	
	As Reported	Impact of adopting Topic 606	As Reported	Impact of adopting Topic 606	As Reported	Balances without adoption of Topic 606
<b>Balance Sheet:</b>						
Accounts receivable, less allowance	\$ 172.4	\$ —	\$ 172.4	\$ —	\$ 172.4	\$ —
Deferred commissions, current and non-current	24.0	24.0	24.0	—	—	—
Deferred revenue, current and non-current	203.6	—	203.6	—	203.6	—
<b>Income Statement:</b>						
Revenue	\$ 261.3	\$ 1.7	\$ 259.6	\$ 757.2	\$ 5.0	\$ 752.2
Cost of revenue	100.0	1.7	98.3	302.2	5.0	297.2
Sales and marketing	35.8	1.5	37.3	113.7	1.7	115.4
Operating income	65.4	(1.5 )	63.9	166.5	(1.7 )	164.8

We recognize revenue by applying the following five-step model to each of our customer arrangements:

1. Identify the customer contract

2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations
5. Recognize revenue when (or as) performance obligations are satisfied

## Table of Contents

Revenues are recognized when (or as) performance obligations are satisfied by transferring a promised product or service to the customer. Products or services are transferred when (or as) the customer obtains control of the product or service. The transaction price for a customer arrangement is the amount we expect to be entitled to in exchange for transferring the promised product or service. The transaction price may include fixed amounts, variable amounts, or both. Amounts invoiced in excess of the revenue recognized for the services transferred during the period will result in an increase to deferred revenue. The timing of cash payments is typically thirty to sixty days after the performance obligation has been satisfied and these payments reduce our outstanding accounts receivable.

Revenue from contracts with customers is derived from license-based arrangements, asset-based arrangements, and transaction-based arrangements.

License-based revenue is generated through subscription contracts with our customers of Morningstar Data, Morningstar Direct, Morningstar Advisor Workstation, Morningstar Enterprise Components, PitchBook Data, and other similar products. Our performance obligations under these contracts are typically satisfied over time, as the customer has access to the product or service during the term of the subscription license and the level of service is consistent during the contract period. Therefore, we recognize revenue for these performance obligations on a straight-line basis, typically over terms of 12 to 36 months.

Asset-based revenue is generated through consulting service contracts with our customers of Morningstar Investment Management, Workplace Solutions, and Morningstar Indexes. Our performance obligations under these contracts are satisfied over time as the customer receives continuous access to a service for the contract term. We recognize revenue over the contract term based on the value of assets under management and a tiered fee agreed to with the customer (typically in a range of 30-55 basis points of the customer's average daily portfolio balance). Asset-based arrangements typically have a term of 12 to 36 months. The fees from such arrangements represent variable consideration, and the customer does not make separate purchasing decisions that result in additional performance obligations. Significant changes in the underlying fund assets, or significant disruptions in the market, are evaluated to determine if revisions on estimates of earned asset-based fees for the current quarter are needed. An estimate of variable consideration is included in the initial transaction price only to the extent it is probable that a significant reversal in the amount of revenue recognized will not occur. Estimates of asset-based fees are based on the most recently reported quarter, and, as a result, it is unlikely a significant reversal of revenue would occur.

Transaction-based revenue is generated through contracts with our customers for Internet advertising, Morningstar Conferences, and Morningstar Credit Ratings. Our performance obligations for Internet advertising and Morningstar Conferences are satisfied as the service is delivered, and therefore we recognize revenue when the performance obligation is satisfied (as the customer's advertisements are displayed and at the completion of the Morningstar Conference). Our performance obligations for Morningstar Credit Ratings include the issuance of the rating, and may include surveillance services for a period of time as agreed with the customer. We allocate the transaction price to the deliverables based on their relative selling price, which is generally based on the price we charge when the same deliverable is sold separately. Our performance obligation for the issuance of the rating is satisfied when the rating is issued, which is when we recognize the related revenue. Our performance obligations for surveillance services is satisfied over time, as the customer has access to the service during the surveillance period and the level of service is consistent during the contract period. Therefore, we recognize revenue for this performance obligation on a straight-line basis.

Our contracts with customers may include multiple performance obligations. For such arrangements, we allocate revenue to each performance obligation based on its estimated standalone selling price. We generally determine standalone selling prices based on prices charged to customers when the same performance obligation is sold separately.

Our contracts with customers may include third-party involvement in providing goods or services to the customer. The inclusion of third-party content does not result in separate performance obligations because is it not delivered separately from the other license obligations. In these arrangements, the customer has contracted to receive a single, bundled solution with third-party and Morningstar content delivered via Morningstar's subscription services. Revenue and related costs of revenue from third-party content is presented on a gross basis within the condensed consolidated interim financial statements.

Table of Contents

**Sales Commissions:** We capitalize sales incentive compensation costs (sales commissions), which are considered directly attributable to obtaining a customer contract. Such costs are capitalized using a portfolio approach that aggregates these costs by legal entity within their geographical regions. Capitalized sales commissions are amortized using the straight-line method over a period that is consistent with the transfer of the products or services to the customer to which the sales commission relates. The period of transfer for each portfolio is the shorter of the weighted-average customer life, or the economic life of the underlying technology that delivers the products or services. As of September 30, 2018, the period of transfer was determined to be two to three years. Discretionary amounts which are added to sales commission payments are expensed as incurred, as they are not considered to be directly attributable to obtaining a customer contract.

**Financial Instruments:** On January 5, 2016, the FASB issued ASU No. 2016-01, Financial Instruments-Overall: Recognition and Measurement of Financial Assets and Financial Liabilities. The new guidance primarily affects the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. In addition, the FASB clarified guidance related to the valuation allowance assessment when recognizing deferred tax assets resulting from unrealized losses on available-for-sale debt securities. The accounting for other financial instruments, such as loans, investments in debt securities, and financial liabilities is largely unchanged. The new standard was effective for us on January 1, 2018. The adoption of ASU No. 2016-01 on January 1, 2018 had no impact on our consolidated financial statements and related disclosures.

**Statement of Cash Flows:** On August 26, 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows: Classification of Certain Cash Receipts and Cash Payments, which reduces diversity in practice of how certain transactions are classified in the statement of cash flows. The new guidance clarifies the classification of cash activities related to debt prepayment or debt extinguishment costs, settlement of zero-coupon debt instruments, contingent consideration payments made after a business combination, proceeds from the settlement of insurance claims, proceeds from the settlement of corporate and bank-owned life insurance policies, distributions received from equity-method investments, and beneficial interests in securitization transactions. The guidance also describes a predominance principle in which cash flows with aspects of more than one class that cannot be separated should be classified based on the activity that is likely to be the predominant source or use of cash flow. The new standard was effective for us on January 1, 2018. The adoption of ASU No. 2016-15 on January 1, 2018 had no impact on our consolidated financial statements and related disclosures.

**Business Combinations:** On January 5, 2017, the FASB issued ASU No. 2017-01, Business Combinations: Clarifying the Definition of a Business, which revises the definition of a business. When substantially all of the fair value of gross assets acquired is concentrated in a single asset (or a group of similar assets), the assets acquired would not represent a business. To be considered a business, an acquisition would have to include an input and a substantive process that together significantly contribute to the ability to create outputs. The new guidance provides a framework to evaluate when an input and substantive process are present (including for early-stage companies that have not generated outputs). To be a business without outputs, there will now need to be an organized workforce. The new guidance also narrows the definition of the term outputs to be consistent with how it is described in Topic 606, Revenue from Contracts with Customers. The new standard was effective for us on January 1, 2018. The adoption of ASU No. 2017-01 on January 1, 2018 had no impact on our consolidated financial statements and related disclosures.

**Compensation—Stock Compensation:** On May 10, 2017, the FASB issued ASU No. 2017-09, Compensation—Stock Compensation: Scope of Modification Accounting, which clarifies when to account for a change to the terms or conditions of a share-based payment award as a modification. Under the new guidance, modification accounting is required only if the fair value, the vesting conditions, or the classification of the award (as equity or liability) changes as a result of the change in terms or conditions. The new standard was effective for us on January 1, 2018. The adoption of ASU No. 2017-09 on January 1, 2018 had no impact on our consolidated financial statements and related

disclosures.

**Income Taxes:** On March 13, 2018, the FASB issued ASU No. 2018-05, Income Taxes (Topic 740): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 118, which allowed SEC registrants to record provisional amounts in earnings for the year ended December 31, 2017 due to the complexities involved in accounting for the enactment of the Tax Reform Act. We recognized the estimated income tax effects of the Tax Reform Act in our Audited Consolidated Financial Statements included in our Annual Report in accordance with SEC Staff Accounting Bulletin No. 118 (SAB 118). Refer to Note 10 for further information regarding the provisional amounts that we recorded as of December 31, 2017.

12

---

Table of Contents

Recently issued accounting pronouncements not yet adopted

**Leases:** On February 25, 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842), which will require lessees to recognize almost all leases on their balance sheet as a right-of-use asset and a lease liability. The new standard is effective for us on January 1, 2019. The new standard required the use of a modified retrospective approach upon adoption. In July 2018, the FASB issued ASU No. 2018-11, Leases (Topic 842) -Targeted Improvements, which allows an additional transition method to adopt the new lease standard at the adoption date, as compared to the beginning of the earliest period presented, and recognize a cumulative-effect adjustment to the beginning balance of retained earnings in the period of adoption. We plan to elect this transition method at the adoption date of January 1, 2019. We continue to evaluate the effect that ASU No. 2016-02 will have on our consolidated financial statements and related disclosures. We are progressing on our project plan and achieving project milestones related to our comprehensive review of our lease portfolio, including identification of all leases where the company is either a lessor or lessee. We are implementing processes and lease accounting software to assist in our ongoing lease data collection and analysis, and updating our accounting policies and internal controls that would be impacted by the new guidance, to ensure readiness for adoption in the first quarter of 2019.

**Intangibles—Goodwill and Other:** On January 26, 2017, the FASB issued ASU No. 2017-04, Intangibles—Goodwill and Other, which simplifies the accounting for goodwill impairment. The guidance removes Step 2 of the goodwill impairment test, which requires a hypothetical purchase price allocation. A goodwill impairment will now be the amount by which a reporting unit’s carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. All other goodwill impairment guidance will remain largely unchanged. Entities will continue to have the option to perform a qualitative assessment to determine if a quantitative impairment test is necessary. The same one-step impairment test will be applied to goodwill at all reporting units, even those with zero or negative carrying amounts. Entities will be required to disclose the amount of goodwill at reporting units with zero or negative carrying amounts. The new standard is effective for us on January 1, 2020. The new standard is required to be applied prospectively. Early adoption is permitted for any impairment tests performed after January 1, 2017. We are evaluating the effect that ASU No. 2017-04 will have on our consolidated financial statements and related disclosures.

