

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

Table of Contents

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

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED June 30, 2013

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File Number: 000-51280

MORNINGSTAR, INC.

(Exact Name of Registrant as Specified in its Charter)

Illinois

(State or Other Jurisdiction of  
Incorporation or Organization)

36-3297908

(I.R.S. Employer  
Identification Number)

22 West Washington Street

Chicago, Illinois

(Address of Principal Executive Offices)

(312) 696-6000

(Registrant's Telephone Number, Including Area Code)

60602

(Zip Code)

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

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

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

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

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

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



Table of Contents

MORNINGSTAR, INC. AND SUBSIDIARIES  
INDEX

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



Table of Contents

PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

3

---

Table of Contents

## Morningstar, Inc. and Subsidiaries

## Unaudited Condensed Consolidated Statements of Income

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

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

Weighted average shares outstanding:

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

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

See notes to unaudited condensed consolidated financial statements.

Table of Contents

## Morningstar, Inc. and Subsidiaries

## Unaudited Condensed Consolidated Statements of Comprehensive Income

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

See notes to unaudited condensed consolidated financial statements.



Table of Contents

## Morningstar, Inc. and Subsidiaries

## Unaudited Condensed Consolidated Balance Sheets

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

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

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

See notes to unaudited condensed consolidated financial statements.

6

---

Table of Contents

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

| (in thousands, except share amounts)  | Morningstar, Inc. Shareholders' Equity |                                |                   |                                  |                      | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Non<br>Controlling<br>Interests | Total<br>Equity |
|---|--|--------------------------------|-------------------|----------------------------------|----------------------|---|---------------------------------|-----------------|
|   | Common Stock<br>Shares<br>Outstanding  | Par Value<br>Treasury<br>Stock | Treasury<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings |   |                                 |                 |
| Balance as of December 31, 2012   | 46,541,571                             | \$5                            | \$(301,839)       | \$521,285                        | \$496,354            | \$9,712   | \$1,378                         | \$726,895       |
| Net income (loss)   |  | —                              | —                 | —                                | 60,739               | —   | (64 )                           | 60,675          |
| Other comprehensive income (loss):  |  |                                |                   |                                  |                      |   |                                 |                 |
| Unrealized gain on available-for-sale investments, net of income tax of \$151                                 |  | —                              | —                 | —                                | —                    | 1,000   | —                               | 1,000           |
| Reclassification of adjustments for gains included in net income, net of income tax of \$414                  |  | —                              | —                 | —                                | —                    | (734 )  | —                               | (734 )          |
| Foreign currency translation adjustment, net  |  | —                              | —                 | —                                | —                    | (16,057 )   | (142 )                          | (16,199 )       |
| Other comprehensive loss, net   |  | —                              | —                 | —                                | —                    | (15,791 )   | (142 )                          | (15,933 )       |
| Issuance of common stock related to stock-option exercises and vesting of 337,886 restricted stock units, net |  | —                              | 1,286             | (3,633 )                         | —                    | —   | —                               | (2,347 )        |
| Stock-based compensation — restricted stock units   |  | —                              | —                 | 7,297                            | —                    | —   | —                               | 7,297           |
| Stock-based compensation — restricted stock   |  | —                              | —                 | 194                              | —                    | —   | —                               | 194             |
| Stock-based compensation — stock-options  |  | —                              | —                 | 246                              | —                    | —   | —                               | 246             |
| Excess tax benefit derived from stock-option exercises and vesting of restricted stock units                  |  | —                              | —                 | 3,842                            | —                    | —   | —                               | 3,842           |
| Common shares repurchased (747,769 )  |  | —                              | (51,950 )         | —                                | —                    | —   | —                               | (51,950 )       |
| Dividends declared — common shares outstanding  |  | —                              | —                 | —                                | (11,563 )            | —   | —                               | (11,563 )       |
| Dividends declared — restricted stock units   |  | —                              | —                 | 103                              | (183 )               | —   | —                               | (80 )           |
| Balance as of June 30, 2013   | 46,131,688                             | \$5                            | \$(352,503)       | \$529,334                        | \$545,347            | \$(6,079)   | \$1,172                         | \$717,276       |

See notes to unaudited condensed consolidated financial statements.



Table of Contents

## Morningstar, Inc. and Subsidiaries

## Unaudited Condensed Consolidated Statements of Cash Flows

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

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

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

8

---

Table of Contents

Supplemental information of non-cash investing and financing activities:

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

See notes to unaudited condensed consolidated financial statements.

9

---

Table of Contents

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

1. Basis of Presentation of Interim Financial Information

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

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

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

2. Summary of Significant Accounting Policies

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

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



Table of Contents

## 3. Acquisitions, Goodwill and Other Intangible Assets

## Acquisitions

## Increased Ownership Interest in Morningstar Sweden AB

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

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

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

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

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

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

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

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



Table of Contents

## Goodwill

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

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

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

## Intangible Assets

The following table summarizes our intangible assets:

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

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

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

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

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

|      |          |
|------|----------|
|      | (\$000)  |
| 2013 | \$21,155 |
| 2014 | 20,174   |
| 2015 | 19,367   |
| 2016 | 14,821   |

|      |        |
|------|--------|
| 2017 | 10,362 |
| 2018 | 8,411  |

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

12

---

Table of Contents

## 4. Income Per Share

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

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



Table of Contents

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

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

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

## 5. Segment and Geographical Area Information

As of June 30, 2013, Morningstar had two operating segments:

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

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

The Investment Information segment also includes Morningstar Credit Ratings, LLC. Morningstar Credit Ratings, LLC offers Structured Credit Ratings as well as research, surveillance services, and data to help institutional investors identify risk in commercial mortgage-backed securities (CMBS).

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

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

The key products and services in this segment based on revenue are Investment Advisory Services, which focuses on investment monitoring and asset allocation for funds of funds, including mutual funds and variable annuities; Retirement Solutions, including the Morningstar Retirement Manager and Advice by Ibbotson platforms; and Morningstar Managed Portfolios, a fee-based discretionary asset management service that includes a series of mutual fund, exchange-traded fund, and stock portfolios tailored to meet a range of investment time horizons and risk levels

that financial advisors can use for their clients' taxable and tax-deferred accounts. In addition, we offer Managed Portfolios through our subsidiary Ibbotson Associates Australia Limited which provides asset management services primarily to institutional clients and individual investors.



