

Morningstar, Inc.  
Form 10-K  
March 16, 2007

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington D.C. 20549

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**FORM 10-K**

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

**FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006**

**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**

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**MORNINGSTAR, INC.**

(Exact Name of Registrant as Specified in its Charter)

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(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)

Securities registered pursuant to Section 12(b) of the Act:

<b>Title of Each Class</b>	<b>Name of Each Exchange on Which Registered</b>
Common stock, no par value	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Accelerated filer

Non-accelerated filer

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

The aggregate market value of shares of common stock held by non-affiliates of the Registrant as of June 30, 2006 was \$442,359,063.

As of March 1, 2007, there were 42,392,526 shares of the Registrant's common stock, no par value, outstanding.

### **DOCUMENTS INCORPORATED BY REFERENCE**

Certain parts of the Registrant's Definitive Proxy Statement for the 2007 Annual Meeting of Shareholders are incorporated into Part III of this Form 10-K.

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**Part I**

**Item 1. Business**

Morningstar is a leading provider of independent investment research to investors around the world. Since our founding in 1984, our mission has been to create great products that help investors reach their financial goals. We offer an extensive line of Internet, software, and print-based products for individual investors, financial advisors, and institutional clients. Our company also provides asset management services for advisors, institutions, and retirement plan participants. In addition to our U.S.-based products and services, we offer local versions of our products designed for investors in Asia, Australia, Canada, and Europe. Morningstar serves more than 5.2 million individual investors, 210,000 financial advisors, and 1,700 institutional clients. We have operations in 15 countries and hold minority ownership positions in companies located in three other countries.

We maintain a series of comprehensive databases on 10 key types of investments that are widely used by investors globally. After building these databases, we add additional value and insight to the data by investing in our core skills of research, technology, and design. As of December 31, 2006, we provided extensive data on more than:

18,000 mutual fund share classes in the United States;

78,000 mutual funds and similar vehicles in international markets;

11,000 stocks;

6,000 hedge funds;

6,000 separate accounts and collective investment trusts;

62,000 variable annuity/life subaccounts and policies;

4,000 pension and life funds;

700 exchange-traded funds;

700 closed-end funds;

80 state-sponsored college savings plans (commonly known as Section 529 College Savings Plans); and

80 years of capital markets data capturing performance of 18 market indexes.

Our business model is based on leveraging our investments in the databases we maintain. We earn returns on these investments by selling a wide variety of products in multiple media to three key market segments around the world.

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Our data and proprietary analytical tools such as the Morningstar Rating for mutual funds, which rates past performance based on risk- and cost-adjusted returns, and the Morningstar Style Box, which provides a visual summary of a mutual fund's underlying investment style, have become important tools that millions of investors and advisors use in making investment decisions. We've created other tools, such as the Ownership Zones, Sector Deltas, and Market Barometer, which allow investors to see how different investments work together to form a portfolio and to track its progress. We developed a Portfolio X-Ray tool that helps investors reduce risk and understand the key characteristics of their portfolios based on nine different factors.

More recently, we've expanded our research efforts on individual stocks and have worked to popularize the concepts of economic moat, a measure of competitive advantage, and margin of safety, which reflects the size of the discount in a stock's price relative to its estimated value. The Morningstar Rating for stocks is based on the stock's current price relative to our analyst-generated fair value estimates, as well as the company's level of business risk and economic moat. We offer a variety of qualitative measures such as Stewardship Grades, which help investors identify stocks and funds that have demonstrated a high level of commitment to shareholders and stewardship of investors' capital.

In 2006, we introduced the Morningstar Investor Return measure, which incorporates the impact of cash flows from purchases and sales as well as growth in fund assets to capture how the average investor fared in a fund over a period of time.

We've also developed in-depth advice on security selection and portfolio building to meet the needs of investors looking for integrated portfolio solutions. We believe many investors rely on these tools because they offer a useful framework for comparing potential investments and making decisions. Our independence and our history of innovation make us a trusted resource for investors.







## Growth Strategies

We operate our business in three global segments: Individual, Advisor, and Institutional. Our mission is to create great products that help investors reach their financial goals. In keeping with our mission, we are pursuing four key growth strategies, which we describe below. We review our growth strategies on a regular basis and refine them as we monitor changes in the business. If you compare the growth strategies we outlined last year with what we describe below, you will see that we are no longer including Morningstar Retirement Manager as one of our major Internet platforms. Instead, we are including all of our retirement advice solutions (including Morningstar Retirement Manager and Advice by Ibbotson) as part of our second growth strategy, which is to become a global leader in funds-of-funds investment management. Separately, we added retirement income tools as one of the core capabilities we plan to focus on for our third growth strategy, expanding the range of services we offer in each of our operating segments. We have maintained our fourth growth strategy, expanding our international brand presence, products, and services.

1. *Enhance our position in each of our three operating segments by focusing on our three major Internet-based platforms.*

We believe that individual investors, financial advisors, and institutional clients increasingly want integrated solutions as opposed to using different research tools for different parts of their portfolios. To help meet the market need for integrated solutions, one of our key strategies is to focus our product offerings on our three major platforms:

Morningstar.com for individual investors;

Morningstar Advisor Workstation for financial advisors; and

Morningstar Direct for institutional investment research professionals.

These products all include integrated research and portfolio tools, allowing investors to use our proprietary information and analysis across multiple security types. We believe we can achieve deeper penetration of our current audiences with each of these platforms, as well as extend their reach to new customers. With Morningstar.com, we are focusing on expanding beyond our core audience of mutual fund investors by adding more stock investors and continuing to expand our reach with our core audience of experienced and engaged investors. Over the next several years, we plan to intensify and improve the Morningstar.com customer experience by upgrading the site's content, speed, and relevance to all users. With Advisor Workstation, we plan to build on our large installed base by continuing to add functionality, such as portfolio accounting, client management, and retirement income tools, which will help us reach more advisors around the world. With Morningstar Direct, we plan to continue an aggressive development program to provide data and analysis on securities and investments around the world. We are focusing on expanding functionality, selling more licenses to existing clients, and expanding to reach new clients.

2. *Become a global leader in funds-of-funds investment management.*

The large number of managed investment products available has made assembling them into well-constructed portfolios a difficult task for many investors. Consequently, funds-of-funds offerings have seen strong growth within the mutual fund, variable annuity, and hedge fund industries. Cerulli Associates estimates that global multimanager assets – including publicly offered funds that invest in other funds as well as investment vehicles managed by multiple subadvisors – totaled more than \$1.3 trillion as of December 31, 2005. We believe assembling and evaluating funds

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of funds is a natural extension of our expertise in understanding managed investment products.

Our investment management programs combine managed investment vehicles – typically mutual funds – in portfolios designed to help investors and financial advisors meet their financial goals. When we create portfolios made up of other funds, our goal is to simplify the investment process and help investors access portfolios that match their level of risk tolerance, time horizon, and long-term investment objectives. We draw on our extensive experience analyzing funds to combine quantitative research with a qualitative assessment of manager skill and investment style.

Morningstar Managed Portfolios, which we introduced in 2001, is a fee-based discretionary asset management service that includes a series of mutual fund and exchange-traded fund portfolios tailored to meet specific investment time horizons and risk levels. We also offer a managed account service as part of our Retirement Advice platform, which includes Morningstar Retirement Manager and Advice by Ibbotson. We offer these managed accounts for retirement plan participants who choose to delegate management of their portfolios to our investment professionals, who select investment options and make retirement planning choices for the participants. We believe that retirement plan participants will continue to adopt managed accounts because of the complexity involved in retirement planning. In addition, the Pension Protection Act of 2006 may encourage plan sponsors to adopt managed accounts as a default investment option. For more information about the Pension Protection Act, see the Industry Overview section of Item 7 – Management’s Discussion and Analysis of Financial Condition and Results of Operations.

In addition to the assets we manage directly, we had a total of \$55.5 billion in assets under advisement in our Investment Consulting business as of December 31, 2006. We significantly expanded our assets under advisement in 2006, reflecting growth in our existing

business as well as new assets acquired from Ibbotson Associates. Our consulting business includes consulting relationships and agreements where we act as a portfolio construction manager or asset allocation program designer for a mutual fund or variable annuity and receive a basis point fee. We see continued potential to develop this part of our business, including in markets outside the United States.