**Income Statement-Reporting Comprehensive Income:** On February 14, 2018, the FASB issued ASU No. 2018-02, Income Statement-Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income, to address a specific consequence of the Tax Cuts and Jobs Act (the Tax Reform Act) by allowing a reclassification from accumulated other comprehensive income (loss) to retained earnings for stranded tax effects resulting from the Tax Reform Act’s reduction of the U.S. federal corporate income tax rate. The new standard is effective for us on January 1, 2019 and is to be applied either in the period of adoption or retrospectively to each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Reform Act is recognized. Early adoption is permitted. We are evaluating the effect that ASU No. 2018-02 will have on our consolidated financial statements and related disclosures.

**Compensation—Stock Compensation:** On June 20, 2018, the FASB issued ASU No. 2018-07, Compensation—Stock Compensation (Topic 718) - Improvements to Nonemployee Share-Based Payment Accounting, which aligns the accounting for share-based payment awards issued to employees and nonemployees. Under ASU No. 2018-07, the existing employee guidance will apply to nonemployee share-based transactions (as long as the transaction is not effectively a form of financing), with the exception of specific guidance related to the attribution of compensation cost. The cost of nonemployee awards will continue to be recorded as if the grantor had paid cash for the goods or services. In addition, the contractual term will be able to be used in lieu of an expected term in the option-pricing model for nonemployee awards. The new standard is effective for us on January 1, 2019. Early adoption is permitted, including in interim periods, and should be applied to all new awards granted after the date of adoption. We are evaluating the effect that ASU No. 2018-07 will have on our consolidated financial statements and related disclosures.



Table of Contents

Cloud Computing: On August 29, 2018, the FASB issued ASU No. 2018-15, Customer's Accounting for Fees Paid in a Cloud Computing Arrangement, which helps entities evaluate the accounting for fees paid by a customer in a cloud computing arrangement (CCA) by providing guidance for determining when an arrangement includes a software license and when an arrangement is solely a hosted CCA service. Under ASU No. 2018-15, customers will apply the same criteria for capitalizing implementation costs as they would for an arrangement that has a software license. The new guidance also prescribes the balance sheet, income statement, and cash flow classification of the capitalized implementation costs and related amortization expense, and requires additional quantitative and qualitative disclosures. The new standard is effective for us on January 1, 2020. Early adoption is permitted, including adoption in any interim period for which financial statements have not been issued. Entities can choose to adopt the new guidance prospectively to eligible costs incurred on or after the date this guidance is first applied or retrospectively. We are evaluating the effect that ASU No. 2018-15 will have on our consolidated financial statements and related disclosures.

### 3. Credit Arrangements

We are party to a credit agreement that provides us with a three-year credit facility expiring in November 2019 with a borrowing capacity of up to \$300.0 million. The credit agreement also provides for issuance of up to \$25.0 million of letters of credit under the revolving credit facility.

The interest rate applicable to any loan under the credit agreement is, at our option, either: (i) the applicable London interbank offered rate (LIBOR) plus an applicable margin for such loans, which ranges between 1.00% and 1.75%, based on our consolidated leverage ratio or (ii) the lender's base rate plus the applicable margin for such loans, which ranges between 2.00% and 2.75%, based on our consolidated leverage ratio.

The credit agreement also contains financial covenants under which we: (i) may not exceed a maximum consolidated leverage ratio of 3.00 to 1.00 and (ii) are required to maintain a minimum consolidated interest coverage ratio of not less than 3.00 to 1.00. We were in compliance with the financial covenants as of September 30, 2018.

Our outstanding principal balance was \$90.0 million at a one-month LIBOR interest rate plus 100 basis points as of September 30, 2018, leaving borrowing availability of \$210.0 million.

### 4. Goodwill and Other Intangible Assets

#### Goodwill

The following table shows the changes in our goodwill balances from December 31, 2017 to September 30, 2018:

	(in millions)
Balance as of December 31, 2017	\$ 564.9
Foreign currency translation	(5.7 )
Balance as of September 30, 2018	\$ 559.2

We did not record any impairment losses in the first nine months of 2018 and 2017. We perform our annual impairment reviews in the fourth quarter and when triggering events are identified.



Table of Contents

## Intangible Assets

The following table summarizes our intangible assets:

(in millions)	As of September 30, 2018				As of December 31, 2017			
	Gross	Accumulated Amortization	Net	Weighted Average Useful Life (years)	Gross	Accumulated Amortization	Net	Weighted Average Useful Life (years)
Intellectual property	\$31.4	\$ (29.1 )	\$2.3	9	\$31.5	\$ (28.9 )	\$2.6	9
Customer-related assets	154.4	(111.4 )	43.0	12	156.6	(108.1 )	48.5	12
Supplier relationships	0.3	(0.2 )	0.1	20	0.2	(0.1 )	0.1	20
Technology-based assets	127.1	(93.5 )	33.6	7	127.9	(84.2 )	43.7	7
Non-competition agreements	2.4	(2.1 )	0.3	5	2.5	(2.0 )	0.5	5
Total intangible assets	\$315.6	\$ (236.3 )	\$79.3	10	\$318.7	\$ (223.3 )	\$95.4	10

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

(in millions)	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Amortization expense	\$5.2	\$5.5	\$15.7	\$18.1

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

We expect intangible amortization expense for the remainder of 2018 and subsequent years as follows:

	(in millions)
Remainder of 2018 (from October 1 through December 31)	\$ 4.9
2019	19.1
2020	16.2
2021	12.9
2022	5.1
Thereafter	21.1

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

Table of Contents

## 5. Income Per Share

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

(in millions, except per share amounts)	Three months ended		Nine months ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Basic net income per share:				
Consolidated net income	\$56.9	\$33.9	\$140.6	\$98.0
Weighted average common shares outstanding	42.6	42.5	42.6	42.8
Basic net income per share	\$1.33	\$0.80	\$3.30	\$2.29
Diluted net income per share:				
Consolidated net income	\$56.9	\$33.9	\$140.6	\$98.0
Weighted average common shares outstanding	42.6	42.5	42.6	42.8
Net effect of dilutive stock options, restricted stock units, performance share awards, and market stock units	0.5	0.3	0.4	0.3
Weighted average common shares outstanding for computing diluted income per share	43.1	42.8	43.0	43.1
Diluted net income per share	\$1.32	\$0.79	\$3.27	\$2.28

The number of weighted average restricted stock units, performance share awards, and market stock units excluded from our calculation of diluted earnings per share, as their inclusion would have been anti-dilutive, was immaterial during the periods presented.

## 6. Revenue

## Disaggregation of Revenue

The following table presents our revenue disaggregated by revenue type. Sales and usage-based taxes are excluded from revenue.

(in millions)	Three months ended		Nine months ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
License-based	\$196.7	\$169.5	\$559.5	\$492.9
Asset-based	50.5	46.2	149.9	134.0
Transaction-based	14.1	14.2	47.8	41.7
Consolidated revenue	\$261.3	\$229.9	\$757.2	\$668.6

License-based performance obligations are generally satisfied over time as the customer has access to the product or service during the term of the subscription license and the level of service is consistent during the contract period. License-based agreements typically have a term of 12 to 36 months. License-based revenue includes Morningstar Data, Morningstar Direct, Morningstar Advisor Workstation, Morningstar Enterprise Components, Morningstar Research, PitchBook Data, and other similar products.

Table of Contents

Asset-based performance obligations are satisfied over time as the customer receives continuous access to a service for the term. Asset-based arrangements typically have a term of 12 to 36 months. The asset based fees represent variable consideration and the customer does not make separate purchasing decisions that result in additional performance obligations. Significant changes in the underlying fund assets, or significant disruptions in the market, are evaluated to determine if revisions of estimates of earned asset-based fees are needed for the current quarter. An estimate of variable consideration is included in the initial transaction price only to the extent it is probable that a significant reversal in the amount of the revenue recognized will not occur. Estimates of asset based fees are based on the most recently completed quarter and as a result, it is unlikely a significant reversal of revenue would occur. Asset-based revenue includes Morningstar Investment Management, Workplace Solutions, and Morningstar Indexes.

Transaction-based performance obligations are satisfied when the product or service is completed or delivered. Transaction-based revenue includes Morningstar Credit Ratings, Internet Advertising Sales, and Conferences. Morningstar Credit Ratings may include surveillance services, which are recognized over time, as the customer has access to the service during the surveillance period.

Contract liabilities

Our contract liabilities represent deferred revenue. We record contract liabilities when cash payments are received or due in advance of our performance, including amounts which are refundable. The contract liabilities balance for the nine months ended September 30, 2018 had a net increase of \$18.1 million, primarily driven by cash payments received or due in advance of satisfying our performance obligations. We recognized \$153.6 million of revenue in the nine-month period ended September 30, 2018 that was included in the contract liabilities balance as of December 31, 2017.

We expect to recognize revenue related to our contract liabilities for the remainder of 2018 and subsequent years as follows:

(in millions)	As of September 30, 2018
Remainder of 2018 (from October 1 through December 31)	\$ 137.6
2019	246.7
2020	69.9
2021	17.4
2022	8.9
Thereafter	37.5
	\$ 518.0

The aggregate amount of revenue we expect to recognize for the remainder of 2018 and subsequent years is higher than our contract liability balance of \$203.6 million as of September 30, 2018. The difference represents the value of performance obligations for signed contracts where we have not yet begun to satisfy the performance obligations, partially satisfied performance obligations, or have not yet billed the customer.

The table above does not include variable consideration for unsatisfied performance obligations related to certain of our asset-based and transaction-based contracts as of September 30, 2018. We are applying the optional exemption as the variable consideration relates to these unsatisfied performance obligations being fulfilled as a series. The performance obligations related to these contracts are expected to be satisfied over the next 12 to 36 months as services are provided to the client. For asset-based contracts, the consideration received for services performed is based on future asset values, which will be known at the time the services are performed. The variable consideration

for this revenue can be affected by changes in the underlying value of fund assets due to client redemptions, additional investments, or significant movements in the market. For transaction-based contracts such as Internet advertising, the consideration received for services performed is based on the number of impressions, which will be known once impressions are created. The variable consideration for this revenue can be affected by the timing and quantity of impressions in any given period.

Table of Contents

The table above does not include revenue for unsatisfied performance obligations related to certain of our license-based and transaction-based contracts as of September 30, 2018. We are applying the optional exemption as the performance obligations for such contracts have an expected duration of one year or less. For certain license-based contracts, the remaining performance obligation is expected to be less than one year based on the corresponding subscription terms. For transaction-based contracts such as new credit rating issuances and the Morningstar conference, the related performance obligations are expected to be satisfied within the next twelve months.

## Contract Assets

Our contract assets represent accounts receivable, less allowance and deferred commissions. We did not record any impairment losses on receivables or deferred commissions in the first nine months of 2018.

