Morningstar, Inc.
Form 10-Q
August 09, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006

OR

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

For the transition period from to

Commission File Number: 000-51280

MORNINGSTAR, INC.

(Exact Name of Registrant as Specified in its Charter)

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

225 West Wacker Drive
Chicago, Illinois
60606-6303

(Address of Principal Executive Offices)

(312) 696-6000

(Registrant s Telephone Number, Including Area Code)

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

Indicate by check mark whether the Registrant is a large accelerated filer, accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer o Non-accelerated filer ý

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

As of August 2, 2006, there were 41,390,901 shares of the Company s common stock, no par value, outstanding.

MORNINGSTAR, INC. AND SUBSIDIARIES

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PART 1: FINANCIAL INFORMATION

Item 1: Unaudited Condensed Consolidated Financial Statements

Morningstar, Inc. and Subsidiaries

Unaudited Condensed Consolidated Statements of Operations

(in thousands except per share amounts)	**Three Months Ended June 30 2006**	**2005**	**Six Months Ended June 30 2006**	**2005**
Revenue	$ 76,257	$ 56,243	$ 146,317	$ 109,447
Operating expense (1):				
Cost of goods sold	22,052	15,674	40,725	31,586
Development	7,306	4,593	13,397	9,742
Sales and marketing	11,880	9,845	23,540	19,630
General and administrative	13,793	11,135	25,825	24,219
Depreciation and amortization	3,767	1,852	6,173	4,248
Total operating expense	58,798	43,099	109,660	89,425
Operating income	17,459	13,144	36,657	20,022
Non-operating income:				
Interest income, net	858	605	1,917	1,054
Other income (expense), net	(186)	(200)	(312)	60
Non-operating income, net	672	405	1,605	1,114
Income before income taxes, equity in net income of unconsolidated entities, and cumulative effect of accounting change	18,131	13,549	38,262	21,136
Income tax expense	7,624	4,600	15,222	8,660
Equity in net income of unconsolidated entities	658	549	1,305	1,029
Income before cumulative effect of accounting change	11,165	9,498	24,345	13,505
Cumulative effect of accounting change, net of income tax expense of $171			259	
Net income	$ 11,165	$ 9,498	$ 24,604	$ 13,505
Basic income per share				
Income before cumulative effect of accounting change	$ 0.27	$ 0.24	$ 0.60	$ 0.35
Cumulative effect of accounting change			0.01	
Net income	$ 0.27	$ 0.24	$ 0.61	$ 0.35
Diluted income per share				

Income before cumulative effect of accounting change	$ 0.24	$ 0.22	$ 0.52	$ 0.31
Cumulative effect of accounting change			0.01	
Net income	$ 0.24	$ 0.22	$ 0.53	$ 0.31
Weighted average shares outstanding:				
Basic	40,925	39,064	40,641	38,758
Diluted	46,684	43,742	46,535	42,994

	Three Months Ended June 30		Six Months Ended June 30	
	2006	**2005**	**2006**	**2005**
(1) Includes stock-based compensation expense of:				
Cost of goods sold	$ 285	$ 264	$ 557	$ 928
Development	131	105	245	380
Sales and marketing	137	128	263	453
General and administrative	1,526	1,441	2,948	5,064
Total stock-based compensation expense	$ 2,079	$ 1,938	$ 4,013	$ 6,825

See notes to unaudited condensed consolidated financial statements.

Morningstar, Inc. and Subsidiaries

Unaudited Condensed Consolidated Balance Sheets

(in thousands except share amounts)		**June 30 2006**		**December 31 2005**
Assets				
Current assets:				
Cash and cash equivalents	$	83,259	$	92,367
Investments		38,182		60,823
Accounts receivable, less allowance of $850 and $418, respectively		56,924		47,530
Income tax receivable, net		4,555		
Other		6,911		5,495
Total current assets		189,831		206,215
Property, equipment, and capitalized software, net of accumulated depreciation of $44,296 and $40,687, respectively		17,040		17,355
Investments in unconsolidated entities		17,238		16,355
Goodwill		64,582		17,500
Intangible assets, net		60,474		7,251
Deferred tax asset, net		8,283		29,729
Other assets		2,330		1,906
Total assets	$	359,778	$	296,311
Liabilities and shareholders equity				
Current liabilities:				
Accounts payable and accrued liabilities	$	17,417	$	13,664
Accrued compensation		22,021		26,463
Income tax payable				1,259
Deferred revenue		90,733		71,155
Deferred tax liability, net		711		833
Other		2,487		2,467
Total current liabilities		133,369		115,841
Accrued compensation		3,201		4,458
Other long-term liabilities		3,484		2,298
Total liabilities		140,054		122,597
Shareholders equity:				
Common stock, no par value, 200,000,000 shares authorized, of which 41,277,019 and 40,284,513 shares were outstanding as of June 30, 2006 and December 31, 2005, respectively		4		4
Treasury stock at cost, 233,334 shares as of June 30, 2006 and December 31, 2005		(3,280)		(3,280)
Additional paid-in capital		247,535		226,593
Accumulated deficit		(26,004)		(50,608)
Accumulated other comprehensive income:				
Currency translation adjustment		1,596		1,130
Unrealized losses on available for sale securities		(127)		(125)
Total accumulated other comprehensive income		1,469		1,005
Total shareholders equity		219,724		173,714
Total liabilities and shareholders equity	$	359,778	$	296,311