3. *Expand the range of services we offer investors, financial advisors, and institutional clients.*

We plan to expand our product offerings to better meet the needs of investors. We plan to continue building new databases for additional types of investments, including hedge funds, various types of funds outside the United States, and other widely used investment products. We expect to continue expanding our product offerings in three primary areas:

*Expand and leverage our stock-research capabilities.* Our equity research complements our approach to mutual fund analysis, which has historically focused on analyzing the individual stocks that make up each fund's portfolio. Over the past several years, we've significantly expanded our equity research coverage. As of December 31, 2006, we provided analyst research on more than 1,800 companies. We've continued to focus on building both depth and breadth of coverage by adding additional coverage on foreign stocks, small-cap stocks, initial public offerings, master limited partnerships, and other areas. We currently have agreements with six major investment banks to provide research under the terms of the Global Analyst Research Settlement, which covers the five-year period ending in July 2009. We're continuing to pursue opportunities to distribute our equity research through a variety of other channels, including through financial advisors, buy-side firms, and outside of the United States. We believe that investors' increasing awareness of the value of independent research will strengthen our business over the long term;

*Expand our capabilities in hedge fund research.* We plan to continue expanding our research and data on hedge funds with the goal of making the hedge fund industry more transparent to investors. Hedge funds worldwide held more than \$1.4 trillion in investor assets as of December 31, 2006, according to a report published by Hennessee Group in March 2007. Offering data on hedge funds is a natural extension of our work on other managed investment vehicles. We introduced our hedge fund database in early 2005 and provided data on about 3,000 hedge funds as of mid-2006. After adding the hedge fund data acquired from the InvestorForce database (described in more detail below), we now provide comprehensive data on more than 6,000 hedge funds. We began offering hedge fund analyst reports on Morningstar.com and through Morningstar Direct in 2006 and have added hedge fund data to several of our products; and

*Build retirement income capabilities.* As the baby boom generation approaches retirement, we believe many investors will need more information to help them manage income during retirement. We believe these trends will lead to a greater need for information and tools focusing on retirement income planning and long-term savings strategies. In October 2006, we launched Retirement Income Strategist, a Web-based financial planning tool that allows financial advisors to create comprehensive income analyses for clients who are in or approaching retirement. We currently offer Retirement Income Strategist as part of our Advisor Workstation platform and plan to incorporate retirement income tools in other products over the next several years.

4. *Expand our international brand presence, products, and services.*

Over the past several years, we have expanded our product offerings outside the United States. In July 2006, we increased our presence in Australia when we acquired Aspect Huntley, which we describe in more detail below. Our non-U.S. operations generated \$44.3 million in revenue in 2006, including \$8.3 million from acquisitions, compared with \$29.4 million in 2005. We plan to continue expanding our non-U.S. operations to meet the increasing demand for wide-ranging, independent investment insight by investors around the globe. Because more than half of the world's investable assets are located outside of the United States, we believe there are significant opportunities for us in non-U.S. markets. Our strategy is to focus our non-U.S. sales efforts on our major products, including Morningstar Advisor Workstation and Morningstar Direct. We also plan to increase our sales staff, build a larger analyst team outside the United States, and explore new markets, such as India and Latin America.

**Acquisitions**

Historically, we have focused primarily on organic growth by introducing new products and services and expanding our marketing efforts for existing products. However, we have made and expect to continue making selective acquisitions that support our four key growth strategies. In reviewing potential acquisitions, we plan to focus on transactions that:

offer a good strategic fit with our mission of creating great products that help investors reach their financial goals;

help us build our proprietary investment databases, research capabilities, technical expertise, or customer base faster and more cost effectively than we could if we built them ourselves; and

offer a good cultural fit with our entrepreneurial spirit and brand leadership.

*Institutional Hedge Fund and Separate Accounts Database Division of InvestorForce, Inc.*

In August 2006, we acquired the institutional hedge fund and separate account database division of InvestorForce, Inc., a financial software and data integration company based in Wayne, Pennsylvania, for \$10.1 million in cash. This acquisition included the Altvest database, one of the largest databases covering hedge funds, managers, and data, as well as InvestorForce's extensive institutional separate account database. It also included several online software applications for manager search, research, and reporting. This acquisition allowed us to strengthen and expand our proprietary investment data.

*Aspect Huntley Pty Limited*

In July 2006, we acquired Aspect Huntley Pty Limited, a leading provider of equity information, research, and financial trade publishing in Australia, for \$23.4 million in cash. This acquisition fit our growth strategy to expand our products and services outside the United States and allowed us to combine Morningstar's expertise in fund research and information with Aspect Huntley's equity research, information, and financial media expertise in Australia.

*Ibbotson Associates, Inc.*



*In March 2006, we acquired Ibbotson Associates, Inc., a firm specializing in asset allocation research and services, for \$86.5 million in cash.* **Ibbotson's key products and services include:**





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a well-established investment consulting practice that provides asset allocation and fund research to institutions;

a portfolio and asset management business that constructs actively managed funds-of-funds offerings for financial institutions;

managed retirement accounts for participants in 401(k) and other defined contribution plans;

the EnCorr software for investment management and strategic asset allocation;

asset allocation, forecasting, and optimization software widely used in broker-dealer advisor platforms;

a long-term database of capital market returns;

training and educational services; and

the *Stocks, Bonds, Bills, and Inflation Yearbook* annual reference guides.

The Ibbotson acquisition complemented our growth strategies in several key areas, including investment consulting, managed retirement accounts, and institutional and advisor software.

We have also made other acquisitions over the past several years. For more information, refer to Note 7 of the Notes to our Consolidated Financial Statements.

### **Business Segments, Products, and Services**

We divide our business operations into three segments:

Individual, which focuses on products and services for individual investors;

Advisor, which focuses on products and services for financial advisors; and

Institutional, which focuses on products and services for institutional clients, including banks, brokerage firms, insurance companies, mutual fund companies, media outlets, and retirement plan providers and sponsors.

The table below shows our revenue by business segment for each of the past three years:



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Revenue by Segment (\$000)	2006		2005		2004	
	Amount	%	Amount	%	Amount	%
Individual	\$ 80,706	25.6%	\$ 63,448	27.9%	\$ 46,996	26.2%
Advisor	94,694	30.0	72,689	32.0	60,880	33.9
Institutional	146,085	46.4	95,947	42.2	78,402	43.6
Elimination of intersegment revenue	(6,310)	(2.0)	(4,970)	(2.1)	(6,620)	(3.7)
Consolidated revenue	\$ 315,175	100.0%	\$ 227,114	100.0%	\$ 179,658	100.0%

For information on segment operating income (loss), refer to Note 5 of the Notes to our Consolidated Financial Statements.

### *Individual Segment*

For individual investors, our largest product based on revenue is our U.S.-based Web site, Morningstar.com, which includes our Premium Membership service and sales of Internet advertising space. Morningstar is a leading provider of broad-based, innovative investment research, and Morningstar.com has received several positive reviews from major business publications such as *Barron's*, *Forbes*, and *The Wall Street Journal*. Our Individual business segment also includes Morningstar Equity Research, which we distribute through several channels. Investors can access our equity research through the Premium Membership service on Morningstar.com. Our independent equity research is currently distributed through six major investment banks to meet the requirement for independent research under the Global Analyst Research Settlement, which covers the five-year period ending in July 2009. In addition, we distribute our research to several other companies who provide our analyst reports and research to their affiliated financial advisors or to individual investors.

We also offer several print and online publications focusing on stocks, mutual funds, personal finance, and other investing topics. We sell several investment newsletters, including *Morningstar FundInvestor* and *Morningstar StockInvestor* and annual reference guides, including the *Morningstar Funds 500*, the *Morningstar Stocks 500*, the *Morningstar ETFs 150*, and the *Stocks, Bonds, Bills, and Inflation Yearbook*. Since we acquired Aspect Huntley in July 2006, this segment has also included several newsletters and other publications for Australian investors. In 2006, about 5% of Individual segment revenue was from outside of the United States.

We offer free local Web sites for individual investors in Australia, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Italy, Japan, Korea, the Netherlands, New Zealand, Norway, People's Republic of China, Spain, Sweden, Switzerland, Thailand, and the United Kingdom. Our Web sites and individual investor publications reach more than 5.2 million investors worldwide.

Within the Individual business segment, most of our products target experienced investors who are actively involved in the investing process and want to take charge of their own investment decisions. We also reach individuals who want to learn more about investing and investors who seek out third-party sources to validate the advice they receive from brokers or financial planners. Our client base in this segment consists of more than 260,000 paying customers, including 165,957 Premium members of Morningstar.com and 95,000 subscribers who purchase our investment newsletters designed for individual investors. In addition to this customer base, approximately 3,800 public and private libraries in the United States subscribe to our services. We also offer a series of books and workbooks about investing, as well as formatted printable reports on individual securities.

We promote our individual investor products primarily through traditional direct mail, e-mail, promotions on our 20 investor Web sites worldwide, public relations, and advertising on related Web sites.

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Our strategy is to increase the number of investors who sign up for Morningstar.com Premium Membership by continuing to develop and promote Premium content such as analyst reports, Fund Analyst Picks and Pans, and value-added portfolio tools, which we market to registered users and other investors. As a core marketing strategy for Morningstar.com, we use search marketing. This includes working to optimize our site's ranking in the search results that appear when users search for information about investing and purchasing advertisements on third-party sites such as Yahoo! and Google based on key words that can bring investors to relevant content on Morningstar.com.