Table of Contents

Our segment accounting policies are the same as those described in Note 2, except for the capitalization and amortization of internal product development costs, amortization of intangible assets, and costs related to corporate functions. We exclude these items from our operating segment results to provide our chief operating decision maker with a better indication of each segment's ability to generate cash flow. This information is one of the criteria used by our chief operating decision maker in determining how to allocate resources to each segment. We include capitalization and amortization of internal product development costs, amortization of intangible assets, and costs related to corporate functions in the Corporate Items category. Our segment disclosures are consistent with the business segment information provided to our chief operating decision maker on a recurring basis; for that reason, we don't present balance sheet information by segment. We disclose goodwill by segment in accordance with the requirements of FASB ASC 350-20-50, Intangibles - Goodwill - Disclosure.

Table of Contents

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

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

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

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



Table of Contents

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

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

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

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

Table of Contents

## Long-lived assets by geographical area

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

## 6. Investments and Fair Value Measurements

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

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

Table of Contents

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

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

As of June 30, 2013 and December 31, 2012, investments with unrealized losses for greater than a 12-month period were not material to the Condensed Consolidated Balance Sheets and were not deemed to have other than temporary declines in value.

The table below shows the cost and fair value of investments classified as available-for-sale and held-to-maturity based on their contractual maturities as of June 30, 2013 and December 31, 2012. The expected maturities of certain fixed-income securities may differ from their contractual maturities because some of these holdings have call features that allow the issuers the right to prepay obligations without penalties.

| (\$000)  | As of June 30, 2013 |            | As of December 31, 2012 |            |
|--|---------------------|------------|-------------------------|------------|
|  | Cost                | Fair Value | Cost                    | Fair Value |
| Available-for-sale:  |                     |            |                         |            |
| Due in one year or less                                    | \$49,646            | \$49,421   | \$87,599                | \$86,784   |
| Due in one to two years                                    | 39,741              | 39,579     | 6,846                   | 6,808      |
| Equity securities, exchange-traded funds, and mutual funds | 18,653              | 20,687     | 30,112                  | 32,194     |
| Total  | \$108,040           | \$109,687  | \$124,557               | \$125,786  |
| Held-to-maturity:  |                     |            |                         |            |
| Due in one year or less                                    | \$28,339            | \$28,339   | \$26,352                | \$26,352   |
| Due in one to three years                                  | 4                   | 4          | 5                       | 5          |
| Total  | \$28,343            | \$28,343   | \$26,357                | \$26,357   |

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

As of June 30, 2013 and December 31, 2012, held-to-maturity investments included a \$1,500,000 certificate of deposit held primarily as collateral against bank guarantees for our office leases, primarily in Australia.

Table of Contents

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

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

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

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

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

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

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

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



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

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

20

---

Table of Contents

Level 1: Valuations based on quoted prices in active markets for identical assets or liabilities that we have the ability to access.

Level 2: Valuations based on quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.

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

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

We measure the fair value of money market funds, mutual funds, equity securities, and exchange-traded funds based on quoted prices in active markets for identical assets or liabilities. All other financial instruments were valued either based on recent trades of securities in inactive markets or based on quoted market prices of similar instruments and other significant inputs derived from observable market data. We did not hold any securities categorized as Level 3 as of June 30, 2013 and December 31, 2012.

## 7. Investments in Unconsolidated Entities

Our investments in unconsolidated entities consist primarily of the following:

|   | As of June 30 | As of December 31 |
|---|---------------|-------------------|
| (\$000)   | 2013          | 2012              |
| Investment in MJKK                              | \$20,900      | \$20,540          |
| Other equity method investments                 | 6,366         | 6,288             |
| Investments accounted for using the cost method | 8,821         | 8,477             |
| Total investments in unconsolidated entities    | \$36,087      | \$35,305          |

Morningstar Japan K.K. Morningstar Japan K.K. (MJKK) develops and markets products and services customized for the Japanese market. MJKK's shares are traded on the Tokyo Stock Exchange under the ticker 47650. We account for our investment in MJKK using the equity method. The following table summarizes our ownership percentage in MJKK and the market value of this investment based on MJKK's publicly quoted share price:

|  | As of June 30 | As of December 31 |
|--|---------------|-------------------|
|  | 2013          | 2012              |
| Morningstar's approximate ownership of MJKK                  | 34            | % 34 %            |
| Approximate market value of Morningstar's ownership in MJKK: |               |                   |
| Japanese yen (¥000)  | ¥9,218,664    | ¥3,109,579        |
| Equivalent U.S. dollars (\$000)                              | \$93,016      | \$36,227          |

Other Equity Method Investments. As of June 30, 2013 and December 31, 2012, other equity method investments consist of our investment in YCharts, Inc. (YCharts), and Inquiry Financial Europe AB (Inquiry Financial). YCharts is a technology company that provides stock research and analysis. Our ownership interest in YCharts was approximately 22% as of June 30, 2013 and December 31, 2012. Inquiry Financial is a provider of sell-side consensus estimate data. Our ownership interest in Inquiry Financial was approximately 34% as of June 30, 2013 and December 31, 2012.



Table of Contents

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

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

Cost Method Investments. As of June 30, 2013 and December 31, 2012, our cost method investments consist of minority investments in Pitchbook Data, Inc. (Pitchbook) and HelloWallet LLC (HelloWallet). Pitchbook offers detailed data and information about private equity transactions, investors, companies, limited partners, and service providers. HelloWallet is a provider of personalized financial guidance to employees of Fortune 1000 companies.