See notes to unaudited condensed consolidated financial statements.

Morningstar, Inc. and Subsidiaries

Unaudited Condensed Consolidated Statement of Shareholders Equity and Comprehensive Income

For the Six Months Ended June 30, 2006

(in thousands, except share amounts)	Common Stock Shares Outstanding	Par Value	Treasury Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income	Total Shareholders Equity
Balance, December 31, 2005	40,284,513	$ 4	$ (3,280)	$ 226,593	$ (50,608)	$ 1,005	$ 173,714
Comprehensive income:							
Net income					24,604		24,604
Unrealized loss on investments, net of income tax benefit						(2)	(2)
Foreign currency translation adjustment						466	466
Total comprehensive income					24,604	464	25,068
Issuance of common stock related to stock option exercises, net	992,506			10,851			10,851
Stock-based compensation				4,013			4,013
Cumulative effect of accounting change				(430)			(430)
Tax benefit derived from stock option exercises				6,508			6,508
Balance, June 30, 2006	41,277,019	$ 4	$ (3,280)	$ 247,535	$ (26,004)	$ 1,469	$ 219,724

See notes to unaudited condensed consolidated financial statements.

Morningstar, Inc. and Subsidiaries

Unaudited Condensed Consolidated Statements of Cash Flows

(in thousands)	Six Months Ended June 30 2006	2005
Operating activities		
Net income	$ 24,604	$ 13,505
Adjustments to reconcile net income to net cash flows from operating activities:		
Cumulative effect of accounting change, net of tax	(259)	
Depreciation and amortization	6,173	4,248
Deferred income tax benefit	(717)	(1,277)
Stock-based compensation expense	4,013	6,825
Provision for bad debt	328	114
Equity in net income of unconsolidated entities	(1,305)	(1,029)
Foreign exchange loss	452	60
Excess tax benefits from stock option exercises	(6,508)	
Other, net	36	(48)
Changes in operating assets and liabilities, net of effects of acquisitions:		
Accounts receivable	(2,758)	(6,477)
Other assets	455	401
Accounts payable and accrued liabilities	(245)	106
Accrued compensation	(7,174)	(6,683)
Income taxes payable	13,467	(1,069)
Deferred revenue	8,425	4,067
Other liabilities	442	(1,094)
Cash provided by operating activities	39,429	11,649
Investing activities		
Purchases of investments	(37,783)	(29,941)
Proceeds from sale of investments	60,454	40,410
Capital expenditures	(2,023)	(2,327)
Acquisitions, net of cash acquired	(86,363)	(8,157)
Other, net	(294)	18
Cash (used for) provided by investing activities	(66,009)	3
Financing activities		
Payments of long-term debt and capital lease obligations		(18)
Proceeds from initial public offering		18,108
Proceeds from stock options exercises	10,851	1,392
Excess tax benefits from stock option exercises	6,508	
Other	(4)	
Cash provided by financing activities	17,355	19,482
Effect of exchange rate changes on cash	117	(157)
Net increase (decrease) in cash and cash equivalents	(9,108)	30,977
Cash and cash equivalents beginning of period	92,367	35,907
Cash and cash equivalents end of period	$ 83,259	$ 66,884
Supplemental disclosure of cash flow information:		
Cash paid for taxes	$ 2,214	$ 10,736
Supplemental information of non-cash investing and financing activities:		
Unrealized gain (loss) on available for sale investments	$ (3)	$ 3

See notes to unaudited condensed consolidated financial statements.