The following table summarizes our contract assets balance:

(in millions)	As of September 30, 2018	As of December 31, 2017
Accounts receivable, less allowance	\$ 172.4	\$ 148.2
Deferred commissions	14.2	—
Deferred commissions, non-current	9.8	—
Total contract assets	\$ 196.4	\$ 148.2

The following table shows the change in our deferred commissions balance from January 1, 2018 to September 30, 2018:

	(in millions)
Balance as of January 1, 2018	\$ 22.7
Commissions earned and capitalized	13.8
Amortization of capitalized amounts	(12.5 )
Balance as of September 30, 2018	\$ 24.0

## 7. Segment and Geographical Area Information

## Segment Information

We report our results in a single reportable segment, which reflects how our chief operating decision maker allocates resources and evaluates our financial results.

Because we have one reportable segment, all required financial segment information can be found directly in the Unaudited Condensed Consolidated Financial Statements.

The accounting policies for our single reportable segment are the same as those described in “Note 2. Summary of Significant Accounting Policies” included in the Audited Consolidated Financial Statements and Notes thereto included in our Annual Report. We evaluate the performance of our reporting segment based on revenue and operating income.



Table of Contents

## Geographical Area Information

The tables below summarize our revenue and long-lived assets by geographical area:

## Revenue by geographical area

(in millions)	Three months ended		Nine months ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
United States	\$198.7	\$171.8	\$566.0	\$503.4
United Kingdom	17.9	17.0	54.6	47.5
Continental Europe	20.1	18.2	60.3	51.0
Australia	9.9	8.8	31.2	25.5
Canada	7.4	7.5	22.6	22.0
Asia	5.9	5.3	18.1	15.7
Other	1.4	1.3	4.4	3.5
Total International	62.6	58.1	191.2	165.2
Consolidated revenue	\$261.3	\$229.9	\$757.2	\$668.6

## Long-lived assets by geographical area

(in millions)	As of September 30, 2018	As of December 31, 2017
United States	\$ 128.4	\$ 131.9
United Kingdom	4.3	6.0
Continental Europe	1.3	1.7
Australia	5.1	2.3
Canada	0.3	0.2
Asia	5.1	5.2
Other	—	0.1
Total International	16.1	15.5
Consolidated property, equipment, and capitalized software, net	\$ 144.5	\$ 147.4

Table of Contents

## 8. Investments and Fair Value Measurements

We classify our investments into three categories: available-for-sale, held-to-maturity, and trading securities. Our investment portfolio consists of stocks, bonds, options, mutual funds, money market funds, or exchange-traded products that replicate the model portfolios and strategies created by Morningstar. These investment accounts may also include exchange-traded products where Morningstar is an index provider. We classify our investment portfolio as shown below:

(in millions)	As of September 30, 2018	As of December 31, 2017
Available-for-sale	\$ 23.1	\$ 21.5
Held-to-maturity	18.8	21.9
Trading securities	1.8	1.7
Total	\$ 43.7	\$ 45.1

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

(in millions)	As of September 30, 2018				As of December 31, 2017			
	Cost	Unrealized Gain	Unrealized Loss	Fair Value	Cost	Unrealized Gain	Unrealized Loss	Fair Value
Available-for-sale:								
Equity securities and exchange-traded funds	\$18.5	\$ 2.5	\$ (0.8 )	\$20.2	\$17.1	\$ 2.4	\$ (0.6 )	\$18.9
Mutual funds	2.8	0.2	(0.1 )	2.9	2.4	0.2	—	2.6
Total	\$21.3	\$ 2.7	\$ (0.9 )	\$23.1	\$19.5	\$ 2.6	\$ (0.6 )	\$21.5
Held-to-maturity:								
Certificates of deposit	\$18.8	\$ —	\$ —	\$18.8	\$19.9	\$ —	\$ —	\$19.9
Convertible note	—	—	—	—	2.0	—	—	2.0
Total	\$18.8	\$ —	\$ —	\$18.8	\$21.9	\$ —	\$ —	\$21.9

As of September 30, 2018 and December 31, 2017, investments with unrealized losses for greater than a 12-month period were not material to the Unaudited Condensed Consolidated Balance Sheets and were not deemed to have other than temporary declines in value.

Table of Contents

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 September 30, 2018 and December 31, 2017.

(in millions)	As of September 30, 2018		As of December 31, 2017	
	Cost	Fair Value	Cost	Fair Value
Available-for-sale:				
Equity securities, exchange-traded funds, and mutual funds	\$21.3	\$ 23.1	\$19.5	\$ 21.5
Total	\$21.3	\$ 23.1	\$19.5	\$ 21.5
Held-to-maturity:				
Due in one year or less	\$18.6	\$ 18.6	\$19.7	\$ 19.7
Due in one to three years	0.2	0.2	2.2	2.2
Total	\$18.8	\$ 18.8	\$21.9	\$ 21.9

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

(in millions)	Three months ended September 30, 2018		Nine months ended September 30, 2017	
	2018	2017	2018	2017
Realized gains	\$0.5	\$0.4	\$1.4	\$1.3
Realized losses	(0.2 )	(0.1 )	(0.5 )	(0.2 )
Realized gains, net	\$0.3	\$0.3	\$0.9	\$1.1

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

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

(in millions)	Three months ended September 30, 2018		Nine months ended September 30, 2017	
	2018	2017	2018	2017
Unrealized gains, net	\$ —	\$ —	\$ —	\$ 0.1

The table below shows the fair value of our assets subject to fair value measurements on a recurring basis using a fair value hierarchy:

- 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.

Edgar Filing: Morningstar, Inc. - Form 10-Q

Level 3: Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

(in millions)	Fair Value as of September 30, 2018	Fair Value Measurements as of September 30, 2018 Using Fair Value Hierarchy		
		Level 1	Level 2	Level 3
Available-for-sale investments:				
Equity securities and exchange-traded funds	\$ 20.2	\$ 20.2	\$ —	\$ —
Mutual funds	2.9	2.9	—	—
Trading securities	1.8	1.8	—	—
Cash equivalents	0.5	0.5	—	—
Total	\$ 25.4	\$ 25.4	\$ —	\$ —

21

---

Table of Contents

(in millions)	Fair Value as of December 31, 2017	Fair Value Measurements as of December 31, 2017 Using Fair Value Hierarchy		
		Level 1	Level 2	Level 3
Available-for-sale investments:				
Equity securities and exchange-traded funds	\$ 18.9	\$ 18.9	\$ —	\$ —
Mutual funds	2.6	2.6	—	—
Trading securities	1.7	1.7	—	—
Cash equivalents	0.5	0.5	—	—
Total	\$ 23.7	\$ 23.7	\$ —	\$ —

Based on our analysis of the nature and risks of our investments in equity securities and mutual funds, we 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. We did not hold any securities categorized as Level 2 or Level 3 as of September 30, 2018 and December 31, 2017.

## 9. Stock-Based Compensation

### Stock-Based Compensation Plans

All of our employees and our non-employee directors are eligible for awards under the Morningstar 2011 Stock Incentive Plan, which provides for a variety of stock-based awards, including stock options, restricted stock units, performance share awards, market stock units, and restricted stock.

The following table summarizes the stock-based compensation expense included in each of our operating expense categories:

(in millions)	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Cost of revenue	\$ 3.1	\$ 2.2	\$ 9.0	\$ 6.6
Sales and marketing	0.8	0.7	2.5	2.1
General and administrative	3.4	2.6	12.4	7.8
Total stock-based compensation expense	\$ 7.3	\$ 5.5	\$ 23.9	\$ 16.5

As of September 30, 2018, the total unrecognized stock-based compensation cost related to outstanding restricted stock units, performance share awards, and market stock units expected to vest was \$44.2 million, which we expect to recognize over a weighted average period of 32 months.



Table of Contents

## 10. Income Taxes

## Effective Tax Rate

The following table shows our effective tax rate for the three and nine months ended September 30, 2018 and September 30, 2017:

(in millions)	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Income before income taxes and equity in net income (loss) of unconsolidated entities	\$72.7	\$50.8	\$184.5	\$139.2
Equity in net income (loss) of unconsolidated entities	0.3	—	(1.6 )	(1.0 )
Total	\$73.0	\$50.8	\$182.9	\$138.2
Income tax expense	\$16.1	\$16.9	\$42.3	\$40.2
Effective tax rate	22.1 %	33.3 %	23.1 %	29.1 %

Our effective tax rate in the third quarter and first nine months of 2018 was 22.1% and 23.1%, respectively, which resulted in respective decreases of 11.2 and 6.0 percentage points compared with the same periods in the prior year. Our effective tax rate in the third quarter and the first nine months of 2018 reflects the U.S. federal statutory income tax rate change from 35% to 21% and other provisions of the Tax Reform Act enacted in December 2017. The impacts of other provisions of the Tax Reform Act on our effective tax rate in the third quarter and first nine months of 2018 are discussed below. Our effective tax rate for the first nine months of 2017, compared to the first nine months of 2018, also reflects a book gain of \$17.5 million on the sale of HelloWallet in the second quarter of 2017 that was not a gain for tax purposes.

On December 22, 2017, the President of the United States signed into law the Tax Reform Act. The legislation significantly changed U.S. tax law by, among other things, lowering corporate income tax rates, changing to a territorial tax system and imposing a transitional tax on deemed repatriated earnings of foreign subsidiaries. The Tax Reform Act permanently reduces the U.S. corporate income tax rate from a maximum of 35% to a flat 21% rate, effective from January 1, 2018.

In our consolidated financial statements for the year ended December 31, 2017, we recognized a \$10.6 million discrete net tax benefit. SAB 118 allowed for the recording of provisional amounts, which were primarily comprised of the following:

A \$14.7 million deferred tax benefit from revaluing our net U.S. deferred tax liabilities at December 31, 2017 to reflect the new U.S. corporate tax rate.

A tax expense of \$7.5 million for the transitional tax liability on deemed repatriated earnings of foreign subsidiaries payable over 8 years. This tax expense was offset by a tax benefit of a \$6.4 million reduction of a deferred tax liability previously recorded for our foreign equity method investments.

A tax expense of \$3.0 million related to changes in our indefinite reinvestment assertion. We recorded deferred taxes in the amount of \$3.0 million for foreign withholding taxes that would be due upon remittance of dividends from certain of our foreign affiliates.

Edgar Filing: Morningstar, Inc. - Form 10-Q

During the nine-month period ended September 30, 2018, we made no changes to the provisional amounts recognized in 2017. We will continue to analyze the effects of the Tax Reform Act and will record additional impacts of the enactment as we complete our accounting within the measurement period, which extends up to one year from the enactment date.

## Table of Contents

The ultimate impact from the enactment of the Tax Reform Act may differ from the provisional amounts that we recorded in 2017, possibly materially, due to, among other things, additional analysis, changes in interpretations and assumptions that we have made, additional legislative or administrative actions taken to clarify the intent of the statutory language that may differ from our current interpretation, any changes in accounting standards for income taxes or related interpretations in response to the Tax Reform Act or any updates or changes to estimates used to calculate the impacts.