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

8. Stock-Based Compensation

Stock-Based Compensation Plans

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

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

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

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

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

|                                    | As of June 30 |
|------------------------------------|---------------|
| (in thousands)                     | 2013          |
| Shares available for future grants | 4,521         |



Table of Contents

## Accounting for Stock-Based Compensation Awards

The following table summarizes our stock-based compensation expense and the related income tax benefit we recorded in the six months ended June 30, 2013 and June 30, 2012:

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

The following table summarizes the amount of unrecognized stock-based compensation expense as of June 30, 2013 and the expected number of months over which the expense will be recognized:

|   | Unrecognized stock-based compensation expense (\$000) | Expected amortization period (months) |
|---|---|---------------------------------------|
| Restricted stock units                              | \$38,079  | 36                                    |
| Restricted stock                                    | 711   | 22                                    |
| Stock options                                       | 831   | 22                                    |
| Total unrecognized stock-based compensation expense | \$39,621  | 35                                    |

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

## Restricted Stock Units

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

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



Table of Contents

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

| Restricted Stock Units (RSUs)      | Unvested | Vested but<br>Deferred | Total    | Weighted<br>Average<br>Grant Date Value<br>per RSU |
|------------------------------------|----------|------------------------|----------|--|
| RSUs outstanding—December 31, 2012 | 727,145  | 18,782                 | 745,927  | \$ 53.37   |
| Granted                            | 244,364  | —                      | 244,364  | 69.99  |
| Dividend equivalents               | 1,357    | 36                     | 1,393    | 54.85  |
| Vested                             | (251,514 | ) —                    | (251,514 | ) 49.88  |
| Vested but deferred                | —        | —                      | —        | —  |
| Issued                             | —        | (2,257                 | ) (2,257 | ) 49.40  |
| Forfeited                          | (23,605  | ) —                    | (23,605  | ) 55.01  |
| RSUs outstanding—June 30, 2013     | 697,747  | 16,561                 | 714,308  | 60.29  |

## Restricted Stock

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

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

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

## Stock Options

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

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

| Options Granted At an Exercise Price Below the Fair Value Per Share on the Grant Date | Underlying<br>Shares | Weighted<br>Average<br>Exercise<br>Price |
|---|----------------------|--|
| Options outstanding—December 31, 2012   | 282,695              | \$20.55                                  |
| Granted   | —                    | —  |
| Canceled  | (250                 | ) 21.04                                  |



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

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

24

---

Table of Contents

| All Other Option Grants, Excluding Activity Shown Above | Underlying Shares | Weighted Average Exercise Price |
|---|-------------------|---------------------------------|
| Options outstanding—December 31, 2012                   | 391,784           | \$28.98                         |
| Granted   | —                 | —                               |
| Canceled  | (1,252            | ) 13.71                         |
| Exercised   | (125,159          | ) 15.89                         |
| Options outstanding—June 30, 2013                       | 265,373           | 35.69                           |
| Options exercisable—June 30, 2013                       | 229,326           | \$32.25                         |

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

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

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

| Range of Exercise Prices   | Options Outstanding |   |                                 | Options Exercisable               |                    |   |                                 |                                   |
|----------------------------|---------------------|---|---------------------------------|-----------------------------------|--------------------|---|---------------------------------|-----------------------------------|
|                            | Number of Options   | Weighted Average Remaining Contractual Life (years) | Weighted Average Exercise Price | Aggregate Intrinsic Value (\$000) | Exercisable Shares | Weighted Average Remaining Contractual Life (years) | Weighted Average Exercise Price | Aggregate Intrinsic Value (\$000) |
| \$8.57 - \$14.70           | 735                 | 0.78  | \$10.95                         | \$49                              | 735                | 0.78  | \$10.95                         | \$49                              |
| \$20.96 - \$47.86          | 441,436             | 1.65  | 23.93                           | 23,683                            | 441,436            | 1.65  | 23.93                           | 23,683                            |
| \$57.28 - \$59.35          | 71,675              | 8.03  | 57.46                           | 1,442                             | 35,628             | 8.01  | 57.37                           | 692                               |
| \$8.57 - \$59.35           | 513,846             | 2.54  | 28.59                           | \$25,174                          | 477,799            | 2.12  | 26.40                           | \$24,424                          |
| Vested or Expected to Vest |                     |   |                                 |                                   |                    |   |                                 |                                   |
| \$8.57 - \$59.35           | 513,846             | 2.54  | \$28.59                         | \$25,174                          |                    |   |                                 |                                   |

The aggregate intrinsic value in the table above represents the total pretax intrinsic value all option holders would have received if they had exercised all outstanding options on June 30, 2013. The intrinsic value is based on our closing stock price of \$77.58 on that date.

Table of Contents

## Excess Tax Benefits Related to Stock-Based Compensation

FASB ASC 718, Compensation—Stock Compensation, requires that we classify the cash flows that result from excess tax benefits as financing cash flows. Excess tax benefits correspond to the portion of the tax deduction taken on our income tax return that exceeds the amount of tax benefit related to the compensation cost recognized in our Statement of Income. The following table summarizes our excess tax benefits for the six months ended June 30, 2013 and June 30, 2012:

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

Table of Contents

## 9. Income Taxes

## Effective Tax Rate

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

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

Our effective tax rate in the second quarter of 2013 was 33.9%, a decrease of 0.7 percentage points compared with the prior-year period. The effective tax rate decrease primarily reflects adjustments to certain deferred income tax benefits and reductions in valuation allowances.

## Unrecognized Tax Benefits

The table below provides information concerning our gross unrecognized tax benefits as of June 30, 2013 and December 31, 2012. The table also provides the effect these gross unrecognized tax benefits would have on our income tax expense, if they were recognized.

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

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

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

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

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

We conduct business globally and as a result, we file income tax returns in U.S. federal, state, local, and foreign jurisdictions. In the normal course of business, we are subject to examination by tax authorities throughout the world. The open tax years for our U.S. federal tax returns and most state tax returns include the years 2008 to the present. In non-U.S. jurisdictions, the statute of limitations generally extends to years prior to 2005.