MORNINGSTAR, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation of Interim Financial Information

The accompanying unaudited condensed consolidated financial statements of Morningstar, Inc. and subsidiaries (Morningstar, we, our, the Company) included herein 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 expense. 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, stockholders equity, and cash flows. These financial statements and notes should be read in conjunction with our Consolidated Financial Statements and Notes thereto as of December 31, 2005 included in our Annual Report on Form 10-K filed with the SEC on March 16, 2006.

In the first quarter of 2006, we changed our segment reporting by allocating stock-based compensation expense to each of our three business segments; before 2006, stock-based compensation expense was recorded as a corporate item. We believe this change gives management a more complete picture of the profitability of each business segment after fully allocating stock-based compensation expense. We have reclassified the 2005 financial results for each segment to reflect this change.

2. Summary of Significant Accounting Policies

We discuss our significant accounting policies in Note 2 of our Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2005 filed with the SEC.

Effective January 1, 2006, we adopted Statement of Financial Accounting Standards (SFAS) No. 123 (Revised 2004), *Share-Based Payment* (SFAS No. 123(R)), using the modified prospective transition method. Under this method, the provisions of SFAS No. 123(R) apply to all awards granted after the date of adoption and to any unrecognized expense of awards unvested at the date of adoption based on the fair value as of the date of grant. Prior to this date, we accounted for our stock options in accordance with the fair value provisions of SFAS No. 123, *Stock-Based Compensation* (SFAS No. 123). Under SFAS No. 123, we accounted for forfeitures of stock options as they occurred. SFAS No. 123(R) requires us to estimate expected forfeitures at the grant date and recognize compensation cost only for those awards expected to vest. Accordingly, in the first quarter of 2006, we recorded a cumulative effect of accounting change, net of tax, of $259,000 to reverse the impact of stock-based compensation expense recorded in prior years related to outstanding stock options that we estimate will not vest. Besides recording this cumulative effect of accounting change, the adoption of SFAS No. 123(R) did not have a significant impact on our financial position or results of operations because we previously recognized stock-based compensation expense in accordance with SFAS No. 123.

Prior to our adoption of SFAS 123(R), we classified tax benefits arising from the exercise of stock options as operating cash flows. SFAS No. 123(R) requires that we classify the cash flows resulting from the tax benefit that arises when the tax deductions exceed the compensation cost recognized for those options (excess tax benefits) as financing cash flows. The excess tax benefits were $6,508,000 in the first six months of 2006, and no comparable amounts were recorded in the first six months of 2005. Refer to Note 8 of the Notes to our Unaudited Condensed Consolidated Financial Statements for more information regarding our adoption of SFAS No. 123(R) and our accounting for stock options and restricted stock units.

3. Acquisitions, Goodwill, and Other Intangible Assets

Ibbotson Associates, Inc.

In March 2006, we acquired Ibbotson Associates, Inc. (Ibbotson), a privately held firm specializing in asset allocation research and services, for $83,000,000 in cash, plus an additional $3,470,000 in cash for working capital and other items, subject to post-closing adjustments. We have included the results of Ibbotson s operations in our Condensed Consolidated Financial Statements beginning on March 1, 2006. This acquisition fits several of Morningstar s growth strategies and broadens our reach in the areas of investment consulting, managed retirement accounts, and institutional and advisor software.

In the first quarter of 2006, we performed a preliminary allocation of the purchase price to the estimated fair values of the assets acquired and liabilities assumed upon acquisition. In the second quarter of 2006, we refined our initial estimates of intangible assets, fixed assets, income tax benefits, and other accrued liabilities. The following table summarizes our current allocation of the purchase price to the estimated fair values of the assets acquired and liabilities assumed at the date of the acquisition:

		($000)
Cash	$	103
Accounts receivable		6,629
Income tax benefits, net		12,776
Other current assets		1,530
Fixed assets		1,407
Other assets		166
Intangible assets		55,280
Goodwill		47,018
Deferred revenue		(10,672)
Accrued liabilities		(4,902)
Deferred tax liability		(22,108)
Other non-current liabilities		(761)
Total purchase price	$	86,466

As part of the purchase price allocation, we recorded an asset of $12,776,000, primarily for the income tax benefit related to payment for the cancellation of Ibbotson s stock options. This cash income tax benefit will reduce the amount of cash we pay for income taxes in 2006. This cash income tax benefit did not impact our income tax expense or net income in the first six months of 2006.

The purchase price allocation also includes $55,280,000 of acquired intangible assets. These assets include customer-related assets of $34,200,000 that will be amortized over a weighted average period of 9 years; intellectual property (including patents and trade names) of $17,710,000 that will be amortized over a weighted average period of 10 years; technology-based assets of $3,070,000 that will be amortized over a weighted average period of 5 years; and a non-compete agreement of $300,000 that will be amortized over 5 years. Because the amortization expense for these intangible assets is not deductible for U.S. income tax purposes, we recorded a deferred tax liability of $21,971,000 based on these preliminary values.