In addition to the reduction of the U.S. corporate income tax rate to a flat 21% rate discussed above, we are subject to the following provisions of the Tax Reform Act effective from January 1, 2018, which:

impose a new minimum tax on certain non-U.S. earnings, irrespective of the territorial system of taxation, and generally allow for the repatriation of future earnings of foreign subsidiaries without incurring additional U.S. taxes by transitioning to a territorial system of taxation (Global Intangible Low-Taxed Income or “GILTI Tax”);

eliminate tax incentives for domestic production activities in the United States (the “Section 199 Deduction”) and create an incentive for U.S. companies to sell, lease or license goods and services abroad by allowing for a new deduction for Foreign-Derived Intangible Income (the “FDII Deduction”);

subject certain payments made by a U.S. company to related foreign companies to certain minimum taxes (Base Erosion Anti-Abuse Tax or “BEAT”);

disallow net business interest deductions in excess of 30% of adjusted U.S. taxable income without regard to interest expense, interest income, taxes, net operating losses, depreciation and amortization (generally, EBITDA) for years beginning before January 1, 2022, and taxable income without regard to interest and taxes (EBIT) thereafter with indefinite carryforwards of excess interest expense (the “163(j) Interest Limitation”);

reduce deductions with respect to certain employee fringe benefits and reduce deductions for compensation paid to specified executive officers.

With respect to the above provisions, our effective tax rate in the three and nine months ended September 30, 2018 is favorably impacted by the federal statutory income tax rate change from 35% of 21% and also the tax benefits of the FDII Deduction. The impact of these favorable provisions is offset by the loss of tax benefits from the repeal of the Section 199 Deduction, the incremental tax expense attributable to GILTI Tax estimates and, to a lesser extent, the incremental tax expense for disallowed deductions for employee fringe benefits and executive compensation. Our effective tax rate in the three and nine months ended September 30, 2018 was not impacted by BEAT or the 163(j) Interest Limitation.

We also continue to evaluate the impact of the GILTI Tax provisions, which are complex and subject to continuing interpretation and administrative actions of the U.S. tax authorities. We are required to make an accounting policy election of either (1) treating taxes due on future U.S. inclusions in taxable income related to the GILTI Tax as a current period expense when incurred (the “period cost method”) or (2) factoring such amounts into the measurement of our deferred taxes (the “deferred method”). Our accounting policy election with respect to the new GILTI Tax rules will depend, in part, on analyzing our global income to determine whether we can reasonably estimate the tax impact. While we have included an estimate of GILTI Tax in our estimated effective tax rate for the three and nine months ended September 30, 2018, we have not completed our analysis and are not yet able to determine which method to elect. Adjustments related to the amount of GILTI Tax recorded in our consolidated financial statements may be required based on the outcome of this election.



Table of Contents

## Unrecognized Tax Benefits

The table below provides information concerning our gross unrecognized tax benefits as of September 30, 2018 and December 31, 2017, as well as the effect these gross unrecognized tax benefits would have on our income tax expense, if they were recognized.

(in millions)	As of September 30, 2018	As of December 31, 2017
Gross unrecognized tax benefits	\$ 12.6	\$ 18.7
Gross unrecognized tax benefits that would affect income tax expense	\$ 12.3	\$ 15.0
Decrease in income tax expense upon recognition of gross unrecognized tax benefits	\$ 11.8	\$ 14.4

The amount of our gross unrecognized tax benefits decreased in 2018 primarily as a result of the following:

In the first quarter of 2018, we settled certain of our U.S. federal and state tax audits including our federal audit for the tax periods covering 2008 to 2012. The impact of the audit settlements decreased our gross unrecognized tax benefits by \$2.4 million but the impact on our tax expense was nominal since the liabilities that we reserved for these audits were approximate to the final settlement amounts.

In the second and third quarters of 2018, there were lapses of statutes of limitation for unsuccessful state refund claims which decreased our gross unrecognized tax benefits by \$3.4 million. We did not previously record a financial statement benefit for the state refund claims and, therefore, this decrease had no impact on our income tax expense in the second and third quarters.

In the third quarter of 2018, there were other lapses of statutes of limitation that decreased our gross unrecognized tax benefits by \$1.0 million and our income tax expense by \$1.0 million.

Our Unaudited 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 (in millions)	As of September 30, 2018	As of December 31, 2017
Current liability	\$ 7.2	\$ 8.7
Non-current liability	5.7	7.0
Total liability for unrecognized tax benefits	\$ 12.9	\$ 15.7

Because we conduct business globally, we file income tax returns in U.S. federal, state, local, and foreign jurisdictions. We are currently under audit by various state and local tax authorities in the United States, as well as tax authorities in certain non-U.S. jurisdictions. It is possible that the examination phase of some of our current audits will conclude in 2018. It is not possible to estimate the effect of current audits on previously recorded unrecognized tax benefits.

Approximately 75% of our cash, cash equivalents, and investments balance as of September 30, 2018 was held by our operations outside of the United States. We believe that our cash balances and investments in the United States, along with cash generated from our U.S. operations, will be sufficient to meet our U.S. operating and cash needs for the foreseeable future, without requiring us to repatriate earnings from these foreign subsidiaries. In December 2017, we recorded a provisional deferred tax liability of \$3.0 million for foreign withholding taxes that would be due upon remittance of dividends from certain of our foreign affiliates. We continue to assess our indefinite reinvestment assertion as a result of the Tax Reform Act. Accordingly, we consider that most of our remaining foreign outside basis

differences to be indefinitely reinvested and we have not recorded deferred taxes on those outside basis differences. As part of our continuing evaluation, we will need to gather additional information to compute outside basis differences for our foreign affiliates in order to assess whether any new deferred taxes should be recorded. We will also need to account for any prospective interpretive guidance issued on the Tax Reform Act as part of our evaluation.

## Table of Contents

Certain of our non-U.S. operations have incurred net operating losses (NOLs), which may become deductible to the extent these operations become profitable. 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. In the year that certain non-U.S. operations record a loss, we do not recognize a corresponding tax benefit, thus increasing our effective tax rate. 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 that period.

### 11. Contingencies

#### Michael D. Green

In August 2017, Michael D. Green, individually and purportedly on behalf of all others similarly situated, filed a complaint in the United States District Court for the Northern District of Illinois. The complaint named as defendants Morningstar, Inc., Prudential Investment Management Services LLC, and Prudential Retirement Insurance and Annuity Co., and contained one count alleging violation of the Racketeer Influenced and Corrupt Organizations Act (RICO). Plaintiff, a participant in a pension plan, alleged that the defendants engaged in concerted racketeering actions to steer plan participants into high-cost investments that pay unwarranted fees to the defendants. The complaint sought unspecified compensatory damages for plaintiff and the members of the putative class, treble damages, injunctive relief, costs, and attorneys' fees. We filed a motion to dismiss the complaint for failure to state a claim, which the court granted without prejudice on March 16, 2018. On April 13, 2018, plaintiff filed an amended complaint, substituting Morningstar Investment Management LLC for Morningstar, Inc. as a defendant, and which again contains one count alleging violation of RICO and seeks unspecified compensatory damages for plaintiff and the members of the putative class, treble damages, injunctive relief, costs, and attorneys' fees. We moved to dismiss the amended complaint on May 11, 2018. Morningstar's motion is fully briefed and is awaiting the court's ruling. Although we are vigorously contesting the claim asserted, we cannot predict the outcome of the proceeding.

#### Other Matters

We are involved from time to time in legal proceedings and litigation that arise in the normal course of our business. While it is difficult to predict the outcome of any particular proceeding, we do not believe the result of any of these matters will have a material adverse effect on our business, operating results, or financial position.

### 12. Share Repurchase Program

In December 2017, the board of directors approved a new share repurchase program that authorizes the company to repurchase up to \$500.0 million in shares of the company's outstanding common stock effective January 1, 2018. The authorization expires on December 31, 2020. We may repurchase shares from time to time at prevailing market prices on the open market or in private transactions in amounts that we deem appropriate.

As of September 30, 2018, we had repurchased a total of 109,289 shares for \$10.5 million under this authorization, leaving approximately \$489.5 million available for future repurchases.

## 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 (this Quarterly Report), 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,” “continue.” These statements 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:

- liability for any losses that result from an actual or claimed breach of our fiduciary duties;
- failing to maintain and protect our brand, independence, and reputation;
- failing to differentiate our products and continuously create innovative, proprietary research tools;
- failing to respond to technological change, keep pace with new technology developments, or adopt a successful technology strategy;
- trends in the asset management industry, including the increasing popularity of passively managed investment vehicles;
- inadequacy in our business continuity program in the event of a material emergency or adverse political or regulatory developments;
- liability related to the storage of personal information related to individuals as well as portfolio and account-level information;
- compliance failures, regulatory action, or changes in laws applicable to our investment advisory or credit rating operations;
  - an outage of our database, technology-based products and services, or network facilities or the movement of parts of our technology infrastructure to the public cloud;
- downturns in the financial sector, global financial markets, and global economy;
- the effect of market volatility on revenue from asset-based fees;
- the failure of acquisitions and other investments to produce the results we anticipate;
- the failure to recruit, develop, and retain qualified employees;
- challenges faced by our non-U.S. operations, including the concentration of data and development work at our offshore facilities in China and India.
- liability relating to the acquisition or redistribution of data or information we acquire or errors included therein; and
- the failure to protect our intellectual property rights or claims of intellectual property infringement against us.

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, 2017 (our Annual Report). 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 previous year unless otherwise stated.

## Table of Contents

### 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 products and services for individual investors, financial advisors, asset managers, retirement plan providers and sponsors, and institutional investors in the private capital markets. We generate revenue through three main business models:

- Subscriptions and license agreements, which typically generate recurring revenue;
- Asset-based fees for our investment management business; and
- Transaction-based revenue for products that involve one-time, non-recurring revenue.

#### Industry Trends

Equities posted strong returns in the third quarter of 2018. The Morningstar Global Markets Index, which contains stocks from 46 developed and emerging markets, increased 4.2%, largely driven by the U.S. The Morningstar U.S. Market Index advanced 7.2% in the third quarter, while the Global Ex-U.S. index rose nearly 1%, reversing declines seen earlier in 2018. Morningstar's Developed Markets Ex-U.S. Index returned approximately 1.2% in the third quarter of 2018, whereas the Emerging Markets Index finished the same period down 0.6%, signaling some improvement relative to the year-to-date decline of 7.5%.

Based on Morningstar Asset Flows data, U.S. fund assets, comprised of both long-term open-end and exchange-traded funds (ETFs), totaled almost \$19.1 trillion as of September 30, 2018, compared with over \$17.3 trillion as of September 30, 2017. The U.S. ETF industry benefited from strong market appreciation and investor inflows, ending the third quarter of 2018 with approximately \$3.7 trillion in assets under management, up from about \$3.1 trillion at the end of September 2017. Assets in U.S. long-term open-end funds also increased to approximately \$15.3 trillion as of September 30, 2018 from \$14.2 trillion as of September 30, 2017. In the third quarter of 2018, investors continued to favor lower-cost, passively managed vehicles, as passively managed funds attracted nearly \$118.6 billion of inflows over the three-month period compared with about \$42.9 billion of outflows from actively managed funds. Morningstar estimates that investors added about \$90.0 billion to ETFs during the third quarter of 2018, while long-term open-end funds experienced approximately \$14.2 billion of outflows.