In our Individual business segment, we compete with the personal finance Web sites of AOL Money & Finance, CNN Money, Google Finance, MarketWatch, MSN Money, The Motley Fool, SmartMoney.com, The Street.com, The Wall Street Journal Online, and Yahoo! Finance. Our print publications compete with Agora Publishing, Forbes, The Motley Fool, Phillips Investment Resources, and Value Line.

We believe our Individual segment has a modest amount of seasonality. The first quarter tends to show more sales activity for Premium Membership on Morningstar.com and other products such as our annual reference guides, including the *Stocks, Bonds, Bills, and Inflation Yearbook*. Sales in our Individual segment tend to be slightly lower over the spring and summer months. However, our

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diversified product base and recognizing revenue ratably over the term of each subscription moderates the impact of this seasonality.

Our largest customer in the Individual segment made up less than 10% of segment revenue in 2006.

### *Morningstar.com*

Our largest Web site for individual investors is Morningstar.com in the United States. As of December 31, 2006, the free membership services offered through Morningstar.com had more than 5.1 million registered users worldwide, who have access to comprehensive data on individual stocks, mutual funds, and other investments to help them conduct research and track performance. In addition, Morningstar.com features extensive market data, Morningstar articles, proprietary portfolio tools, and educational content to help investors of all levels access timely, relevant investment information. Morningstar.com also includes Portfolio X-Ray, which helps investors reduce risk and understand key characteristics of their portfolios, and a variety of other portfolio tools.

We use our free content as a gateway into paid Premium Membership, which includes access to written analyst reports on more than 1,800 stocks, 2,000 mutual funds, and 140 exchange-traded funds, as well as Analyst Picks and Pans, Stewardship Grades, and Premium Stock and Fund Screeners. We currently offer Premium Membership services only in the United States.

To help draw investors deeper into Morningstar.com, in 2006 we added more news, alerts, and video segments, mainly focusing on stocks. We also introduced a Personal Returns measure within Morningstar.com's Portfolio Manager tool to give investors a more accurate picture of their portfolios' investment performance after taking into account all transactions and fees.

As of December 31, 2006, we had 165,957 paid Premium subscribers for Morningstar.com. We currently charge \$15.95 for a monthly subscription, \$145 for an annual subscription, \$245 for a two-year subscription, and \$345 for a three-year subscription for Morningstar.com's Premium service. We also sell advertising space on Morningstar.com.

Morningstar.com is one of our five largest products based on revenue and was our largest product in the Individual segment in 2006. This product accounted for 9.9%, 11.2%, and 11.5% of our consolidated revenue in 2006, 2005, and 2004, respectively.

*Morningstar Equity Research*

As of December 31, 2006, we offered independent equity research on more than 1,800 companies. Our approach to stock analysis focuses on long-term fundamentals. Our analysts evaluate companies by assessing each firm's competitive advantage, analyzing the level of business risk, and completing an in-depth projection of future cash flows. For the companies we cover, we create an analyst-generated fair value estimate, a Morningstar Rating for stocks, a rating for business risk, and an assessment of the company's economic moat. Economic moat is a concept originally developed by Warren Buffett that describes a company's competitive advantage relative to other companies. For the remaining 5,500 stocks included in our database, we offer quantitatively generated grades for growth, profitability, and financial health, as well as an explanation of the company's business operations. We currently deliver our equity research to individual investors as part of our Premium Membership service on Morningstar.com and to six major investment banks under the terms of the Global Analyst Research Settlement, as well as to several other companies who provide our research to their affiliated financial advisors or to individual investors.

We have significantly expanded our equity research coverage over the past several years. We currently provide analyst reports on virtually all of the most widely held stocks in the S&P 500 index. Our coverage list includes more than 99% of the market value of the common shares outstanding for companies included in this market benchmark. We continue to expand our analyst staff to support these research efforts and had 95 stock analysts in the United States as of December 31, 2006, compared with 87 as of December 31, 2005.

We continue to focus on building our competitive advantage by expanding the breadth and depth of our equity coverage. As part of this effort, in 2006 we increased coverage of areas such as smaller-sized stocks, initial public offerings, non-U.S. stocks, and master limited partnerships. We also introduced a new discounted cash-flow (DCF) model for valuing banks in 2006. In addition, we established an analyst presence in London and Shenzhen and used this local expertise to begin covering companies based in Europe and China. We had 113 stock analysts worldwide as of December 31, 2006.

Pricing for Morningstar Equity Research that we deliver related to the Global Analyst Research Settlement or for other institutional clients varies based on the level of distribution, the number of securities covered, the amount of custom coverage required, and the



length of the contract term. Morningstar Equity Research, which primarily consists of research related to the Global Analyst Research Settlement, was the second-largest product in the Individual segment based on revenue in 2006, following Morningstar.com.

*Morningstar Mutual Funds*

*Morningstar Mutual Funds* is a reference publication that features our signature one-page reports on approximately 1,600 mutual funds. These reports contain historical performance data, portfolio statistics, proprietary measurement tools, and analyst reports. Twice a month, subscribers receive updated reports for approximately 160 of the covered funds, along with news, analyst commentary, industry research, and summary performance data for all 1,600 funds. Subscribers can also access a Web-based version for the most current information. We charge \$549 for a one-year subscription to *Morningstar Mutual Funds*.

*Morningstar FundInvestor*

*Morningstar FundInvestor* is a monthly newsletter that provides information and insight on 500 of the most popular mutual funds. It also includes a list of 175 Analyst Picks hand-selected funds that our analysts think are the most compelling for long-term investors. Each monthly issue contains extensive data, ideas on building better portfolios, news on current developments and changes within the fund industry, and proprietary research and ratings. *Morningstar FundInvestor* also features three mutual fund portfolios constructed and updated by Morningstar's senior analyst team. We charge \$99 for a one-year subscription to *Morningstar FundInvestor*.

*Morningstar StockInvestor*

*Morningstar StockInvestor* is a monthly newsletter that focuses on companies with strong competitive positions and stock prices that we believe are low enough to provide investors with a margin of safety. Each issue includes updates on two model portfolios: a Tortoise portfolio designed for conservative investors and a Hare portfolio designed for more risk-tolerant investors. Other key features include articles on international investing ideas, notes from company visits, bull/bear debates on high-profile companies, and the Morningstar Bellwether 50, a watch list of 50 dominant companies with wide economic moats, or competitive advantages. Each issue also offers ideas about how investors can improve their stock selection and learn from leading portfolio managers. We charge \$109 for a one-year subscription to *Morningstar StockInvestor*.

*Stocks, Bonds, Bills, and Inflation Yearbook*



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The *Stocks, Bonds, Bills, and Inflation Yearbook* is the definitive study of historical capital markets data in the United States. Used by advisors, financial planners, and brokers to analyze asset class performance, the yearbook contains total returns and index values dating back to 1926 for large and small company stocks, long-term corporate bonds, long- and intermediate-term government bonds, Treasury bills, and inflation. Optional reports supplement the yearbook on a monthly, quarterly, or semiannual basis. We charge \$120 for the annual book, or higher amounts for the optional updates.

In addition to the products described above, we offer several other investment newsletters and a series of books about investing in stocks and mutual funds, which are available directly from us and in bookstores. In response to greater investor interest in exchange-traded funds, we introduced a new newsletter, *Morningstar ETFInvestor*, in 2006. We also introduced a new annual softcover reference guide on exchange-traded funds, the *Morningstar ETFs 100*, which we've now expanded to become the *Morningstar ETFs 150*.

Following the Aspect Huntley acquisition, our Individual segment also includes several publications for investors in Australia, including *IFA Magazine*, Australia's leading magazine for independent financial advisors; *Your Money Weekly*, which focuses on the larger companies listed in Australia; and *Smaller Companies Guide*, a weekly newsletter with investment recommendations and portfolio ideas focusing on smaller-sized stocks.

### *Advisor Segment*

For financial advisors, our largest products based on revenue are Morningstar Advisor Workstation, a comprehensive Web-based investment planning system, and Principia, our CD-ROM-based investment research and planning software. We also offer Morningstar Managed Portfolios, a fee-based discretionary asset management program distributed exclusively through financial advisors. Our advisor products are integrated into the daily operations and research processes of many financial advisors who use our research and tools to provide guidance for individual investors. According to a report published in January 2005 by the consulting firm Tiburon Strategic Advisors, Morningstar was ranked as the leading provider of investment research and data, financial planning software, and asset allocation software among approximately 1,500 independent financial advisors surveyed.