## Table of Contents

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

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

## 10. Contingencies

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

In September 2011, three individual investors in Life's Good S.T.A.B.L. Mortgage hedge fund (LG), Marta Klass, Gregory Martin, and Richard Roellig, filed a complaint in the United States District Court for the Eastern District of Pennsylvania against LG, its principal Robert Stinson, and several other parties, including Morningstar, Inc. (the Klass Matter). The plaintiffs claim that Morningstar committed fraud and aided and abetted the other defendants' breach of fiduciary duty through the 5-star rating LG obtained from Morningstar. The plaintiffs seek unspecified damages. Hedge fund managers self-report their performance data to Morningstar. More than a year before the Klass Matter, in June 2010, the SEC filed suit against LG and other entities claiming they were part of a Ponzi scheme operated by Stinson. As a result, LG and the other entities were placed in court-appointed receivership. Morningstar was not part of the SEC suit or receivership. Since that time, the Receiver, as part of his duties, has been investigating whether to assert claims against third parties. Morningstar is aware of 14 lawsuits filed by the Receiver seeking to recover money for the fund.

In November 2011, Morningstar filed a motion to dismiss the Klass Matter. On behalf of the entities in receivership, the Receiver filed a motion to stay the proceedings because the Receivership Order does not permit suits against the entities in receivership without court permission. The court granted the Receiver's motion and stayed the Klass Matter. In April 2012, the Receiver filed a complaint against Morningstar, in which the Receiver claims that Morningstar is liable for contribution and aiding and abetting Stinson's breach of fiduciary duty and fraud through the 5-star rating LG obtained from Morningstar. The Receiver seeks unspecified damages. The same day the Receiver filed his complaint, Morningstar sought leave from the court to file a counter suit against Stinson and two of his entities-Keystone State Capital Corporation and LG for, among other things, fraud, misrepresentation, and breach of user agreements. In June 2012, the court denied Morningstar's motion for leave to file suit. The court took no position on the merits of Morningstar's claims, and did not preclude us from renewing our motion to file a complaint at a later time, but deferred to the Receiver's request not to subject the receivership estate to additional litigation at this early point in the receivership. In August 2012, the court denied Morningstar's motion to dismiss the Receiver's complaint. We believe the allegations against Morningstar by the Klass plaintiffs and the Receiver have no legal or factual basis and we plan to vigorously contest the claims. We also intend to refile our affirmative claims against Stinson, Keystone, and LG at a later time consistent with the court's order. We cannot predict the outcome of the proceedings. We have not provided an estimate of loss or range of loss in connection with this matter because no such estimate can reasonably be made.



Table of Contents

Business Logic Holding Corporation

In November 2009, Business Logic Holding Corporation filed a complaint in the Circuit Court of Cook County, Illinois against Ibbotson Associates, Inc. and Morningstar, Inc. relating to Ibbotson's prior commercial relationship with Business Logic. Business Logic is alleging breach of contract and trade secret misappropriation in connection with Ibbotson's development of a proprietary web-service software and user interface that connects plan participant data with the Ibbotson Wealth Forecasting Engine. Business Logic seeks, among other things, compensatory damages, punitive damages, attorneys' fees, and injunctive relief. Ibbotson and Morningstar answered the complaint, and Ibbotson asserted a counterclaim against Business Logic alleging trade secret misappropriation and breach of contract, also seeking damages and injunctive relief. Business Logic filed a motion for summary judgment on its breach of contract claim, which is pending but has not yet been decided by the Circuit Court.

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

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

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

11. Share Repurchase Program

In September 2010, the board of directors approved a share repurchase program that authorizes the repurchase of up to \$100 million in shares of our outstanding common stock. In December 2011, the board approved an increase to the \$100 million share repurchase program it announced in 2010. The board approval authorized the company to repurchase up to an additional \$200 million in shares of our outstanding common stock. In December 2012, the board authorized the company to repurchase an additional \$200 million in shares of our outstanding common stock, increasing the repurchase program from \$300 million to \$500 million with a revised expiration date of December 31, 2014. We may repurchase shares from time to time at prevailing market prices on the open market or in private transactions at our discretion. As of June 30, 2013, we had repurchased a total of 5,804,364 shares for \$352,886,000 under this authorization.



## Table of Contents

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

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

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

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

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

### Understanding our Company

#### Our Business

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

As of the second quarter of 2013, we currently have two operating segments: The Investment Information segment includes all of our data, software, and research products and services. These products and services are typically sold through subscriptions or license agreements. The Investment Management segment includes all of our asset management operations, which are registered investment advisors and earn more than half of their revenue from asset-based fees.

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

Over our 29-year history, we have focused primarily on organic growth by introducing new products and services and expanding our existing products. From 2006 through 2010, we also completed 24 acquisitions to support our growth strategies. During the second quarter of 2013, we also acquired the remaining ownership interest in Morningstar Sweden AB to become the sole owner.

Table of Contents

Industry Overview

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

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

U.S. mutual fund assets stood at \$13.9 trillion as of May 31, 2013, based on data from the Investment Company Institute (ICI), compared with \$13.0 trillion as of December 31, 2012. Based on Morningstar's estimated asset flow data, investors withdrew \$47 billion from long-term open-end funds in June 2013, driven entirely by heavy outflows from taxable and municipal bond funds. For the second quarter overall, investors added about \$27 billion to long-term open-end funds, down from \$184 billion in the first quarter.

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

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

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

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

Table of Contents

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

## Consolidated Results

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

pp — percentage points

NMF — Not meaningful

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

## Consolidated Revenue

In the second quarter of 2013, our consolidated revenue increased 5.7% to \$175.4 million, compared with \$166.0 million in the second quarter of 2012. Currency movements had a slightly negative effect in the quarter, lowering revenue by approximately \$0.7 million. We had \$0.9 million of revenue during 2013 from acquisitions. Our 2012 results included revenue of \$1.5 million from businesses that we sold in 2012 and that did not recur in 2013.

Excluding acquisitions, divestitures, and the effect of foreign currency translations, our consolidated revenue rose \$10.8 million, or 6.6%, in the second quarter of 2013. Leading the growth were Morningstar Direct, Morningstar Managed Portfolios, Retirement Solutions, and Morningstar Data.

Revenue for the first half of the year increased 5.4% to \$344.3 million. Currency movements had a slightly negative effect in the first half, lowering revenue by approximately \$1.2 million. We had \$0.9 million of revenue during the first half of 2013 from acquisitions. Our 2012 results included revenue of \$2.7 million from businesses that we sold in 2012 and that did not recur in 2013.