Ongoing global economic growth, tightening monetary policy across the developed market central banks, and global inflation nearing targeted levels all led to rising interest rates in the third quarter, which proved to be a headwind across the fixed income marketplace. Morningstar's U.S. Treasury Bond Index declined 0.6% in the third quarter. However, tightening credit spreads in the corporate bond markets were able to more than offset the negative impact of rising underlying interest rates. The average credit spread of Morningstar's Corporate Bond Index tightened 18 basis points, helping lift the index by 1.0%. Overall, the combination of losses in the government bond market were offset by gains in the corporate bond market and Morningstar's Core Bond Index (our broadest measure of the fixed-income universe) remained essentially unchanged for the third quarter.

Based on the information collected by PitchBook, private capital markets registered healthy results across dealmaking, fundraising and exits in the third quarter of 2018. Competition for assets has driven up multiples while average transaction and fund sizes continue to expand. Over \$225 billion was deployed in the U.S. private equity (PE) and venture capital (VC) markets during the third quarter, a 29% quarter-over-quarter (QoQ) increase. However, total deal count fell approximately 10% between the second and third quarters of 2018. Average deal sizes increased as many sizable deals closed, allowing for the substantial QoQ expansion in deal value. PE closed eight transactions above

\$2.5 billion, compared with five in the first and second quarters of 2018 combined. Fundraising was equally active, with PE and VC registering quarterly upticks in commitments. In total, \$69.5 billion was raised across 112 funds as money continues to flow into alternatives. Finally, exit activity totaled \$115.1 billion in the quarter. PE exit value was roughly flat while VC was down significantly. However, five VC-backed companies valued above \$1 billion, including Sonos and Eventbrite, went public in the quarter, compared to just two PE-backed IPOs of the same size.

Table of Contents

The industry wide shift to passive investment management continues to put pressure on spending for many asset management firms. Globally, financial advisors have been adapting to the increasing demand for solutions that are in the best interest of investors, including moving from a sales to a fiduciary model, emphasizing low-fee investment choices, and improving the transparency of their client communications. In the U.S., despite the recent successful court challenge to the U.S. Department of Labor's fiduciary rule, the ongoing debate has already prompted many financial institutions to take steps to provide best-interest advice or limit perceived conflicts of interest embedded in their business practices. There is also ongoing uncertainty about the scope of potential regulatory changes given the SEC's newly proposed "Regulation Best Interest," a rule intended to address the same concerns as the Department of Labor regarding investment advice, but with a narrower scope. The SEC is evaluating comments on the proposal and may release a final rule that adds additional momentum toward best interest advice.

Outside the U.S., policymakers also continue to look for ways to move advisors toward acting in the best interests of their clients, including in the European Union with the implementation of the markets in financial instruments directive (MiFID) II legislation, in Australia with a new examination called the Financial Services Royal Commission, and in Japan with recently-promulgated principles governing fiduciary duties. Regardless of the regulatory environment, we believe that greater emphasis on serving investors' interests and lowering fees is a fundamental change that will continue.

Table of Contents

## Supplemental Operating Metrics (Unaudited)

The tables below summarize our key product metrics and other supplemental data.

	As of September 30,		
	2018	2017	Change
Our business			
Morningstar.com Premium Membership subscriptions (U.S.)	117,340	118,209	(0.7 )%
Morningstar.com average monthly unique users (U.S.)	2,353,978	1,923,483	22.4 % (1)
Advisor Workstation clients (U.S.)	180	182	(1.1 )%
Morningstar Office licenses (U.S.)	4,468	4,303	3.8 %
Morningstar Direct licenses	14,751	13,476	9.5 %
PitchBook Platform licenses	20,195	12,410	62.7 %
Asset value linked to Morningstar Indexes (\$bil)	\$45.4	\$ 31.5	44.1 %
Assets under advisement and management (approximate) (\$bil) (2)			
Workplace Solutions			
Managed Accounts (3)	\$63.1	\$ 56.1	12.5 %
Fiduciary Services	43.1	39.1	10.2 %
Custom Models	29.5	26.5	11.3 %
Total	\$135.7	\$ 121.7	11.5 %
Morningstar Investment Management			
Morningstar Managed Portfolios	\$45.6	\$ 38.1	19.7 %
Institutional Asset Management	16.0	(4)53.0	(5)(69.8)%
Asset Allocation Services	10.6	8.8	20.5 %
Total	\$72.2	\$ 99.9	(6)(27.7)%

Table of Contents

Our  
employees  
(approximate)

Worldwide  
headcount 5,230 4,820 8.5 %

	Three months ended September 30,			Nine months ended September 30,		
(in millions)	2018	2017	Change	2018	2017	Change

Key  
product  
and  
investment  
area  
revenue

(7)

Morningstar

Data 46.5 \$ 41.5 (9)12.0 % \$ 137.6 \$ 122.3 (9)12.5 %

(8)

Morningstar

Direct 34.4 32.2 6.8 % 102.5 92.0 11.4 %

Morningstar

Investment 27.9 25.1 (9)11.3 % 83.9 74.1 (9)13.1 %

Management

(10)

PitchBook

Data 25.3 16.6 52.2 % 70.0 44.8 56.2 %

Morningstar

Advisor 23.6 22.2 6.5 % 68.2 64.8 5.2 %

Workstation

Workplace 19.1 18.4 3.9 % 56.0 55.3 1.3 %

Solutions

Morningstar

Crédit 8.2 4.6 % 24.6 20.2 22.0 %

Ratings

Revenue

by

Type

(7)

License-based

\$ 196.7 \$ 169.5 (9)16.0 % \$ 559.5 \$ 492.9 (9)13.5 %

(11)

Asset-based

50.5 46.2 (9)9.3 % 149.9 134.0 (9)11.9 %

(12)

Transaction-based

14.1 14.2 (9)(0.3 )% 47.8 41.7 (9)14.5 %

(13)

Other Metrics					
Average assets under management and advisement (\$bil)	\$205.1	\$217.5	(5.5 )%	\$201.9	\$209.9 (3.8 )%
Number of new-issue ratings completed (14)	30	30	— %	86	57 50.9 %
Asset value of new-issue ratings (\$bil) (14)	\$13.7	\$8.6	47.7 %	\$39.5	\$23.1 71.0 %

(1) In prior periods, the company estimated traffic on Morningstar.com using a combination of internal tools and our third-party platform. The new website launched in the first quarter of 2018 now allows tracking of 100% of website traffic using a third-party platform. The company believes the current reporting is a more accurate representation of traffic, and this change in methodology is the primary driver of the difference in reported traffic numbers versus the first nine months of 2017.

(2) The asset totals shown above (including assets we either manage directly or for which we provide consulting or subadvisory work) only include assets for which we receive basis-point fees. Some of our client contracts include services for which we receive a flat fee, but we do not include those assets in the total reported.

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.

Aside from Morningstar Managed Portfolios, it's difficult for the Investment Management business to quantify these cash inflows and outflows. The information we receive from most of our clients does not separately identify the effect of cash inflows and outflows on asset balances for each period. We also cannot specify the impact of market appreciation or depreciation because the majority of our clients have discretionary authority to implement their own portfolio allocations.

Table of Contents

(3) Many factors can cause changes in assets under management and advisement for our managed retirement accounts, including employer and employee contributions, plan administrative fees, market movements, and participant loans and hardship withdrawals. The information received from the plan providers does not separately identify these transactions or the changes in balances caused by market movement.

(4) Decline due to client losses related to a planned strategic shift away from customized institutional asset management offerings to Managed Portfolios.

(5) Revised to exclude Australia and South Africa assets, which are reflected in Morningstar Managed Portfolios.

(6) Excludes \$1.4 billion of assets under advisement and management related to Manager Selection Services that was reclassified to Morningstar Data. The associated revenue is included in Morningstar Data.

(7) Key product and investment area revenue and revenue by type includes the effect of foreign currency translation.

(8) The adoption of Topic 606 favorably impacted revenue for the three and nine months ended September 30, 2018 by \$0.4 million and \$1.0 million, respectively.

(9) Restated from prior periods due to realignment of individual products within the product groups.

(10) The adoption of Topic 606 favorably impacted revenue for the three and nine months ended September 30, 2018 by \$1.3 million and \$3.8 million, respectively.

(11) License-based revenue includes Morningstar Data, Morningstar Direct, Morningstar Advisor Workstation, Morningstar Enterprise Components, Morningstar Research, PitchBook Data, and other similar products. License-based revenue for the third quarter and first nine months of 2018 included a \$10.5 million license fee related to an amended license agreement.

(12) Asset-based revenue includes Morningstar Investment Management, Workplace Solutions, and Morningstar Indexes.

(13) Transaction-based revenue includes Morningstar Credit Ratings, Internet advertising sales, and Conferences.

(14) Includes commercial mortgage-backed securities, residential mortgage-backed securities, other asset-backed securities, and corporate and financial institutions.

Table of Contents

Three and Nine Months Ended September 30, 2018 vs. Three and Nine Months Ended September 30, 2017

## Consolidated Results

Key Metrics (in millions)	Three months ended September 30,			Nine months ended September 30,		
	2018	2017	Change	2018	2017	Change
Revenue	\$261.3	\$229.9	13.6 %	\$757.2	\$668.6	13.2 %
Operating income	65.4	52.8	23.8 %	166.5	127.2	30.9 %
Operating margin	25.0	% 23.0	% 2.0	pp22.0	% 19.0	% 3.0 pp
Cash provided by operating activities	\$79.8	\$62.5	27.7 %	\$209.5	\$164.7	27.2 %
Capital expenditures	(19.6 )	(13.1 )	49.6 %	(55.2 )	(46.4 )	19.0 %
Free cash flow	\$60.2	\$49.4	21.9 %	\$154.3	\$118.3	30.4 %

pp — percentage points

To supplement our consolidated financial statements presented in accordance with U.S. Generally Accepted Accounting Principles (GAAP), we use the following non-GAAP measures:

• consolidated revenue excluding acquisitions, divestitures, adoption of accounting changes, and the effect of foreign currency translations (organic revenue);

• consolidated international revenue excluding acquisitions, divestitures, adoption of accounting changes, and the effect of foreign currency translations (international organic revenue); and

• cash provided by or used for operating activities less capital expenditures (free cash flow).

These non-GAAP measures may not be comparable to similarly titled measures reported by other companies and should not be considered an alternative to any measure of performance as promulgated under GAAP.

We present organic revenue and international organic revenue because we believe these non-GAAP measures help investors better compare period-over-period results.

We present free cash flow solely as supplemental disclosure to help investors better understand the level of cash available after capital expenditures. Our management team uses free cash flow to evaluate our business.