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We sell our advisor-related products both directly to independent financial advisors and through enterprise licenses, which allow financial advisors associated with the licensing enterprise to use our products. Most of our license agreements in the Advisor segment have terms ranging from one to three years. As of December 31, 2006, we had established relationships with more than 170,000 financial advisors in the United States and approximately 40,000 financial advisors in international markets. Approximately 12% of our Advisor segment revenue was from international sales in 2006. In addition to the U.S. versions of our Advisor products, we offer products for financial advisors in a variety of other countries. For example, we have versions of Advisor Workstation tailored to markets in Asia, Australia, Canada, and Europe, and we offer a product similar to Principia in Canada.

Our products for advisors are sold primarily through our sales force, with promotional support from direct mail, online and print advertising, public relations, and conference exhibits. We also use the annual Morningstar Investment Conference to promote our offerings for advisors. We believe that there are opportunities to increase Advisor Workstation sales by attracting additional brokerage firms and investment advisors and increasing revenue per license from existing clients by expanding the amount of functionality licensed. We also plan to continue expanding our offerings for financial advisors outside the United States. Our primary competitors in the Advisor segment include Standard & Poor's, SunGard, and Thomson Financial Services. For Morningstar Managed Portfolios, our primary competitors are AssetMark, Brinker Capital, Envestnet PMC, Fundquest, and SEI Investments.

In the Advisor segment, sequential revenue growth tends to be higher in the second quarter because our annual investment conference is held in June. Sales for Financial Communications materials have also shown some seasonal patterns, with a relatively larger percentage of annual sales occurring in the first quarter. Other products in this segment generally have not shown marked seasonality.

Our largest customer in this segment accounted for less than 5% of segment revenue in 2006.

### *Morningstar Advisor Workstation*

Morningstar Advisor Workstation, a Web-based investment planning system, provides financial advisors with a comprehensive set of tools for conducting their core business including investment research, planning, and presentation. It allows advisors to build and maintain a client

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portfolio database that can be fully integrated with the firm's back-office technology and resources. Moreover, it helps advisors create customized reports for client portfolios that combine mutual funds, stocks, separate accounts, variable annuity/life subaccounts, exchange-traded funds, hedge funds, and closed-end funds. As of December 31, 2006, nearly 154,000 advisors in the United States were licensed to use Advisor Workstation, which is available in two editions: the Office Edition for independent financial advisors and the Enterprise Edition for financial advisors affiliated with larger firms. We generally charge \$5,000 per year for the Office Edition. Pricing for the Enterprise Edition varies based on the number of users, as well as the level of functionality offered, and generally ranges between \$80 and \$2,800 per licensed user.

In 2006, we introduced several new components for Advisor Workstation Enterprise Edition. These modules can be purchased as stand-alone products or combined as part of a full Workstation license and include:

Morningstar Retirement Income Strategist, a Web-based financial planning tool that helps advisors analyze retirement income for clients who are retired or nearing retirement. Retirement Income Strategist helps advisors analyze whether an individual's savings will last during retirement and explore alternative scenarios for sustaining income during retirement;

Retirement Income Education Center, a Web site offering educational content and tools about retirement income for financial advisors affiliated with institutions;

Morningstar Portfolio Builder, which provides advisors with a clearly defined step-by-step process for efficiently creating portfolio proposals to present to clients. Advisors can use Portfolio Builder to construct a portfolio with an appropriate investment mix based on preset asset allocation models and investments as well as a client's current holdings, risk tolerance, and other information;

A global version of our Hypothetical Illustrator tool, which helps advisors explain an investment or portfolio strategy to a client by analyzing past performance in relation to a benchmark or competing investment; and

529 Suitability Manager, which helps advisors create disclosure reports that communicate the fees and state tax benefits associated with 529 college savings plans.

In addition, we added portfolio accounting and reporting capabilities to Advisor Workstation Office Edition. The new system includes importing, portfolio tracking, performance reporting, and accounting functionality, and it allows financial advisors to easily merge client accounting reports with Morningstar's investment data and portfolio analytics. We also added hedge fund and offshore fund data to Advisor Workstation in 2006.

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Morningstar Advisor Workstation is one of our five largest products based on revenue and made up 13.7%, 12.9%, and 10.8% of our consolidated revenue in 2006, 2005, and 2004, respectively.

### *Morningstar Principia*

Principia is our CD-ROM-based investment research and planning software for financial planners and had 47,835 subscriptions as of December 31, 2006. The modules offered in Principia provide data on mutual funds, stocks, separate accounts, variable annuity/life subaccounts, exchange-traded funds, closed-end funds, and defined contribution plans. Each module is available separately or together in a CD-ROM format and features searching, screening, and ranking tools. Principia allows advisors to create integrated portfolios for clients and offers three-page Portfolio Snapshot reports that provide a comprehensive picture of the client's portfolio. The Snapshot report shows overall style and sector weightings as well as the cumulative exposure to individual stocks. The Snapshot report is among those approved by the National Association of Securities Dealers for financial advisors to distribute and review with their clients. Principia prices generally range from approximately \$635 per year for monthly updates on one investment database to \$2,925 per year for monthly updates on the complete package spanning all investment universes. Pricing for Principia Enterprise licenses varies based on the investment universes selected, level of functionality, and number of users and generally starts at about \$655 per user.

In 2006, we added a Variable Annuity Advanced module to the Principia product line, which provides additional policy-level information on each variable annuity contract in our database. This additional information became available through our acquisition of VARDS.

Principia is one of our five largest products based on revenue and accounted for 9.1%, 12.7%, and 16.3% of our consolidated revenue in 2006, 2005, and 2004, respectively.

### *Morningstar Managed Portfolios*

Morningstar Managed Portfolios is a fee-based discretionary asset management service that includes a series of mutual fund and exchange-traded fund portfolios tailored to meet specific investment time horizons and risk levels. This program is only available through financial advisors. Our team of investment professionals uses a disciplined process for asset allocation, fund selection, and portfolio construction. They actively monitor the portfolios and make adjustments as needed. We complement these asset management services with online client-management functions such as risk profiling and access to client statements, transaction capabilities, and performance reports.

We introduced the Morningstar Managed Portfolios program in 2001 and had approximately \$1.8 billion in assets under management as of December 31, 2006. We charge asset-based fees for Morningstar Managed Portfolios. The management fee is based on a tiered schedule that depends on the client's average daily portfolio balance and generally ranges from 0.20% to 0.40% of assets.

The Morningstar Managed Portfolios program is offered through Morningstar Investment Services, Inc., a registered investment advisor, registered broker-dealer, member of the National Association of Securities Dealers (NASD), and wholly owned subsidiary of Morningstar, Inc.

In addition to the products described above, we offer a series of NASD-reviewed Financial Communications materials that advisors can use to educate clients about asset allocation and demonstrate other key investment concepts. The materials include our SBBI Kit, which is a collection of presentation materials based on Ibbotson Associates' Stocks, Bonds, Bills, and Inflation research.

*Institutional Segment*

For institutional clients, our largest products and services based on revenue include:

Investment Consulting, which focuses on investment monitoring and asset allocation for funds of funds, including mutual funds and variable annuities;

Licensed Data, a set of investment data spanning 10 core databases, available through electronic data feeds;

Retirement Advice, including the Morningstar Retirement Manager and Advice by Ibbotson platforms;

Licensed Tools and Content, a set of online tools and editorial content designed for institutions to use in their Web sites and software;

Morningstar Direct, a Web-based institutional research platform that provides advanced research and tools on the complete range of securities in Morningstar's global database;

Investment Profiles & Guides, which are designed for institutions to use in communicating investment information to individual investors; and

Morningstar EnCorr, an asset allocation software package.

With the addition of Aspect Huntley, this segment now includes financial information as well as other data feeds on Australian stocks, which we sell to stock brokers, information providers, and financial Web sites. The Institutional segment also includes the hedge fund and separate account database division we acquired from InvestorForce.

As of December 31, 2006, we served approximately 1,700 clients through our Institutional segment, including banks, brokerage firms, insurance companies, mutual fund companies, media outlets, and retirement plan sponsors and providers. We believe our institutional clients value our independence, breadth of information, and customized services; in addition, we believe our research, tools, and advice reach many individual investors through this channel. Across the Institutional segment, we've established relationships with many of the largest companies in the financial services industry, including Fidelity, MetLife, Nationwide, and Prudential. Approximately 20% of our institutional sales are to clients located outside of the United States primarily in Australia, Canada, and various countries in Europe. We typically sell our institutional products based on a contract term of one to three years.

We market our products for institutional clients almost exclusively through our sales team. We provide marketing support for our sales team in the form of online and print advertising, public relations, direct mail, and conference exhibits. We also have data reselling agreements with third-party providers of investment tools and applications, allowing us to increase the distribution of our data with minimal additional cost.