Based on the purchase price allocation, we recorded $47,018,000 of goodwill. The goodwill we recorded is not deductible for income tax purposes. SFAS No. 109, *Accounting for Income Taxes*, prohibits recognition of a deferred tax asset or liability for goodwill temporary differences if goodwill is not amortizable and deductible for tax purposes. The goodwill will be tested at least annually for impairment in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*.

Based on plans in place at the time of acquisition, we recorded a liability of $614,000 for severance and $761,000 for lease termination costs, net of estimated sub-lease income. As of June 30, 2006, we have made substantially all of the related severance payments. We expect to pay the lease termination costs beginning in March 2008, which is when we plan to vacate the office space.

The following unaudited pro forma information presents a summary of our consolidated statements of operations for the three and six months ended June 30, 2006 and 2005 as if we had acquired Ibbotson as of January 1, 2006 and 2005, respectively. In calculating the pro forma information below, we made an adjustment to eliminate stock-based compensation expense previously recorded by Ibbotson based on the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. We also made an adjustment to record stock-based compensation expense for an estimated value of stock options assumed to be granted to Ibbotson employees. This adjustment assumes the stock option awards were made in May 2005, consistent with the timing of our annual equity grant, and vest over a four-year period. In 2005, we recorded stock-based compensation expense based on the recognition and measurement principles of SFAS No. 123, *Accounting for Stock-Based Compensation*.

($000)	Three Months Ended June 30 2006	2005	Six Months ended June 30 2006	2005
Revenue	$ 76,257	$ 68,829	$ 153,708	$ 133,308
Operating income	17,459	13,717	36,998	20,958
Income before cumulative effect of accounting change	11,165	9,483	24,320	13,335
Net income	11,165	9,483	24,579	13,335
Basic income per share:				
Income before cumulative effect of accounting change	$ 0.27	$ 0.24	$ 0.60	$ 0.34
Net income	$ 0.27	$ 0.24	$ 0.60	$ 0.34
Diluted income per share:				
Income before cumulative effect of accounting change	$ 0.24	$ 0.22	$ 0.52	$ 0.31
Net income	$ 0.24	$ 0.22	$ 0.53	$ 0.31

Variable Annuity Research and Data Service

In January 2005, we acquired Variable Annuity Research and Data Service (VARDS) from Finetre Corporation for $8,192,000 in cash, including costs directly related to the acquisition. The results of VARDS operations have been included in our Condensed Consolidated Financial Statements beginning in January 2005.

The following table summarizes the allocation of the purchase price to the estimated fair values of the assets acquired and liabilities assumed at the date of the acquisition:

	($000)
Accounts receivable	$ 639
Other assets	57
Intangible assets	6,370
Goodwill	3,084
Liabilities, primarily deferred revenue	(1,958)
Total purchase price	$ 8,192

The acquired intangible assets include $5,700,000 of customer-related assets, consisting primarily of acquired customer contracts; $430,000 for technology-based assets, consisting of a database and developed software; and $240,000 related to supplier relationships. Both the acquired intangible assets and the acquired goodwill are deductible for U.S. income tax purposes.

Goodwill

The following table shows the changes in our goodwill balance from January 1, 2005 to June 30, 2006:

		($000)
Balance as of January 1, 2005	$	14,408
Goodwill acquired related to VARDS		3,084
Other, primarily currency translation adjustment		8
Balance as of December 31, 2005	$	17,500
Goodwill acquired related to Ibbotson		47,018
Other, primarily currency translation adjustment		64
Balance as of June 30, 2006	$	64,582

We did not record any impairment losses in the quarter or year-to-date periods ended June 30, 2006 or 2005, respectively.

Intangible Assets

We amortize intangible assets using the straight-line method over their expected economic useful lives. The following table summarizes our intangible assets:

	As of June 30, 2006				As of December 31, 2005			
($000)	Gross	Accumulated Amortization	Net	Weighted Average Useful Life (years)	Gross	Accumulated Amortization	Net	Weighted Average Useful Life (years)
Intellectual property	$ 18,842	$ (1,070)	$ 17,772	10	$ 1,132	$ (405)	$ 727	7
Customer-related assets	40,771	(2,046)	38,725	11	6,571	(597)	5,974	18
Supplier relationships	240	(19)	221	20	240	(12)	228	20
Technology-based assets	3,896	(420)	3,476					