## Consolidated Revenue

(in millions)	Three months ended September 30,			Nine months ended September 30,		
	2018	2017	Change	2018	2017	Change
Consolidated revenue	\$261.3	\$229.9	13.6 %	\$757.2	\$668.6	13.2 %

In the third quarter of 2018, consolidated revenue increased 13.6% to \$261.3 million. Foreign currency movements had a negative impact in the quarter, decreasing revenue by approximately \$1.9 million.

Licensed-based revenue grew 16.0% during the third quarter of 2018. We experienced continued demand for license-based products, such as PitchBook Data, Morningstar Data, and Morningstar Direct. Revenue from PitchBook Data increased by \$8.7 million due primarily to strong sales of new licenses and high renewal rates. Morningstar Data

revenue also increased by \$5.0 million, as result of adding new clients and expanding our relationships with existing clients by adding additional datasets primarily within our managed products and market data product lines. Revenue from Morningstar Direct rose \$2.2 million, reflecting growth in licenses for both new and existing clients and certain price increases. During the third quarter of 2018, licensed-based revenue also included a \$10.5 million license fee related to an amended license agreement.

## Table of Contents

Asset-based revenue increased by 9.3% during the third quarter of 2018, reflecting the 2.8 percentage point favorable impact of the adoption of Topic 606. See Note 2 of the Notes to our Unaudited Condensed Consolidated Financial Statements (Note 2) for additional information. Morningstar Managed Portfolios was the primary driver of the increase. This increase was partially offset by decreases in assets under management and advisement driven by our choice to focus on the scalable and higher margin Managed Portfolios offering, while shifting away from customized institutional asset management. The asset-based revenue we earn in both Morningstar Investment Management and Workplace Solutions is generally based on average asset levels during each quarter. Average assets under management and advisement (calculated based on available average quarterly or monthly data) were approximately \$205.5 billion in the third quarter of 2018, compared to \$217.5 billion in the third quarter of 2017.

Transaction-based revenue was flat during the third quarter of 2018. Revenue from Morningstar Credit Ratings increased \$0.4 million, primarily due to growth in the asset value of new-issue ratings in structured finance securities. Ad sales on Morningstar.com also contributed to the growth during the third quarter of 2018. These increases were offset almost entirely by the discontinuation of the standalone ETF conference in order to combine the event with the flagship Morningstar Investment Conference that took place in the second quarter of 2018.

For the first nine months of 2018, consolidated revenue increased 13.2% to \$757.2 million, compared to \$668.6 million in the same period of 2017. Foreign currency movement had a positive effect in the first nine months of 2018, increasing revenue by approximately \$6.5 million.

Licensed-based revenue grew 13.5% during the first nine months of 2018 driven by PitchBook Data, Morningstar Data, and Morningstar Direct. Revenue from PitchBook Data increased \$25.2 million due primarily to strong sales of new licenses and high renewal rates. Morningstar Data revenue also increased \$15.3 million due to the same factors listed above. Revenue from Morningstar Direct rose \$10.5 million, reflecting growth in licenses for both new and existing clients and certain price increases. Licensed-based revenue for the first nine months of 2018 also included a \$10.5 million license fee related to an amended license agreement.

Asset-based revenue increased 11.9% during the first nine months of 2018, primarily driven by Morningstar Managed Portfolios and Workplace Solutions. The adoption of Topic 606 favorably impacted asset-based revenue by 2.8 percentage points for the first nine months of 2018. See Note 2 for additional information. Morningstar Managed Portfolios increased \$12.0 million, with assets under management and advisement growing 19.7% as of September 30, 2018 compared to the prior year period. This increase was partially offset by decreases in Institutional Asset Management assets under management and advisement. Average assets under management and advisement were approximately \$201.9 billion in the first nine months of 2018, compared to \$209.9 billion in the first nine months of 2017.

Transaction-based revenue grew 14.5% during the first nine months of 2018 driven by Morningstar Credit Ratings and ad sales on Morningstar.com. Morningstar Credit Ratings completed 86 new-issue ratings, primarily of structured finance securities, representing a 71.0% increase in asset value during the first nine months of 2018 compared to the first nine months of 2017.

### Organic revenue

To allow for more meaningful comparisons of our results in different periods, we provide information about organic revenue, which reflects our underlying business excluding acquisitions, divestitures, adoption of accounting changes, and the effect of foreign currency translations. We exclude revenue from acquired businesses from our organic revenue growth calculation for a period of 12 months after we complete the acquisition. For divestitures, we exclude revenue in the prior period for which there is no comparable revenue in the current period.



Table of Contents

The table below reconciles consolidated revenue with organic revenue:

(in millions)	Three months ended			Nine months ended		
	September 30,			September 30,		
	2018	2017	Change	2018	2017	Change
Consolidated revenue	\$261.3	\$229.9	13.6 %	\$757.2	\$668.6	13.2 %
Less: acquisitions	—	—	—	—	—	—
Less: divestitures	—	(0.6 )	NMF	—	(5.4 )	NMF
Less: adoption of accounting changes	(1.7 )	—	NMF	(5.0 )	—	NMF
Effect of foreign currency translations	1.9	—	NMF	(6.5 )	—	NMF
Organic revenue	\$261.5	\$229.3	14.0 %	\$745.7	\$663.2	12.4 %

NMF - not meaningful

In the third quarter of 2018, organic revenue increased 14.0%. Foreign currency translations had an unfavorable impact of \$1.9 million on revenue. Our adoption of Topic 606 on January 1, 2018 also favorably impacted revenue by \$1.7 million during the third quarter of 2018, primarily revenue from Institutional Asset Management and Morningstar Managed Portfolios. See Note 2 for additional information. Our third quarter of 2017 results included \$0.6 million of revenue from our 15(c) board consulting services product line, which we divested in the first quarter of 2018, and that did not recur in the third quarter of 2018.

Organic revenue increased 12.4% for the first nine months of 2018. Foreign currency translation had a favorable effect of \$6.5 million on revenue. Our first nine months of 2017 results included revenue of \$5.4 million from our divestitures of HelloWallet and our 15(c) board consulting services product line, which did not recur in the first nine months of 2018. Our adoption of Topic 606 on January 1, 2018 also favorably impacted revenue by \$5.0 million during the first nine months of 2018, primarily revenue from Institutional Asset Management and Morningstar Managed Portfolios. See Note 2 for additional information.

Organic revenue growth included a \$10.5 million license fee related to an amended license agreement, which contributed 4.6 percentage points and 1.6 percentage points to organic revenue growth during the third quarter and first nine months of 2018, respectively.

## Revenue by region

(in millions)	Three months ended			Nine months ended		
	September 30,			September 30,		
	2018	2017	Change	2018	2017	Change
United States	\$198.7	\$171.8	15.7 %	\$566.0	\$503.4	12.4 %
United Kingdom	17.9	17.0	5.3 %	54.6	47.5	14.9 %
Continental Europe	20.1	18.2	10.4 %	60.3	51.0	18.2 %
Australia	9.9	8.8	12.5 %	31.2	25.5	22.4 %
Canada	7.4	7.5	(1.3 )%	22.6	22.0	2.7 %
Asia	5.9	5.3	11.3 %	18.1	15.7	15.3 %
Other	1.4	1.3	7.7 %	4.4	3.5	25.7 %
Total International	62.6	58.1	7.7 %	191.2	165.2	15.7 %
Consolidated revenue	\$261.3	\$229.9	13.6 %	\$757.2	\$668.6	13.2 %

Edgar Filing: Morningstar, Inc. - Form 10-Q

International revenue comprised approximately 24% and 25% of our consolidated revenue for the first nine months of 2018 and 2017, respectively. About 61% is from Continental Europe and the United Kingdom, with most of the remainder from Australia, Canada, and Asia.

Revenue from international operations increased \$4.5 million, or 7.7%, in the third quarter of 2018. For the first nine months of 2018, revenue from international operations increased \$26.0 million, or 15.7%.

Table of Contents

The table below presents a reconciliation from international revenue to international organic revenue:

(in millions)	Three months ended			Nine months ended		
	September 30,			September 30,		
	2018	2017	Change	2018	2017	Change
International revenue	\$62.6	\$58.1	7.7 %	\$191.2	\$165.2	15.7 %
Less: acquisitions	—	—	—	—	—	—
Less: divestitures	—	—	—	—	—	—
Less: adoption of accounting changes	(1.6 )	—	NMF	(4.8 )	—	NMF
Effect of foreign currency translations	1.9	—	NMF	(6.5 )	—	NMF
International organic revenue	\$62.9	\$58.1	8.3 %	\$179.9	\$165.2	8.9 %

International organic revenue increased 8.3%, mainly reflecting growth in Morningstar Data and Morningstar Direct during the third quarter of 2018. Our adoption of Topic 606 on January 1, 2018 also favorably impacted international revenue by \$1.6 million during the third quarter of 2018, primarily revenue from Institutional Asset Management and Morningstar Managed Portfolios in Australia. See Note 2 for additional information.

During the first nine months of 2018, international organic revenue increased 8.9%. Morningstar Data, Morningstar Direct, and Morningstar Managed Portfolios were the main contributors to the organic international growth. Our adoption of Topic 606 on January 1, 2018 also favorably impacted international revenue by \$4.8 million during the first nine months of 2018, primarily revenue from Institutional Asset Management and Morningstar Managed Portfolios in Australia. See Note 2 for additional information.

## Consolidated Operating Expense

(in millions)	Three months ended			Nine months ended		
	September 30,			September 30,		
	2018	2017	Change	2018	2017	Change
Cost of revenue	\$100.0	\$90.9	9.9 %	\$302.2	\$283.2	6.7 %
% of consolidated revenue	38.3 %	39.5 %	(1.2 ) pp	39.9 %	42.4 %	(2.5 ) pp
Sales and marketing	35.8	31.1	14.9 %	113.7	100.2	13.4 %
% of consolidated revenue	13.7 %	13.6 %	0.1 pp	15.0 %	15.0 %	— pp
General and administrative	35.4	33.3	6.6 %	103.6	93.2	11.2 %
% of consolidated revenue	13.6 %	14.5 %	(0.9 ) pp	13.7 %	13.9 %	(0.2 ) pp
Depreciation and amortization	24.7	21.8	13.5 %	71.2	64.8	9.9 %
% of consolidated revenue	9.4 %	9.5 %	(0.1 ) pp	9.4 %	9.7 %	(0.3 ) pp
Total operating expense	\$195.9	\$177.1	10.6 %	\$590.7	\$541.4	9.1 %
% of consolidated revenue	75.0 %	77.0 %	(2.0 ) pp	78.0 %	81.0 %	(3.0 ) pp

Consolidated operating expense increased \$18.8 million, or 10.6%, in the third quarter of 2018 and \$49.3 million, or 9.1%, in the first nine months of 2018. Foreign currency translations had a favorable effect of \$1.8 million and an unfavorable effect of \$6.1 million on operating expense during the third quarter and first nine months of 2018, respectively.