For Licensed Data and Investment Profiles & Guides, our primary competitors are FactSet Research Systems, Lipper, Standard & Poor's, and Thomson Financial. For Morningstar Direct, our primary competitors are eVestment Alliance, Informa, Lipper, Strategic Insight, and Zephyr Management. Our Investment Consulting business competes primarily with Lipper, Standard & Poor's, and Wilshire, as well as some smaller competitors in the retirement consulting business. In the retirement advice market, we compete primarily with Financial Engines and Promanage.

Most products within our Institutional segment have not shown pronounced seasonality.

Our largest customer in the Institutional segment accounted for approximately 10% of segment revenue in 2006.

#### *Investment Consulting*

Our Investment Consulting area provides a broad range of services, many of which involve investment monitoring and asset allocation for funds of funds, including mutual funds and variable annuities. Our investment professionals evaluate investment plans, recommend strategies, help set investment policies, develop asset allocation programs, construct portfolios, and monitor ongoing performance. We offer these consulting services to clients in the United States, Asia, Australia,

Canada, and Europe, including insurance companies, investment management companies, mutual fund companies, and broker-dealers. We also provide services for retirement plan sponsors and providers, including developing plan lineups, creating investment policy statements, and monitoring investment performance.

Our team of investment consultants draws on both quantitative research tools and qualitative expertise to assess investment programs, provide detailed analysis of performance and portfolio characteristics, and make comprehensive recommendations for improvement. We also offer investment manager search services. Our staff combines the depth of Morningstar's historical fundamental databases with detailed investment knowledge and investment experience to recommend qualified candidates for subadvisory firms, mutual fund managers, variable insurance trust managers, and separate account managers. Our investment monitoring services include analyst reports, customizable board reports, select lists, watch lists, and in-depth attribution analysis. Pricing for our consulting services is based on the scope of work and the level of service required. For agreements where we act as a portfolio construction manager for a mutual fund or variable annuity, we receive asset-based fees.

In 2006, we introduced a customized, discretionary portfolio management and oversight service for foundations and endowments. The new program is designed to serve mid-sized foundations and endowments with less than \$1 billion in assets.

Also in 2006, we significantly expanded our Investment Consulting business when we acquired Ibbotson. Ibbotson's Investment Consulting unit is a leading authority on asset allocation and draws on its knowledge of capital markets and portfolio building to construct portfolios from the top down, starting at the asset class level. Ibbotson develops customized asset allocation programs for mutual fund firms, banks, broker-dealers, and insurance companies. The group offers consulting services and funds-of-funds subadvisory services, as well as tailored model portfolios, fund classification schemes, and questionnaire design.

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We offer our Investment Consulting services primarily through Morningstar Associates, LLC and Ibbotson Associates, Inc., which are registered investment advisors and wholly owned subsidiaries of Morningstar, Inc.

Investment Consulting is currently our largest product based on revenue and accounted for 14.8%, 9.6%, and 7.7% of our consolidated revenue in 2006, 2005, and 2004, respectively.

### *Licensed Data*

Our Licensed Data service gives institutions access to a set of proprietary investment data spanning 10 core databases. The data packages we offer include proprietary statistics, such as the Morningstar Style Box and Morningstar Rating, and a wide range of other data, including information on investment performance, risk, portfolios, operations data, fees and expenses, cash flows, and ownership. Institutions can use Licensed Data in a variety of investor communications, including Web sites, print publications, and marketing fact sheets, as well as for internal research and product development. We deliver Licensed Data through electronic data feeds and provide daily updates to clients. Pricing for Licensed Data is based on the number of funds or other securities covered, the amount of information provided for each security, and the level of distribution.

In 2006, we expanded our data offerings to include prospectus summaries, the Morningstar Ownership Zone, pension and life funds based in the United Kingdom, and historical asset class returns from Ibbotson's Stocks, Bonds, Bills, and Inflation database.

Licensed Data is one of our five largest products based on revenue and accounted for 12.0%, 14.3%, and 15.1% of our consolidated revenue in 2006, 2005, and 2004, respectively.

### *Retirement Advice*

Our Retirement Advice offering includes the Morningstar Retirement Manager and Advice by Ibbotson platforms, which both provide advice and guidance to help retirement plan participants plan and invest for retirement.

Morningstar Retirement Manager is designed to help retirement plan participants determine how much to invest and which investments are most appropriate for their portfolios. It gives clear guidance explaining whether participants' suggested plans are on target to meet their retirement goals. As part of this service, we deliver personalized recommendations for a target savings goal, a recommended contribution rate to help achieve that goal, a portfolio mix based on risk tolerance, and specific fund recommendations. Morningstar Retirement Manager includes a managed account service designed for plan participants who choose to delegate management of their portfolios to Morningstar's investment professionals. We offer these services primarily through retirement plan providers—typically third-party asset management companies or companies that offer administrative services to retirement plans. These providers often offer proprietary mutual funds to retirement plan sponsors and their participants. As of December 31, 2006, more than 9 million plan participants had access to Morningstar Retirement Manager through approximately 71,000 plan sponsors and 24 plan providers. Pricing for Morningstar Retirement Manager depends on the number of participants, as well as the level of service we provide.



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Advice by Ibbotson offers a set of services and proprietary software to give retirement plan participants access to investment education, self-service advice, and managed retirement accounts. We offer these services mainly through retirement plan providers. The platform includes installed software advice solutions that can be co-branded by retirement plan sponsors and providers. Advice by Ibbotson combines asset allocation and human capital methodologies (patent pending) that help participants determine how to prepare for retirement based on their financial assets as well as their future earnings and savings power. Advice by Ibbotson's customized software can be integrated with existing systems to help investors accumulate wealth, transition into retirement, and manage income during retirement. As of December 31, 2006, nearly 8 million plan participants had access to Advice by Ibbotson through approximately 37,000 plan sponsors and seven plan providers. Pricing for Advice by Ibbotson depends on the number of participants, as well as the level of service we provide.

We offer our Retirement Advice services primarily through Morningstar Associates, LLC and Ibbotson Associates, Inc., which are registered investment advisors and wholly owned subsidiaries of Morningstar, Inc.

### *Licensed Tools and Content*

We offer an extensive set of online tools and editorial content that institutional clients can license to use in their Web sites and software products. Clients can select from more than 40 different tools and content offerings or purchase modules focusing on

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screening and performance tools, editorial commentary and educational articles, or goal planning and portfolio analysis. Our online tools and content can be customized to meet the needs of international audiences, and can also be modified to analyze a set of investments, focus on client-defined data points, or perform calculations required by specific products or services. We also offer licenses for investment research and portfolio analysis tools. Licensed Tools and Content can be integrated with a client's existing Web site and allows users to drill down into the underlying data when researching a potential investment.

In 2006, we added a series of proprietary Morningstar Stock Charts that are available for license. Clients can use these charts to track price movements, perform fundamental analysis, and evaluate technical aspects of stocks such as volume, momentum, and trends.

Pricing for Licensed Tools and Content depends on the audience, the level of distribution, and the scope of information and functionality licensed.

### *Morningstar Direct*

Morningstar Direct is a Web-based institutional research platform that provides advanced research on the complete range of securities in Morningstar's global database. This comprehensive research platform allows research and marketing professionals to conduct advanced performance comparisons and in-depth analyses of a portfolio's underlying investment style. Morningstar Direct includes access to numerous investment universes, including U.S. mutual funds; European and offshore funds; funds based in most major markets around the world; stocks; separate accounts; global hedge funds; closed-end funds; exchange-traded funds; global equity ownership data; variable annuity and life portfolios; and market indexes.

In 2006, we launched a new version of Morningstar Direct that included expanded information on U.S. stocks, a global stock ownership database, hedge fund firm portfolio information, hedge fund analyst reports, and an expanded European mutual fund database. We also added several news feeds and a library of pre-formatted graphs and data tables that users can incorporate into their investment fact sheets. We continued to expand our sales efforts outside the United States in 2006. Morningstar Direct had 1,348 licensed users worldwide as of December 31, 2006.

Pricing for Morningstar Direct is based on the number of licenses purchased. We charge \$15,000 for the first user, \$10,000 for the second user, and \$7,500 for each additional user.

### *Investment Profiles & Guides*

Our Investment Profiles & Guides are designed for institutions to use as an alternative to creating their own materials for communicating with clients, or for companies to use in communicating with retirement plan participants. Investment Profiles are single-page reports that combine key elements from our data, design, and editorial content to clearly present the essential facts about an investment. They cover mutual funds, stocks, exchange-traded funds, hedge funds, variable annuity/life subaccounts, separate accounts, custom funds, offshore funds, pension and life funds, and Section 529 College Savings Plans. We also offer Investment Guides, which are a collection of Investment Profiles combined with summary information and educational articles. Morningstar handles all of the document production, including data collection, design, and delivery. Investment Profiles & Guides are available in multiple languages both in print and online, and can be delivered as a stand-alone communication

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vehicle or through Morningstar Retirement Manager.