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

Excluding acquisitions, divestitures, and the effect of foreign currency translations, our consolidated revenue rose \$20.5 million, or 6.3%, in the first half of 2013. Leading the growth were Morningstar Direct, Morningstar Data, Morningstar Managed Portfolios, and Retirement Solutions.

The positive product trends mentioned above for both the second quarter and first half of 2013 helped offset the loss of business from our largest client in the Investment Management segment. As previously announced, a large Investment Advisory Services client moved to in-house management of several fund-of-funds portfolios in April 2012. We recognized about \$0.6 million and \$3.8 million in revenue in the second quarter and first half of 2012, respectively, associated with our work on these portfolios.

Table of Contents

To make it easier for investors to compare our results in different periods, we provide information on organic revenue, which reflects our underlying business excluding acquisitions, divestitures, and the effect of foreign currency translations, and revenue from divestitures and acquisitions. We had one acquisition during the six months ended June 30, 2013. We had two divestitures in the fourth quarter of 2012. We include a divested operation as part of revenue from divestitures for 12 months after we complete the divestiture.

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

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

NMF - not meaningful

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

International revenue made up about 28% of our consolidated revenue in the second quarter and first half of 2013, compared with about 29% in the second quarter and first half of 2012. More than half of our international revenue is from Europe, with most of the remainder from Australia and Canada. Revenue from international operations was up \$1.1 million, or 2.2%, to \$49.1 million for the second quarter of 2013 compared to \$48.0 in the second quarter of 2012. Revenue from international operations rose \$2.2 million, or 2.4%, to \$96.5 million in the first half of 2013 compared to \$94.3 million in the first half of 2012.

Foreign currency translations had a slightly negative effect on our international revenue. We had \$0.9 million in incremental revenue during the second quarter and first half of 2013 from acquisitions. Our second quarter and first six months of 2012 international results included revenue of \$1.4 million and \$2.5 million, respectively, from businesses that we sold in 2012 and that did not recur in 2013. Excluding acquisitions, divestitures, and the effect of foreign currency translations, international revenue rose 5.0% in the second quarter and 5.5% in the first half of 2013, reflecting stronger product sales in most regions.

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

Table of Contents

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

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

## Consolidated Operating Expense

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

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

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

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

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

## Cost of Goods Sold

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

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

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

34

---



Table of Contents

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

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

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

## Development Expense

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

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

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

## Sales and Marketing Expense

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

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

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

## General and Administrative Expense

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

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

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

35

---

Table of Contents

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

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

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

## Depreciation and Amortization Expense

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

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

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

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

## Stock-Based Compensation Expense

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

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

with the same period in 2012.

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

36

---

Table of Contents

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

## Bonus Expense

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

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

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

## Consolidated Operating Income

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

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

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

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

## Consolidated Free Cash Flow

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

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

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

Cash provided by operating activities

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

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

Table of Contents

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

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

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

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

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

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



Table of Contents

## Segment Results

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

## Investment Information Segment

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

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

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

The Investment Information segment also includes Morningstar Credit Ratings, LLC. Morningstar Credit Ratings, LLC offers Structured Credit Ratings as well as research, surveillance services, and data to help institutional investors identify risk in commercial mortgage-backed securities (CMBS).

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

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

Table of Contents

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

## Revenue

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

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

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

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

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

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

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

## Table of Contents

### Operating Income

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

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

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

### Investment Management Segment

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

The key products and services in this segment based on revenue are Investment Advisory Services, which focuses on investment monitoring and asset allocation for funds of funds, including mutual funds and variable annuities; Retirement Solutions, including the Morningstar Retirement Manager and Advice by Ibbotson platforms; and Morningstar Managed Portfolios, a fee-based discretionary asset management service that includes a series of mutual fund, ETF, and stock portfolios tailored to meet a range of investment time horizons, risk levels, and investment strategies that financial advisors can use for their clients' taxable and tax-deferred accounts.

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

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

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

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

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

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

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

Table of Contents

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

## Revenue

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

These positive product trends were partially offset by lower revenue for Investment Advisory Services, which was driven by the loss of business from our largest client in the Investment Management segment. As previously announced, a large Investment Advisory Services client moved to in-house management of several fund-of-funds portfolios in April 2012. We recognized about \$0.6 million and \$3.8 million in associated revenue in the second quarter and first half of 2012, respectively.

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

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

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

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

## Assets under Advisement and Management for Investment Advisory Services

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

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

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

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



Table of Contents

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

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

## Assets under Advisement and Management for Retirement Solutions

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

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

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

## Morningstar Managed Portfolios

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

## Ibbotson Australia Managed Portfolios

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

## Operating Income

Operating income for the Investment Management segment increased \$3.0 million, or 22.6%, in the second quarter of 2013 from higher revenue of \$2.8 million and slightly lower operating expense of \$0.2 million. Operating income for the Investment Management segment increased \$2.2 million in the first half of 2013. Operating expense in the segment rose \$0.6 million, or 1.7%, in the first half of 2013.

Operating margin increased 5.4 percentage points and 2.1 percentage points in the second quarter and first six months of 2013, as the revenue increase exceeded the decline in operating expense. Lower expense for operations outside the United States as a percentage of revenue contributed to the margin increase in both periods.

Table of Contents

## Corporate Items

We do not allocate corporate costs to our business segments. The corporate items category includes capitalization and amortization of internal product development costs and amortization expense related to intangible assets recorded for acquisitions. The table below shows the components of corporate items that affected our consolidated operating income:

| (\$000)               | Three months ended June 30 |          |          | Six months ended June 30 |          |         |
|-----------------------|----------------------------|----------|----------|--------------------------|----------|---------|
|                       | 2013                       | 2012     | Change   | 2013                     | 2012     | Change  |
| Amortization expense  | \$5,337                    | \$5,976  | (10.7 )% | \$10,962                 | \$12,031 | (8.9 )% |
| Depreciation expense  | 3,563                      | 2,305    | 54.6 %   | 6,901                    | 4,142    | 66.6 %  |
| Corporate unallocated | 8,881                      | 7,059    | 25.8 %   | 17,259                   | 14,743   | 17.1 %  |
| Corporate items       | \$17,781                   | \$15,340 | 15.9 %   | \$35,122                 | \$30,916 | 13.6 %  |

Amortization of intangible assets decreased \$0.6 million in the second quarter of 2013 and \$1.1 million in the first half of 2013, primarily because certain intangible assets from some of our earlier acquisitions are now fully amortized. As of June 30, 2013, we had \$112.1 million of net intangible assets. We amortize these assets over their estimated lives, ranging from one to 25 years. We estimate that aggregate amortization expense for intangible assets will be approximately \$21.2 million in 2013.