Compensation expense (which primarily consists of salaries, bonus, and other company-sponsored benefits) increased \$10.5 million in the third quarter of 2018 and \$24.0 million in the first nine months of 2018. Salary expense increased by \$3.3 million and \$12.8 million, respectively, primarily driven by higher headcount at PitchBook. We accrued

higher bonus expense of \$6.0 million in the third quarter and \$10.8 million in the first nine months of 2018 compared to the same periods in the prior year due to stronger performance against our internal targets.

## Table of Contents

Stock-based compensation expense increased \$1.7 million in the third quarter and \$7.4 million in the first nine months of 2018 due to stronger performance against our incentive plan targets. Accelerated vesting related to retirement or service provisions also contributed to the increase during the first nine months of 2018.

Depreciation expense increased \$3.2 million in the third quarter and \$8.8 million in the first nine months of 2018, driven mainly by depreciation expense related to capitalized software development incurred over the past several years. Production expense increased \$1.3 million in the third quarter and \$6.9 million in the first nine months of 2018, related primarily to our adoption of Topic 606. See Note 2 for additional information.

Offsetting these expenses in the third quarter and in the first nine months of 2018 was an increase in capitalized software development of \$3.0 million and \$5.6 million, respectively. Lower intangible amortization of \$2.4 million also offset the increase in expenses noted above during the first nine months of 2018.

We had 5,230 employees worldwide as of September 30, 2018 compared to 4,820 as of September 30, 2017. This increase reflects continued investment in our key growth initiatives, including operations in India and PitchBook in the United States and Europe.

### Cost of revenue

Cost of revenue is our largest category of operating expense, representing about one-half of our total operating expense. Our business relies heavily on human capital, and cost of revenue includes the compensation expense for employees who develop our products and deliver our services. We include compensation expense for approximately 80% of our employees in this category.

Cost of revenue increased \$9.1 million in the third quarter of 2018. Higher compensation expense of \$7.1 million was the largest contributor to the increase with bonus expense increasing \$4.0 million. Higher production expense also contributed to the unfavorable variance in this category and includes \$1.7 million of expense related to our adoption of Topic 606. See Note 2 for additional information.

Higher internally developed capitalized software partially offset these increases. Continuous focus on development of our major software platforms, coupled with bringing new products and capabilities to market, resulted in an increase in capitalized software development, which in turn reduced operating expense. During the third quarter of 2018, we capitalized \$14.0 million associated with software development activities, mainly related to enhanced capabilities in our products, internal infrastructure, and software, including PitchBook, Workplace Solutions and Morningstar Data. In comparison, we capitalized \$11.0 million in the third quarter of 2017.

For the first nine months of 2018, cost of revenue increased \$19.0 million. Higher compensation expense of \$11.7 million was the largest contributor to the increase with bonus expense increasing \$6.8 million. Production expense increased \$6.9 million and includes \$5.0 million of expense related to our adoption of Topic 606. Higher stock-based compensation expense also contributed to the increase in this category.

Higher amounts of internally developed capitalized software partially offset these increases. We capitalized \$40.2 million associated with software development activities related to the same products and other capabilities mentioned above in the first nine months of 2018 compared to \$34.6 million in the first nine months of 2017.

As a percentage of revenue, cost of revenue decreased 1.2 percentage points in the third quarter of 2018 and 2.5 percentage points in the first nine months of 2018.

Sales and marketing

Sales and marketing expense increased \$4.7 million in the third quarter of 2018, mainly due to an increase of \$3.8 million in compensation expense. Within compensation expense, bonus expense increased \$1.7 million.

Table of Contents

For the first nine months of 2018, sales and marketing expense increased \$13.5 million, reflecting a \$10.3 million increase in compensation expense and a \$3.3 million increase in sales commission expense due to higher sales. Advertising and marketing spend decreased \$1.7 million during the first nine months of 2018 due to a shift in strategy and mix of spend related to greater use of digital channels versus direct mail campaigns.

As a percentage of revenue, sales and marketing expense increased 0.1 percentage points in the third quarter of 2018 and was unchanged in the first nine months of 2018.

General and administrative

General and administrative expense increased \$2.1 million during the third quarter of 2018. Stock-based compensation increased \$0.8 million due to higher accruals for incentive plans. We also recorded \$0.6 million of expense during the third quarter as a result of vacating office space prior to the lease termination date. Software subscriptions increased \$0.6 million and professional fees expense increased \$0.4 million during the third quarter of 2018.

For the first nine months of 2018, general and administrative expense increased \$10.4 million. Stock-based compensation increased \$4.6 million due to accelerated vesting related to retirement or service provisions. Compensation expense increased \$2.0 million during the first nine months of 2018. Software subscriptions increased \$1.9 million and rent expense also increased \$1.1 million during the first nine months of 2018.

As a percentage of revenue, general and administrative expense decreased 0.9 percentage points in the third quarter of 2018 and 0.2 percentage points in the first nine months of 2018.

Depreciation and amortization

Depreciation expense increased \$3.2 million in the third quarter of 2018, driven mainly by depreciation expense related to capitalized software development incurred over the past several years. Intangible amortization expense decreased \$0.3 million.

For the first nine months of 2018, depreciation expense increased \$8.8 million, largely driven by capitalized software development incurred over the past several years. Intangible amortization expense decreased \$2.4 million as 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 \$4.9 million for the remainder of 2018. These estimates may be affected by additional acquisitions, divestitures, changes in the estimated average useful lives, and foreign currency translation.

As a percentage of revenue, depreciation and amortization expense decreased 0.1 percentage points in the third quarter of 2018 and 0.3 percentage points in the first nine months of 2018.

Consolidated Operating Income and Operating Margin

(in millions)	Three months ended			Nine months ended		
	September 30, 2018	September 30, 2017	Change	September 30, 2018	September 30, 2017	Change
Operating income	\$65.4	\$52.8	23.8 %	\$166.5	\$127.2	30.9 %

Edgar Filing: Morningstar, Inc. - Form 10-Q

% of revenue      25.0 % 23.0 % 2.0      pp22.0    % 19.0    % 3.0      pp

Consolidated operating income increased \$12.6 million in the third quarter of 2018, as revenue increased \$31.4 million and operating expense increased \$18.8 million. Operating margin was 25.0%, up 2.0 percentage points compared to the third quarter of 2017.

Consolidated operating income increased \$39.3 million in the first nine months of 2018 as revenue increased \$88.6 million and operating expense increased \$49.3 million. Operating margin was 22.0%, up 3.0 percentage points compared to the first nine months of 2017.

Table of Contents

For the third quarter and first nine months of 2018, the \$10.5 million license fee related to an amended license agreement positively impacted operating income growth by 19.9 percentage points and 8.3 percentage points, respectively, and operating margin by 3.1 percentage points and 1.1 percentage points, respectively. This recognition of revenue was not accompanied by a commensurate increase in operating expense.

#### Non-Operating Income (Expense), Net, Equity in Net Income (Loss) of Unconsolidated Entities, and Effective Tax Rate and Income Tax Expense

##### Non-operating income (expense), net

	Three months ended		Nine months ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
(in millions)				
Interest income	\$0.6	\$0.4	\$1.7	\$1.3
Interest expense	(0.8 )	(1.3 )	(2.9 )	(3.9 )
Gain on sale of investments, net	0.3	0.3	0.9	1.1
Gain on sale of business	—	—	—	17.5
Gain on sale of product line	—	—	10.5	—
Gain on sale of equity investments	5.6	—	5.6	—
Other income (expense)	1.6	(1.4 )	2.2	(4.0 )
Non-operating income (expense), net	\$7.3	\$(2.0)	\$18.0	\$12.0

Interest income reflects interest from our investment portfolio. Interest expense mainly relates to the outstanding principal balance on our credit facility. Gain on sale of business relates to our sale of HelloWallet in the second quarter of 2017. Gain on sale of product line relates to the sale of our 15(c) board consulting services product line in the first quarter of 2018.

During the third quarter of 2018 and first nine months of 2018, gain on sale of equity investments relates to the sale of a portion of our equity ownership interest in Morningstar Japan K.K. (MJKK).

Other income (expense) primarily includes foreign currency exchange gains and losses resulting from U.S. dollar denominated short-term investments held in non-U.S. jurisdictions.

##### Equity in net income (loss) of unconsolidated entities

	Three months ended		Nine months ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
(in millions)				
Equity in net income (loss) of unconsolidated entities	\$ 0.3	\$ —	\$(1.6)	\$(1.0)

Equity in net income (loss) of unconsolidated entities primarily reflects income from MJKK offset by losses in our other equity method investments.



Table of Contents

## Effective tax rate and income tax expense

(in millions)	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Income before income taxes and equity in net income (loss) of unconsolidated entities	\$72.7	\$50.8	\$184.5	\$139.2
Equity in net income (loss) of unconsolidated entities	0.3	—	(1.6 )	(1.0 )
Total	\$73.0	\$50.8	\$182.9	\$138.2
Income tax expense	\$16.1	\$16.9	\$42.3	\$40.2
Effective tax rate	22.1 %	33.3 %	23.1 %	29.1 %

Our effective tax rate in the third quarter and first nine months of 2018 was 22.1% and 23.1%, respectively, which resulted in respective decreases of 11.2 and 6.0 percentage points compared with the same periods in the prior year. Our effective tax rate in the third quarter and the first nine months of 2018 reflects the U.S. federal statutory income tax rate change from 35% to 21% and other provisions of the Tax Reform Act enacted in December 2017. Our effective tax rate for the first nine months of 2017, compared to the first nine months of 2018, also reflects a book gain of \$17.5 million on the sale of HelloWallet in the second quarter of 2017 that was not a gain for tax purposes.

## Liquidity and Capital Resources

As of September 30, 2018, we had cash, cash equivalents, and investments of \$366.7 million, an increase of \$13.4 million compared with \$353.3 million as of December 31, 2017. The increase reflects cash provided by operating activities and proceeds of \$10.5 million related to the sale of our 15(c) board consulting services product line in the first quarter of 2018, partially offset by \$90.0 million of repayments of long-term debt, \$55.2 million of capital expenditures, dividends paid of \$31.9 million, and \$11.5 million for employee taxes paid from withholding of restricted stock units. We also used \$10.8 million to repurchase common stock through our share repurchase program, of which \$0.3 million was repurchased in the fourth quarter of 2017, but settled and paid in January 2018.

Cash provided by operating activities is our main source of cash. In the first nine months of 2018, cash provided by operating activities was \$209.5 million, reflecting \$227.0 million of net income, adjusted for non-cash items, and offset by \$17.5 million in negative changes from our net operating assets and liabilities, which included bonus payments of \$54.7 million.

We are party to a credit agreement that provides us with a three-year credit facility with a borrowing capacity of up to \$300.0 million expiring in November 2019. We had an outstanding principal balance of \$90.0 million as of September 30, 2018, leaving borrowing availability of \$210.0 million. The credit agreement also contains financial covenants under which we: (i) may not exceed a maximum consolidated leverage ratio of 3.00 to 1.00 and (ii) are required to maintain a minimum consolidated interest coverage ratio of not less than 3.00 to 1.00. We were in compliance with the financial covenants as of September 30, 2018.