Pricing for Investment Profiles and Investment Guides is based on the number of securities covered, the amount of information we provide, and the level of distribution.

### *Morningstar EnCorr*

Morningstar EnCorr, which became part of our Institutional segment following the Ibbotson acquisition, is an asset allocation software platform that helps institutional clients create, analyze, and implement asset allocation strategies. This advanced research tool allows investment professionals to develop recommendations and produce portfolios at various risk/reward tradeoffs along the efficient frontier, which is a visual representation of the asset mixes that deliver the higher return per unit of risk. EnCorr incorporates historical data analysis, strategic asset allocation, forecasting, returns-based style analysis, portfolio attribution, and advanced statistical and graphical analyses. Target clients include analysts, investment consultants, registered investment advisors, and portfolio managers.

Pricing for EnCorr is based on the number of licenses purchased. We charge \$10,000 for the first user and \$3,000 for each additional user.

### *Morningstar Indexes*

Based on the same methodology as the Morningstar Style Box, our 33 real-time indexes track the U.S. equity market by capitalization and investment style. They include a broad market index, three capitalization-based indexes, three composite style indexes, nine indexes based on investment style and market capitalization, 15 sector indexes, and two dividend indexes. The Morningstar Indexes cover approximately 97% of the market capitalization of the U.S. equity market. We charge licensing fees for the Morningstar Indexes, with fee levels varying by client.

Barclays Global Investors licenses our 16 style-based indexes and has introduced nine exchange-traded funds (ETFs) based on the Morningstar Indexes.

In 2006, we created the Morningstar Dividend Leaders Index, a broadly diversified portfolio of 100 stocks that have strong potential for sustaining and increasing dividend payouts. First Trust Advisors L.P. licenses the Dividend Leaders Index and introduced an exchange-traded fund based on this index in February 2006.

We are in the process of developing a series of commodity indexes, which we plan to introduce in 2007. We are also planning to launch a family of fixed-income indexes, the Morningstar Fixed-Income Indexes, which can serve as tools for portfolio benchmarking and performance measurement. These indexes can also be licensed to institutions for creating investment vehicles, including mutual funds, exchange-traded funds (ETFs), and derivative securities. We plan to launch these indexes in stages beginning in 2007, with the first indexes covering the core fixed-income categories of U.S. Treasury and corporate bonds.

### **Marketing and Sales**

We promote our print, software, Web-based products and services, and consulting services with a staff of sales and marketing professionals, as well as public relations. Our marketing staff includes both product specialists and a corporate marketing group that manages company initiatives. As part of these groups, we have several strategic account managers who oversee all aspects of our largest institutional client relationships. We also have a sales operations staff, which focuses on tracking revenue, forecasting sales, and other tasks to support our sales team. Across all three of our segments, we emphasize high levels of product support to help our customers use our products effectively and provide our product managers with feedback from customers. We had approximately 200 sales and marketing professionals on staff as of December 31, 2006.

### **International Operations**

We conduct our business operations outside of the United States through wholly owned or majority-owned operating subsidiaries doing business in each of the following markets: Australia, Canada, France, Germany, Italy, Japan, the Netherlands, New Zealand, Norway, People's Republic of China (both Hong Kong and the mainland), Spain, Taiwan, Thailand, and the United Kingdom. See Note 5 of the Notes to our Consolidated Financial Statements for additional information concerning revenue from customers and long-lived assets from our business operations outside the United States. See Note 16 of the Notes to our Consolidated Financial Statements for information on a legal proceeding that may, if decided adversely to us, affect our ownership of our Australian and New Zealand subsidiaries.

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In addition, we hold minority ownership positions in operating companies based in Denmark, Japan, Korea, and Sweden. As of December 31, 2006, we owned approximately 35% of the outstanding shares in Morningstar Japan K.K. (Morningstar Japan) and our share had a market value of approximately \$85.5 million. Morningstar Japan is publicly traded under ticker 4765 on the Osaka Stock Exchange Hercules Market. See Note 8 of the Notes to our Consolidated Financial Statements for information on our investments in unconsolidated entities.

To enable these companies to do business in their designated territories, we provide them with the rights to the Morningstar name and logo and with access to certain of our products and technology. Each company operating within a particular country is responsible for developing marketing plans tailored to meet the specific needs of investors within its own market and working with Morningstar's data collection and development centers to create and maintain databases, develop new products, and enhance existing products.

See Item 1A Risk Factors for a discussion of the risks related to our business operations outside of the United States.

### **Intellectual Property and Other Proprietary Rights**

We treat our brand, product names and logos, software, technology, databases, and other products as proprietary. We try to protect this property by using trademark, copyright, patent and trade secrets laws, licensing and nondisclosure arrangements, and other security measures. For example, in the normal course of business, we only provide our intellectual property to third parties through standard

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licensing agreements. The purposes of these agreements are to both define the extent and duration of any third-party usage rights and to provide for our continued ownership in any intellectual property furnished.

Because of the value of our brand name and logo, we have tried to register one or both of them in all of the relevant international classes under the trademark laws of most of the jurisdictions in which we do business. As we move into new countries, we are continuing to effect these registrations and, in some jurisdictions, the registration of certain product identifiers as well. To date, we have registered our name and/or logo in 12 countries and the European Union and have applied for registrations in several other countries.

We currently hold three U.S. patents, one U.K. patent, and one Canadian patent. We believe these patents represent our commitment to developing innovative products and tools for investors.

From time to time, we encounter jurisdictions in which one or more third parties have a pre-existing trademark registration in certain relevant international classes that may prevent us from registering our own marks in those jurisdictions. It is possible that our continued ability to use the Morningstar name or logo, either on a stand-alone basis or in association with certain products or services, could be compromised in those jurisdictions because of these pre-existing registrations. Similarly, from time to time, we encounter situations in certain jurisdictions where one or more third parties are already using the Morningstar name, either as part of a registered corporate name, a registered domain name or otherwise. It is possible that our ability to continue to effectively market certain of our products and/or services could be adversely affected by these usages.

Morningstar and the Morningstar logo are registered marks of Morningstar in the United States and in certain other jurisdictions. The following are also trademarks or service marks of our company in the United States:

Advice by Ibbotson®	Morningstar® Managed Portfolios <sup>SM</sup>
Morningstar® Advisor Workstation <sup>SM</sup>	Morningstar® Mutual Funds <sup>TM</sup>
Morningstar.com®	Morningstar® Ownership Zone <sup>SM</sup>
Morningstar Direct <sup>SM</sup>	Morningstar® Portfolio Builder <sup>SM</sup>
Morningstar® EnCorr®	Morningstar® Principia®
Morningstar® Equity Research	Morningstar Rating <sup>TM</sup>
Morningstar® ETFInvestor <sup>TM</sup>	Morningstar® Retirement Income Strategist <sup>SM</sup>
Morningstar® ETFs 150 <sup>TM</sup>	Morningstar® Retirement Manager <sup>SM</sup>
Morningstar® FundInvestor <sup>TM</sup>	Morningstar® Stewardship Grade <sup>SM</sup>
Morningstar® Funds 500 <sup>TM</sup>	Morningstar® StockInvestor <sup>TM</sup>
Morningstar® Indexes <sup>SM</sup>	Morningstar® Stocks 500 <sup>TM</sup>
Morningstar® Investment Guides <sup>TM</sup>	Morningstar Style Box <sup>TM</sup>
Morningstar® Investment Profiles <sup>TM</sup>	Portfolio X-Ray®
Morningstar® Licensed Data <sup>SM</sup>	Stocks, Bonds, Bills, and Inflation®

### *License Agreements*

In the majority of our licensing agreements, we license our products and/or other intellectual property to our customers for a fee. We generally use our standard agreements, whether in paper or electronic form, and we do not provide our products and services to customers or other users without having an agreement in place.

We also maintain licensing agreements with each of our minority-owned operations. We put these agreements in place so these companies can use our intellectual property, such as our products and trademarks, to develop and market similar products under our name in their operating territories.

We also license certain intellectual property from third parties, and in the ordinary course of our business, we incorporate and use intellectual property from a variety of third-party sources.

### **Seasonality**

We believe our business has a modest amount of seasonality. Most of our products are sold with subscription or license terms of at least one year, and we recognize revenue ratably over the term of each subscription or license agreement. This tends to moderate seasonality in sales patterns for individual products. Over the past three years, sequential revenue growth at the company level on a consolidated basis in the first quarter has been slightly higher than in other quarters. Refer to the discussion in Business Segments, Products, and Services above for additional information on the seasonality of each segment.

## **Customers**

In 2006, our largest customer accounted for less than 5% of our consolidated revenue.