Depreciation expense for corporate items increased \$1.3 million in the second quarter of 2013 and \$2.8 million in the first half of 2013, primarily related to higher capital expenditures for our operations in the United States.

Corporate unallocated expense increased \$1.8 million in the second quarter of 2013 and \$2.5 million in the first half of the year, mainly reflecting higher professional fees and salary expense. In addition, corporate unallocated in the first quarter of 2012 included about \$1.6 million of expense for a litigation settlement and an impairment charge for one of our smaller products. These expenses did not recur in 2013.

We capitalized \$2.2 million and \$3.8 million of software development expense in the second quarter and first half of 2013, respectively, reducing the expense that we would otherwise report in this category. In comparison, we capitalized \$2.4 million and \$4.1 million in the second quarter and first six months of 2012, respectively.

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

## Equity in Net Income of Unconsolidated Entities

| (\$000)   | Three months ended June 30 |       | Six months ended June 30 |         |
|---|----------------------------|-------|--------------------------|---------|
|   | 2013                       | 2012  | 2013                     | 2012    |
| Equity in net income of unconsolidated entities | \$360                      | \$497 | \$857                    | \$1,063 |

Equity in net income of unconsolidated entities includes our portion of the net income (loss) of Morningstar Japan K.K. (MJKK), Morningstar Sweden AB, YCharts, Inc., and beginning in the fourth quarter of 2012, Inquiry Financial Europe AB. Equity in net income of unconsolidated entities is primarily from our position in MJKK.

In May 2013, we acquired an additional 76% ownership interest in Morningstar Sweden, increasing our ownership interest to 100%. Because Morningstar Sweden is now a wholly owned subsidiary, we no longer account for our investment using the equity method. Beginning in May 2013, we consolidate the assets, liabilities, and results of

operations of Morningstar Sweden in our Unaudited Condensed Consolidated Financial Statements. See Note 3 of the Notes to our Unaudited Condensed Consolidated Financial Statements for additional information concerning our acquisition of Morningstar Sweden.

We describe our investments in unconsolidated entities in more detail in Note 7 of the Notes to our Unaudited Condensed Consolidated Financial Statements.

Table of Contents

## Non-Operating Income (Expense)

The following table presents the components of net non-operating income (expense):

| (\$000)  | Three months ended June 30 |         | Six months ended June 30 |         |
|--|----------------------------|---------|--------------------------|---------|
|  | 2013                       | 2012    | 2013                     | 2012    |
| Interest income  | \$664                      | \$1,260 | \$1,405                  | \$2,129 |
| Gain (loss) on sale of investments, reclassified from other comprehensive income   | 423                        | 37      | 1,148                    | (49)    |
| Holding gain upon acquisition of additional ownership of equity method investments | 3,713                      | —       | 3,713                    | —       |
| Other expense, net   | (1,689)                    | (302)   | (2,210)                  | (426)   |
| Non-operating income, net  | \$3,111                    | \$995   | \$4,056                  | \$1,654 |

Interest income mainly reflects interest from our investment portfolio.

In the first half of 2013, non-operating income includes a preliminary non-cash gain of \$3.7 million. This gain represents the difference between the estimated preliminary fair value and the book value of our investment in Morningstar Sweden at the date of acquisition.

Other income (expense), net also includes foreign currency exchange gains and losses arising from the ordinary course of business related to our U.S. and non-U.S. operations, realized gains and losses from our investment portfolio, gains and losses on sale of fixed assets, and royalty income from MJKK.

## Income Tax Expense

The following table shows our effective tax rate:

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

Our effective tax rate in the second quarter of 2013 was 33.9%, a decrease of 0.7 percentage points compared with 34.6% in the prior-year period. Year to date, our effective tax rate was 31.8%, compared with 35.3% in the first half of 2012. The decreases primarily reflect reductions in valuation allowances, and for the year-to-date period, adjustments to certain deferred income tax benefits.

As of June 30, 2013, we had \$14.3 million of gross unrecognized tax benefits which, if recognized, would reduce our effective income tax rate and decrease our income tax expense by \$11.9 million. As of December 31, 2012, we had \$12.7 million of gross unrecognized tax benefits which, if recognized, would reduce our effective income tax rate and decrease our income tax expense by \$10.4 million.

As of June 30, 2013, our Unaudited Condensed Consolidated Balance Sheet included a current liability of approximately \$6.6 million and a non-current liability of \$7.4 million for unrecognized tax benefits. As of December 31, 2012, our Condensed Consolidated Balance Sheet included a current liability of \$6.6 million and a non-current liability of \$5.7 million for unrecognized tax benefits. These amounts include interest and penalties, less any associated tax benefits.

## Table of Contents

We have not provided federal and state income taxes on accumulated undistributed earnings of certain foreign subsidiaries because these earnings have been permanently reinvested. Approximately 44% of our cash, cash equivalents, and investments as of June 30, 2013 were held by our operations outside of the United States. As such, 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. It is not possible to determine the amount of the unrecognized deferred tax liability related to the undistributed earnings.

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

## Liquidity and Capital Resources

We believe our available cash balances and investments, along with cash generated from operations, 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, consisting primarily of fixed-income securities. We maintain a conservative investment policy for our investments and invest a portion of these assets in government obligations and corporate bonds with high-quality stand-alone credit ratings. Investments in our portfolio have a maximum maturity of two years; the weighted average maturity is approximately one year. We also invest a portion of our investments balance (approximately 19% as of June 30, 2013) in proprietary Morningstar portfolios, exchange-traded funds that seek to track the performance of certain Morningstar proprietary indexes, and various mutual funds. The proprietary Morningstar portfolios may consist of stocks, bonds, options, mutual funds, or exchange-traded funds. Approximately 56% of our cash, cash equivalents, and investments was held by our operations in the United States as of June 30, 2013, compared with 58% as of December 31, 2012.