We believe our available cash balances and investments, along with cash generated from operations and our line of credit, will be sufficient to meet our operating and cash needs for at least the next 12 months. We invest our cash reserves in cash equivalents and investments and maintain a conservative investment policy. We invest a portion of our investment balance (approximately \$24.9 million, or 57% of our total investments balance as of September 30, 2018) in stocks, bonds, options, mutual funds, money market funds, or exchange-traded products that replicate the model portfolios and strategies created by Morningstar. These investment accounts may also include exchange-traded

products where Morningstar is an index provider.

Approximately 75% of our cash, cash equivalents, and investments balance as of September 30, 2018 was held by our operations outside the United States, up from approximately 69% as of December 31, 2017.

We intend to use our cash, cash equivalents, and investments for general corporate purposes, including working capital and funding future growth.

Table of Contents

In October 2018, our board of directors approved a regular quarterly dividend of \$0.25 per share payable on October 31, 2018 to shareholders of record as of October 17, 2018. We will pay a quarterly dividend of approximately \$10.7 million on October 31, 2018.

In December 2017, the board of directors approved a new share repurchase program that authorizes the company to repurchase up to \$500.0 million in shares of the company's outstanding common stock, effective January 1, 2018. The authorization expires on December 31, 2020. In the first nine months of 2018, we repurchased a total of 109,289 shares for \$10.5 million and had approximately \$489.5 million available for future repurchases as of September 30, 2018.

We expect to continue making capital expenditures in 2018, primarily for computer hardware and software provided by third parties, internally developed software, and leasehold improvements for new and existing office locations. We are in the process of migrating our infrastructure to the cloud over the next several years. The migration will have some transitional effects on our level of capital expenditures and operating expenses and we expect to maintain certain redundant infrastructure prior to the completion of a full transition.

## 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.

(in millions)	Three months ended			Nine months ended		
	September 30,			September 30,		
	2018	2017	Change	2018	2017	Change
Cash provided by operating activities	\$79.8	\$62.5	27.7 %	\$209.5	\$164.7	27.2 %
Capital expenditures	(19.6 )	(13.1 )	49.6 %	(55.2 )	(46.4 )	19.0 %
Free cash flow	\$60.2	\$49.4	21.9 %	\$154.3	\$118.3	30.4 %

We generated free cash flow of \$60.2 million in the third quarter of 2018, an increase of \$10.8 million compared with the third quarter of 2017. The change reflects a \$17.3 million increase in cash provided by operating activities as well as a \$6.5 million increase in capital expenditures.

In the first nine months of 2018, we generated free cash flow of \$154.3 million, an increase of \$36.0 million compared with free cash flow of \$118.3 million in the same period of 2017. The increase reflects a \$44.8 million increase in cash provided by operating activities as well as a \$8.8 million increase in capital expenditures.

## Application of Critical Accounting Policies and Estimates

We discuss our critical accounting policies and estimates in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, included in our Annual Report. We also discuss our significant accounting policies in Note 2 of the Notes to our Audited Consolidated Financial Statements included in our Annual Report and in Note 2 of the Notes to our Unaudited Condensed Consolidated Financial Statements contained in Part 1, Item 1 of this Quarterly Report.

Table of Contents

## Rule 10b5-1 Sales Plans

Our directors and executive officers may exercise stock options or purchase or sell shares of our common stock in the market from time to time. We encourage them to make these transactions through plans that comply with Exchange Act Rule 10b5-1(c). Morningstar will not receive any proceeds, other than proceeds from the exercise of stock options, related to these transactions. The following table, which we are providing on a voluntary basis, shows the Rule 10b5-1 sales plans entered into by our directors and executive officers that were in effect as of October 15, 2018:

Name and Position	Date of Plan	Plan Termination Date	Number of Shares to be Sold under the Plan	Timing of Sales under the Plan	Number of Shares Sold under the Plan through October 15, 2018	Projected Beneficial Ownership (1)
Gail Landis Director	7/31/2018	10/29/2019	2,000	Shares to be sold under the plan if the stock reaches a specified price	—	2,840
Bill Lyons Director	5/14/2018	8/15/2019	2,500	Shares to be sold under the plan if the stock reaches specified prices	1,875	21,681
Joe Mansueto Executive Chairman	3/20/2018	4/30/2019	1,600,000	Shares to be sold over the course of the plan subject to price limitations	800,000	22,606,846

During the third quarter of 2018, the previously disclosed Rule 10b5-1 sales plan for Bevin Desmond completed in accordance with its terms.

(1) This column reflects an estimate of the number of shares each identified director and executive officer will beneficially own following the sale of all shares under the Rule 10b5-1 sales plan. This information reflects the beneficial ownership of our common stock on September 30, 2018, and includes shares of our common stock subject to options that were then exercisable or that will have become exercisable by November 29, 2018 and restricted stock units that will vest by November 29, 2018. The estimates do not reflect any changes to beneficial ownership that may have occurred since September 30, 2018. Each director and executive officer identified in the table may amend or terminate his or her Rule 10b5-1 sales plan and may adopt additional Rule 10b5-1 plans in the future.

Table of Contents

## Item 3. Quantitative and Qualitative Disclosures about Market Risk

Our investment portfolio is actively managed and may suffer losses from fluctuating interest rates, market prices, or adverse security selection. These accounts may consist of stocks, bonds, options, mutual funds, money market funds, or exchange-traded products that replicate the model portfolios and strategies created by Morningstar. These investment accounts may also include exchange-traded products where Morningstar is an index provider. As of September 30, 2018, our cash, cash equivalents, and investments balance was \$366.7 million. Based on our estimates, a 100 basis-point change in interest rates would not have a material effect on the fair value of our investment portfolio.

We are subject to risk from fluctuations in the interest rates related to our long-term debt. The interest rates are based upon the applicable LIBOR rate plus an applicable margin for such loans or the lender's base rate plus an applicable margin for such loans. On an annualized basis, we estimate a 100 basis-point change in the LIBOR rate would have a \$0.9 million impact on our interest expense, based on our current outstanding principal balance and LIBOR rates around September 30, 2018.

We are subject to risk from fluctuations in foreign currencies from our operations outside of the United States. To date, we have not engaged in currency hedging, and we do not currently have any positions in derivative instruments to hedge our currency risk.

The table below shows our exposure to foreign currency denominated revenue and operating income for the nine months ended September 30, 2018:

(in millions, except foreign currency rates)	Three months ended September 30, 2018			
	Euro	British Pound	Australian Dollar	Other Foreign Currencies
Currency rate in U.S. dollars as of September 30, 2018	1.1608	1.3034	0.7225	—
Percentage of revenue	5.1 %	7.2 %	4.1 %	8.9 %
Percentage of operating income (loss)	11.7 %	0.9 %	3.3 %	(5.7) %
Estimated effect of a 10% adverse currency fluctuation on revenue	\$(4.9)	\$(7.2)	\$(4.3)	\$(7.8)
Estimated effect of a 10% adverse currency fluctuation on operating income (loss)	\$(2.4)	\$(0.2)	\$(0.8)	\$ 2.6

The table below shows our net investment exposure to foreign currencies as of September 30, 2018:

(in millions)	As of September 30, 2018			
	Euro	British Pound	Australian Dollar	Other Foreign Currencies
Assets, net of unconsolidated entities	\$120.5	\$132.3	\$ 82.4	\$ 191.0
Liabilities	63.6	18.6	55.4	63.8
Net currency position	\$56.9	\$113.7	\$ 27.0	\$ 127.2
Estimated effect of a 10% adverse currency fluctuation on equity	\$(5.7)	\$(11.4)	\$(2.7)	\$(12.7)



Table of Contents

Item 4. Controls and Procedures

(a) Evaluation and Disclosure Controls and Procedures

Disclosure controls and procedures are designed to reasonably assure that information required to be disclosed in the reports filed or submitted under the Securities Exchange Act of 1934 (Exchange Act) is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to reasonably assure that information required to be disclosed in the reports filed under the Exchange Act is accumulated and communicated to management, including the chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

We carried out an evaluation, under the supervision and with the participation of management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act of 1934, as of September 30, 2018. Based on that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed in the reports we file or submit under the Exchange Act is recorded, processed, summarized, and reported as and when required and is accumulated and communicated to management, including the chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

(b) Changes in Internal Control Over Financial Reporting

Beginning on January 1, 2018, we implemented ASU No. 2014-09, Revenue from Contracts with Customers and the related revenue ASUs. As a result of the new revenue standard, we implemented changes to our processes and controls related to revenue recognition. These included the development of new policies based on the five-step model provided in the new revenue standard, new training, ongoing contract review requirements, and gathering of information provided for disclosures. We also implemented changes to our processes and controls related to sales commissions.

Other than the changes noted above, there were no changes in our internal control over financial reporting during the quarter ended September 30, 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

## PART 2. OTHER INFORMATION

## Item 1. Legal Proceedings

We incorporate by reference the information regarding legal proceedings set forth in Note 11, Contingencies, of the Notes to our Unaudited Condensed Consolidated Financial Statements contained in Part 1, Item 1 of this Quarterly Report on Form 10-Q.

## Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in Item 1A. Risk Factors in our Annual Report.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

## Issuer Purchases of Equity Securities

Subject to applicable law, we may repurchase shares at prevailing market prices directly on the open market or in privately negotiated transactions in amounts that we deem appropriate.

In December 2017, the board of directors approved a new share repurchase program that authorizes the company to repurchase up to \$500.0 million in shares of the company's outstanding common stock, effective January 1, 2018. The authorization expires on December 31, 2020.

The following table presents information related to repurchases of common stock we made during the three months ended September 30, 2018:

Period:	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced programs	Approximate dollar value of shares that may yet be purchased under the programs
July 1, 2018 - July 31, 2018	—	\$ —	—	\$489,482,623
August 1, 2018 - August 31, 2018	—	—	—	\$489,482,623
September 1, 2018 - September 30, 2018	—	—	—	\$489,482,623
Total	—	\$ —	—	

Table of Contents

Item 6. Exhibits

Exhibit No Description of Exhibit

<u>31.1</u>	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as amended
<u>31.2</u>	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as amended
<u>32.1</u>	Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
<u>32.2</u>	Certification of Chief Financial Officer Pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101	The following financial information from Morningstar, Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2018, filed with the SEC on October 26, 2018 formatted in XBRL: (i) Unaudited Condensed Consolidated Statements of Income, (ii) Unaudited Condensed Consolidated Statements of Comprehensive Income (iii) Unaudited Condensed Consolidated Balance Sheets, (iv) Unaudited Condensed Consolidated Statement of Equity, (v) Unaudited Condensed Consolidated Statements of Cash Flows and (vi) the Notes to Unaudited Condensed Consolidated Financial Statements

Table of Contents

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MORNINGSTAR, INC.

Date: October 26, 2018 By: /s/ Jason Dubinsky

Jason Dubinsky  
Chief Financial Officer