## **Competitive Landscape**

The economic and financial information market has been marked by increased consolidation over the past five years, with the strongest players generally gaining market share at the expense of smaller competitors. Our largest competitors are Lipper, Standard & Poor's, and Thomson Financial Services. These companies have financial resources that are significantly greater than ours. We also have a number of smaller competitors in each of our three business segments; for more information, refer to the discussion in Business Segments, Products, and Services above. Most of our competitors compete with individual products or segments of our business; we are not aware of any company that offers substantially similar product solutions in all three of our segments.

Our non-U.S. operations compete with a variety of other companies not named above, including IWL Limited, MoneyMate, and van Eyk Research.

We believe the most important competitive factors in our industry are brand and reputation, data quality and comprehensiveness, quality of investment analysis and analytics, design, reliability, product support capabilities, and value of the products and services provided.

## **Research and Development**

A key aspect of our growth strategy is to expand our investment research capabilities and enhance our existing products and services. We strive to rapidly adopt new technology that can improve our products and services. We have also built a flexible technology platform that allows our products to work together across a full range of investment databases, delivery formats, and market segments. As a general practice, we manage our own Web sites and build our own software applications rather than relying on outside vendors. This allows us to control our development and better manage costs, enabling us to respond quickly to market changes and to meet customer needs efficiently. As of December 31, 2006, our technology team consisted of approximately 340 programmers and technology and infrastructure professionals.

In 2006, 2005, and 2004, our development expense represented 9.4%, 8.7%, and 9.0%, respectively, of our revenue. We expect that development expense will continue to represent a meaningful percentage of our revenue in the future.

## **Government Regulation**

*United States*



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Our investment advisory and broker-dealer businesses are subject to extensive regulation in the United States at both the federal and state level, as well as by self-regulatory organizations. Financial services companies are among the nation's most extensively regulated. The Securities and Exchange Commission (SEC) is responsible for enforcing the federal securities laws and serves as a supervisory body for all federally registered investment advisors and broker-dealers.

As of December 31, 2006, four of our subsidiaries, Ibbotson Associates, Inc., Ibbotson Associates Advisors, LLC, Morningstar Associates, LLC, and Morningstar Investment Services, Inc. are registered as investment advisors with the SEC under the Investment Advisers Act of 1940 (Advisers Act). As registered investment advisors, these companies are subject to the requirements and regulations of the Advisers Act. Such requirements relate to, among other things, record-keeping and reporting requirements, disclosure requirements, and limitations on principal transactions between an advisor and advisory clients, as well as general anti-fraud prohibitions.

Because Morningstar Associates and Ibbotson Associates provide investment advisory services to retirement plans and their participants, they may be acting as fiduciaries under the Employee Retirement Income Security Act of 1974 (ERISA). As fiduciaries under ERISA, Morningstar Associates and Ibbotson Associates have duties of loyalty and prudence, as well as duties to diversify investments and to follow plan documents to the extent that they comply with ERISA.

We provide each of our investment advisor companies with financial and operational support. However, each of them operates independently from other areas of Morningstar, using separate personnel and making independent investment decisions.

Morningstar Investment Services is a broker-dealer registered under the Securities Exchange Act of 1934 (Exchange Act) and a member of the National Association of Securities Dealers (NASD). The regulation of broker-dealers has, to a large extent, been delegated by the federal securities laws to self-regulatory organizations, including the NASD. Subject to approval by the SEC, the

NASD adopts rules that govern its members. The NASD conducts periodic examinations of the operations of Morningstar Investment Services. Broker-dealers are subject to regulations that cover all aspects of the securities business, including sales practices, market making and trading among broker-dealers, use and safekeeping of clients' funds and securities, capital structure, record-keeping, and the conduct of directors, officers, and employees. Violation of applicable regulations can result in the revocation of a broker-dealer license, the imposition of censures or fines, and the suspension or expulsion of a firm or its officers or employees. Morningstar Investment Services is subject to certain net capital requirements under the Exchange Act. The net capital requirements, which specify minimum net capital levels for registered broker-dealers, are designed to measure the financial soundness and liquidity of broker-dealers.

Additional legislation and regulations, including those relating to the activities of investment advisors and broker-dealers, changes in rules imposed by the SEC or other U.S. or non-U.S. regulatory authorities and self regulatory organizations, or changes in the interpretation or enforcement of existing laws and rules may adversely affect our business and profitability. Our businesses may be materially affected not only by regulations applicable to it as an investment advisor or broker-dealer, but also by regulations that apply to companies generally.

#### *Australia*

In order to provide financial information services in Australia, our Australian subsidiaries, Morningstar Research Pty Limited (Morningstar Australia) and Huntley's Investment Information Pty Limited, must hold an Australian Financial Services License and submit to the jurisdiction of the Australian Securities and Investments Commission (ASIC). This license requires Morningstar Australia and Huntley's Investment Information Pty Limited to maintain positive net asset levels and sufficient cash resources to cover three months of expenses and to comply with the audit requirements of the ASIC. The availability of this license may be adversely affected by the legal proceeding described in Note 16 of the Notes to our Consolidated Financial Statements.

#### *United Kingdom*

Morningstar Associates Europe Limited is authorized and regulated by the Financial Services Authority as an investment advisor. As an authorized firm, this company is subject to the requirements and regulations of the Financial Services Authority. Such requirements relate to, among other things, financial reporting and other reporting obligations, record keeping, and cross-border requirements.

#### **Employees**

We had approximately 1,440 employees as of December 31, 2006, including approximately 220 investment analysts, 180 data analysts, 340 programmers and technology staff, 30 designers, and 200 sales and marketing professionals. Our employees are not represented by any unions and we have never experienced a walkout or strike.

#### **Executive Officers**

As of December 31, 2006, we had 15 executive officers. The table below summarizes information about each of these officers.

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<b>Name</b>	<b>Age</b>	<b>Position</b>
Joe Mansueto	50	Chairman, Chief Executive Officer, and Director
Tim Armour	58	Managing Director
Chris Boruff	41	President, Advisor Business
Peng Chen	36	President and Chief Investment Officer, Ibbotson Associates
Bevin Desmond	40	President, International Business
Martha Dustin Boudos	40	Chief Financial Officer
Catherine Gillis Odelbo	44	President, Individual Business
Tao Huang	44	Chief Operating Officer
Elizabeth Kirscher	42	President, Data Services Business
Art Lutschaunig	48	President and Chief Investment Officer, Morningstar Investment Services
Don Phillips	44	Managing Director and Director
Patrick Reinkemeyer	41	President, Morningstar Associates
John Reenthaler	46	Vice President, Research and New Product Development
Richard E. Robbins	44	General Counsel and Corporate Secretary
David W. Williams	46	Managing Director, Design

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### *Joe Mansueto*

Joe Mansueto founded Morningstar in 1984. He has served as our chairman since our inception and as our chief executive officer from our inception to 1996 and from 2000 to the present. He holds a bachelor's degree in business administration from The University of Chicago and a master's degree in business administration from The University of Chicago Graduate School of Business.

### *Tim Armour*

Tim Armour has been one of our managing directors since 2000. He is responsible for strategic relationships and business development. He joined us in 1998 as our chief operating officer and from 1999 to 2000 served as our president. He holds a bachelor's degree in business administration from Gettysburg College and a master's degree in business administration from the Columbia Business School at Columbia University.

### *Chris Boruff*

Chris Boruff has been the president of our advisor business since 2000. He is responsible for overseeing strategy, development, and marketing associated with our products for financial advisors. He joined us in 1996 as product manager for Principia, and from 1997 to 1998, he served as senior product manager of advisor products. From 1999 to 2000, he served as vice president of advisor products, where he was responsible for all marketing related to financial advisors. He holds a bachelor's degree in economics and psychology from Northwestern University.

### *Peng Chen*

Peng Chen has been president and chief investment officer of Ibbotson Associates since August 2006. Prior to Morningstar's acquisition of Ibbotson, he served as its managing director and chief investment officer. He joined Ibbotson in 1997 and played a key role in the development of its investment consulting and 401(k) advice/managed retirement account services. He received a bachelor's degree in industrial management engineering from Harbin Institute of Technology and a master's and doctorate in consumer economics from The Ohio State University.

### *Bevin Desmond*

Bevin Desmond has been president of our international business since 2000. She is responsible for identifying and developing new markets, managing and directing operations, and launching new products. She joined us in 1993 and was one of three employees who started our international business. From 1998 to 2000, she served as manager of all international ventures. She holds a bachelor's degree in psychology from St. Mary's College.

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### *Martha Dustin Boudos*

Martha Dustin Boudos has been our chief financial officer since 2001. She oversees our finance, human resources, and accounting operations. She joined us in 1992 as a marketing manager. She also played a key role in the creation of our Web site for individual investors, Morningstar.com. From 1998 to 2000, she was responsible for our retirement advice service. During 2001, she served as our vice president of human resources. She holds a bachelor's degree in political science from Wellesley College and a master's degree in business administration from the Kellogg School of Management at Northwestern University.