We intend to use our cash, cash equivalents, and investments for general corporate purposes, including working capital, funding future growth, repurchasing shares under our share repurchase program, and paying quarterly dividends. To date, we have not needed to access any significant commercial credit and have not attempted to borrow or establish any lines of credit.

In December 2012, the board approved an increase to our \$300 million share repurchase program. The board approval authorized us to repurchase up to an additional \$200 million in shares of our outstanding common stock, bringing the total amount authorized under the program to \$500 million. 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.

In the first six months of 2013, we repurchased a total of 747,769 shares for approximately \$51.9 million, of which \$2.7 million was settled and paid early in the third quarter of 2013. As of June 30, 2013, we have repurchased a total of 5,804,364 shares for \$352.9 million since we announced the share repurchase program in 2010.

We expect to make a recurring quarterly dividend payment of 12.5 cents per share in 2013. We paid dividends of \$5.9 million in the first six months of 2013. In May 2013, our board of directors approved a payment of a regular quarterly dividend of 12.5 cents per share payable on July 31, 2013 to shareholders of record as of July 12, 2013. As of June 30, 2013, we recorded a liability for dividends payable of \$5.8 million.

## Cash, Cash Equivalents, and Investments

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

As of June 30, 2013, we had cash, cash equivalents, and investments of \$314.8 million, a decrease of \$6.6 million compared with \$321.4 million as of December 31, 2012. The decrease reflects \$53.9 million used to repurchase common stock through our share repurchase program, bonus payments of \$36.6 million made during the first quarter of 2013 related to the 2012 bonus, and \$18.9 million of capital expenditures. In addition, we used cash of approximately \$11.1 million to acquire the additional 76% of Morningstar Sweden to become the sole owner. These items, which decreased our cash, cash equivalents, and investments balance, were partially offset by net income, adjusted for non-cash items, and the positive effect of changes in our operating assets and liabilities.

### Cash Provided by Operating Activities

Our main source of capital is cash generated from operating activities.



## Table of Contents

In the first six months of 2013, cash provided by operating activities was \$85.1 million, driven by \$83.7 million of net income, adjusted for non-cash items and \$1.4 million in changes from our net operating assets and liabilities. Changes in our operating assets and liabilities mainly benefited from an increase in income taxes and deferred revenue. A decrease in accrued compensation partially offset these benefits. The decline in accrued compensation primarily reflects the bonus payments made in the first quarter of 2013 of approximately \$36.6 million, partially offset by the current-year bonus liability for the first six months of 2013. The cash flow benefit of income taxes was partially offset by tax payments of \$14.5 million made during the first six months of the year.

Cash provided by operating activities increased \$30.3 million compared with the same period in 2012. The increase primarily reflects the higher net income, adjusted for non-cash items, a \$6.9 million decrease in income tax payments, and a \$6.3 million decrease in cash paid for bonus. We paid \$36.6 million in annual bonuses in the first quarter of 2013, compared with \$42.8 million in the prior-year period.

### Cash Provided by (Used for) Investing Activities

Cash provided by (used for) investing activities consists primarily of purchases of investments less proceeds from the maturity or sale of investments, cash used for capital expenditures, purchases of equity and cost method investments, cash used for acquisitions, and proceeds from the sale of businesses. The level of investing activities varies from period to period depending on activity in these categories. In the first six months of 2013, cash used for investing activities was \$15.7 million, compared with cash provided by investing activities of \$3.0 million in the same period of 2012.

In the first six months of 2013, proceeds from the maturity and sale of investments exceeded purchases of investments by \$13.8 million compared with \$27.6 million in the first six months of 2012. We have used a portion of these proceeds to fund our share repurchase program. As of June 30, 2013 and December 31, 2012, we had investments, consisting primarily of fixed-income securities, of \$145.0 million and \$157.5 million, respectively. As of June 30, 2013, our investments represented approximately 46% of our total cash, cash equivalents, and investments balance, compared with 49% as of December 31, 2012.

Capital expenditures were \$18.9 million in the first six months of 2013, a slight increase of \$1.0 million compared with the first six months of 2012. Capital expenditures in the first six months of 2013 reflect spending primarily for computer software and hardware and capitalized software. The capital expenditures in the first six months of 2012 were primarily for computer hardware and software, capitalized software, and an expansion of our office space in Chicago. We expect to make total capital expenditures of approximately \$42 million to \$47 million in 2013, primarily for computer hardware and software, leasehold improvements for new and existing office locations, and capitalized software. In addition, we expect to make further investments in network and systems security in an amount that may be material.

Cash used for acquisitions, net of cash acquired, was \$11.1 million in the first half of 2013 for the Sweden share acquisition. We did not complete any acquisitions in the first six months of 2012. We also used cash of \$0.9 million for additional funding in our investment in YCharts, Inc. In the first six months of 2012, we used approximately \$6.8 million in cash to acquire a minority equity stake in HelloWallet LLC.

### Cash Provided by (Used for) Financing Activities

Cash provided by (used for) financing activities consists primarily of cash used to repurchase common stock through our share repurchase program, dividend payments, and net proceeds from stock-option exercises and excess tax

benefits related to stock-option exercises and vesting of restricted stock units.

Table of Contents

Excess tax benefits occur at the time a stock option is exercised when the intrinsic value of the option (the difference between the fair value of our stock on the date of exercise and the exercise price of the option) is greater than the fair value of the option at the time of grant. Similarly, the vesting of restricted stock units generates excess tax benefits when the market value of our common stock on the vesting date exceeds the grant price of the restricted stock units. These excess tax benefits reduce the cash we pay for income taxes in the year we recognize them. It is not possible to predict the timing of stock-option exercises or the intrinsic value that will be achieved at the time options are exercised or upon vesting of restricted stock units. As a result, we expect cash flow from financing activities to vary over time. Note 8 in the Notes to our Unaudited Condensed Consolidated Financial Statements includes additional information concerning stock options and restricted stock units outstanding as of June 30, 2013.

Cash used for financing activities was \$58.4 million in the first six months of 2013. We used cash of approximately \$53.9 million under our share repurchase program in the first six months of 2013. In addition, we made dividend payments of \$5.9 million and had a net cash inflow of \$2.8 million from the proceeds from stock-option exercises. Taxes withheld for restricted stock units represented an outflow of \$5.2 million. Additionally, excess tax benefits related to stock-option exercises and vesting of restricted stock units represented an outflow of \$3.8 million.

Cash used for financing activities was \$110.1 million in the first six months of 2012. We made purchases of \$105.4 million under our share repurchase program in the first six months of 2012. We also paid dividends of \$10.0 million. Taxes withheld for restricted stock units represented an outflow of \$3.7 million. Partially offsetting these cash outflows were proceeds from stock-option exercises of \$4.5 million, as well as excess tax benefits related to stock-option exercises and vesting of restricted stock units totaling \$4.5 million.

Employees exercised approximately 0.2 million and 0.3 million stock options in the first six months of 2013 and 2012, respectively. The total intrinsic value (the difference between the market value of our stock on the date of exercise and the exercise price of the option) of options exercised during the first six months of 2013 and 2012 was \$8.2 million and \$14.5 million, respectively.

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 on Form 10-K for the year ended December 31, 2012, as filed with the SEC on February 28, 2013. We also discuss our significant accounting policies in Note 3 of our Consolidated Financial Statements included in our Annual 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 July 15, 2013:

| 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 July 15, 2013 | Projected Beneficial Ownership (1) |
|----------------------------|--------------|-----------------------|--|--|--|------------------------------------|
| Cheryl Francis<br>Director | 5/21/2013    | 5/31/2014             | 2,800                                      | Shares to be sold under the plan if the stock reaches specified prices | —  | 20,952                             |
| Steve Kaplan<br>Director   | 3/4/2013     | 12/31/2013            | 6,000                                      | Shares to be sold under the plan on specified dates                    | —  | 51,055                             |
| Jack Noonan<br>Director    | 11/15/2012   | 5/2/2015              | 24,000                                     | Shares to be sold under the plan if the stock reaches specified prices | 6,000  | 63,232                             |

During the second quarter of 2013, the previously disclosed Rule 10b5-1 sales plans for Chris Boruff and David Williams completed in accordance with their 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 plans identified above. This information reflects the beneficial ownership of our common stock on June 30, 2013, and includes shares of our common stock subject to options that were then exercisable or that will have become exercisable by August 29, 2013 and restricted stock units that will vest by August 29, 2013. The estimates do not reflect any changes to beneficial ownership that may have occurred since June 30, 2013. 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.

## 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. We invest our investment portfolio mainly in high-quality fixed-income securities. As of June 30, 2013, our cash, cash equivalents, and investments balance was \$314.8 million. Based on our estimates, a 100 basis-point change in interest rates would change the fair value of our investment portfolio by approximately \$0.9 million.

As our non-U.S. revenue increases as a percentage of our consolidated revenue, fluctuations in foreign currencies present a greater potential risk. Our European operations are subject to currency risk related to the euro. 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. Our results could suffer if certain foreign currencies decline relative to the U.S. dollar. In addition, because we use the local currency of our subsidiaries as the functional currency, we are affected by the translation of foreign currencies into U.S. dollars.

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 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.

Table of Contents

We carried out an evaluation, under the supervision and with the participation of our 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 Securities Exchange Act of 1934, as of June 30, 2013. 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

There were no changes in our internal control over financial reporting during the quarter ended June 30, 2013 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 10, 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 on Form 10-K for the year ended December 31, 2012.

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

## Issuer Purchases of Equity Securities\*

The following table presents information related to repurchases of common stock we made during the three months ended June 30, 2013:

| Period:                           | Total number of shares purchased | Average price paid per share | Total number of shares purchased as part of publicly announced programs (1) | Approximate dollar value of shares that may yet be purchased under the programs (1) |
|-----------------------------------|----------------------------------|------------------------------|---|---|
| Cumulative through March 31, 2013 | 5,222,136                        | \$59.63                      | 5,222,136   | \$188,490,274   |
| April 1, 2013 – April 30, 2013    | 10,218                           | 66.06                        | 10,218  | \$187,815,036   |
| May 1, 2013 – May 31, 2013        | 250,333                          | 68.75                        | 250,333   | \$170,600,168   |
| June 1, 2013 – June 30, 2013      | 321,677                          | 72.99                        | 321,677   | \$147,113,706   |
| Total                             | 5,804,364                        | \$60.78                      | 5,804,364   |   |

\* 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 September 2010, our board of directors approved a share repurchase program that authorized the purchase of up to \$100 million of the outstanding common stock with an expiration date of December 31, 2012. In December 2011, the board approved an increase to this program. The board approval authorized the company to repurchase (1) up to an additional \$200 million in shares of our outstanding common stock. In December 2012, the board approved another increase to this program. The board approval authorized the company to repurchase up to an additional \$200 million in shares of our outstanding common stock with a revised expiration date of December 31, 2014.

## Item 6. Exhibits

Incorporated by reference to Exhibit Index included herewith.

51

---



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: July 31, 2013

By: /s/ Scott Cooley  
Scott Cooley  
Chief Financial Officer

Table of Contents

EXHIBIT INDEX

| Exhibit No | Description of Exhibit   |
|------------|--|
| 10.1       | Form of Morningstar 2011 Stock Incentive Plan Restricted Stock Unit Award Agreement for awards made on and after May 15, 2013  |
| 10.2       | Form of Morningstar 2011 Stock Incentive Plan Director Restricted Stock Unit Award Agreement for awards made on and after May 15, 2013   |
| 31.1       | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as amended   |
| 31.2       | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as amended   |
| 32.1       | 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  |
| 32.2       | 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 June 30, 2013, filed with the SEC on July 31, 2013 formatted in XBRL: (i) Condensed Consolidated Statements of Income, (ii) Condensed Consolidated Statements of Comprehensive Income (iii) Condensed Consolidated Balance Sheets, (iv) Condensed Consolidated Statement of Equity, (v) Condensed Consolidated Statements of Cash Flows and (vi) the Notes to Unaudited Condensed Consolidated Financial Statement |