In March 2007, we announced that Martha will be taking on a new role in the company. We are in the process of searching for a new chief financial officer, and Martha will remain chief financial officer until we name a replacement.

### *Catherine Gillis Odelbo*

Catherine Gillis Odelbo has been president of our Individual segment since 2000. She joined us in 1988 as a mutual fund analyst and from 1999 to 2000 served as senior vice president of content development for the company, as well as publisher and editor of our stock and closed-end fund research. She holds a bachelor's degree in American history from The University of Chicago and a master's degree in business administration from The University of Chicago Graduate School of Business.

### *Tao Huang*

Tao Huang has been our chief operating officer since 2000. He is responsible for corporate strategy, oversight of all business units, and directing our day-to-day operations. He joined us in 1990 as a software developer and from 1996 to 1998 served as chief technology officer. From 1998 to 2000, he served as senior vice president of business development and head of international

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operations. He holds a bachelor's degree in computer science from Hunan University in China, a master's degree in computer science from Marquette University, and a master's degree in business administration from The University of Chicago Graduate School of Business.

### *Elizabeth Kirscher*

Elizabeth Kirscher has been president of our data services business since 2000. She is responsible for managing our investment databases and related products. She joined us in 1995 as a major accounts manager in our institutional sales area. From 1998 to 1999, she served as international product manager and worked on the launch of Morningstar Japan. From 1999 to 2000, she was director of sales and business development for Morningstar.com and marketed Morningstar.com data and tools to other Web sites. She holds a bachelor's degree from Vassar College and a master's degree in business administration from the Columbia Business School at Columbia University.

### *Art Lutschaunig*

Art Lutschaunig has been president and chief investment officer for Morningstar Investment Services since August 2001. He is responsible for managing the investment services business, including oversight of the group's investment research and portfolio management. Before joining us in May 2001, he was an independent consultant. From 2000 to 2001, he served as president of Giving Capital, Inc. He holds a bachelor's degree in marketing from Villanova University.

### *Don Phillips*

Don Phillips has been one of our managing directors since 2000. He is responsible for corporate strategy, research, and corporate communications. He joined us in 1986 as our first analyst. He served as our vice president and publisher from 1991 to 1996, as our president from 1996 to 1998, and as our chief executive officer from 1998 to 2000. He has served on our board of directors since August 1999. He also serves on the board of directors for Morningstar Japan. He holds a bachelor's degree in English from the University of Texas and a master's degree in American literature from The University of Chicago.

### *Patrick Reinkemeyer*

Patrick Reinkemeyer has been president of Morningstar Associates since October 2004. He is responsible for Morningstar's investment consulting and retirement businesses. From 2001 until October 2004, he served as president of Morningstar's institutional investment consulting business. He joined us in 1996. From 1996 to 1997, he directed our print and software variable annuity/life products. He holds a bachelor's degree in history from Middlebury College and a master's degree in business administration from The University of Chicago Graduate School of Business.

### *John Rekenhaller*

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John Rekenhaller has been vice president of new product development since October 2004. In April 2005, he took on additional responsibilities as vice president of research. From 2001 until October 2004, he served as president of Morningstar Associates and head of the company's retirement advice business. He joined us in 1988 as an assistant editor. From 1991 to 1995, he served as editor of *Morningstar Mutual Funds* and *Morningstar FundInvestor*. From 1998 to 2000, he served as our director of research. He holds a bachelor's degree in English from the University of Pennsylvania and a master's degree in business administration from The University of Chicago Graduate School of Business.

### *Richard E. Robbins*

Richard E. Robbins has been our general counsel and corporate secretary since August 2005. He is responsible for directing Morningstar's legal department and managing its relationships with outside counsel. From May 1999 until he joined Morningstar, he was a partner at Sidley Austin LLP, which he joined as an associate in August 1991. He holds bachelor's and master's degrees in computer science and electrical engineering from the Massachusetts Institute of Technology and a juris doctor degree from The University of Chicago Law School.

### *David W. Williams*

David W. Williams has been one of our managing directors since 2000. He is in charge of design and its application to brand identity, products, communications, and the workplace. He joined us in 1993 and has been instrumental in establishing design as one of our recognized core capabilities. He holds a bachelor's degree in industrial design from The Ohio State University and a master's degree in fine arts from the Yale University School of Art.

## Company Information

We were incorporated in Illinois on May 16, 1984. Our corporate headquarters are located at 225 West Wacker Drive, Chicago, Illinois, 60606.

We maintain a Web site at <http://corporate.morningstar.com>. Our Annual Report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to any of these documents are available free of charge on this site as soon as reasonably practicable after the reports are filed with or furnished to the Securities and Exchange Commission. We also post quarterly press releases on our financial results and other documents containing additional information related to our company on this site. We provide this Web site and the information contained in or connected to it for informational purposes only. That information is not part of this Annual Report on Form 10-K.

## Item 1A. Risk Factors

You should carefully consider the risks described below and all of the other information included in this Form 10-K when deciding whether to invest in our common stock or otherwise evaluating our business. If any of the following risks actually occur, our business, financial condition, or operating results could suffer. In this case, the trading price of our common stock could decline, and you may lose all or part of your investment.

### *Competition could reduce our share of the investment research market and hurt our financial performance.*

We operate in a highly competitive industry, with many investment research providers competing for business from individual investors, financial advisors, and institutional clients. We compete with many different types of companies that vary in size, product scope, and media focus, including large and well-established distributors of financial information, such as Lipper, a division of Reuters; The McGraw-Hill Companies, through its Standard & Poor's division; and Thomson Corporation, through its Thomson Financial Services division. In addition to these key competitors, we compete with a variety of other companies in different areas of our business, which we discuss in greater detail in the Business Segments, Products, and Services section in Item 1 Business.

Many of our competitors have larger customer bases and significantly greater resources than we do. This may allow these competitors to respond more quickly to new technologies and changes in demand for products and services, to devote greater resources to developing and promoting their services, and to make more attractive offers to potential clients, subscribers, and strategic partners. Industry consolidation may also lead to more intense competition. Increased competition could result in price reductions, reduced gross margins, or loss of market share, any of which could hurt our business, operating results, or financial condition.

### *If we do not maintain and increase the number of subscriptions and license agreements, our operating results could suffer.*

A substantial portion of our revenue is generated from subscriptions and license agreements. In 2006, walk-in revenue, which we define as revenue from licenses or subscriptions that were in place at the beginning of the year adjusted for cancellations, currency translations,



and other routine adjustments during the year, accounted for 47.5% of our revenue excluding 2006 acquisitions. Renewal revenue, which we define as revenue from renewals of licenses or subscriptions, accounted for 36.3% of our revenue excluding 2006 acquisitions. In general, our subscriptions are paid in advance. We may be obligated to refund a portion of prepaid subscription fees when a customer cancels. Cancellations may have a negative impact on our revenue and cash position. Our license agreements, which typically do not allow for cancellation, have terms ranging from one to three years. As of January 1, 2007, we had subscriptions and license agreements in place that were expected to generate \$182.9 million of revenue in 2007, including \$21.2 million of walk-in revenue from 2006 acquisitions. In 2006 and 2005, cancellations reduced walk-in revenue by between 2% and 4%. Our future success depends on our maintaining (through renewals) and increasing (through new subscriptions and license agreements) the number of customers who pay for our investment research and services. Further, if the market for our products and services develops more slowly than we expect, or declines, and the number of customers who pay for our services does not increase, or declines, our business, operating results, or financial condition could suffer.

*The availability of free or low-cost investment information could lead to lower demand for our products and adversely affect our financial results.*

Investment research and information relating to publicly traded companies and mutual funds is widely available for little or no cost from various sources, including the Internet and public libraries. Investors can also access information directly from publicly traded companies and mutual funds. The EDGAR database available through the Securities and Exchange Commission (SEC) Web site provides real-time access to SEC filings, including annual, semi-annual, and quarterly reports. Many brokerage firms also provide financial and investment research to their clients. The widespread availability of free or low-cost investment information may make it

difficult for us to maintain or increase the prices we charge for our publications and services and could lead to a lower demand for our products. A loss of a significant number of customers would hurt our financial results.

***Certain products and services have historically made up a large percentage of our revenue base. Our business could suffer if sales of these products and services decline.***

In 2006, our five largest products based on revenue (Investment Consulting, Morningstar Advisor Workstation, Licensed Data, Morningstar.com and Principia) accounted for a combined 59.5% of our consolidated revenue. We believe that sales of these products and services will continue to make up a substantial portion of our consolidated revenue for the foreseeable future. If we experience a significant decline in sales of any of these products for any reason, it would have a material adverse impact on our revenue and could harm our business. The independent equity research we are providing to six investment banks under the terms of the Global Analyst Research Settlement accounted for a significant portion of our consolidated revenue in 2006. The period during which investment banks are required to provide independent equity research to their clients will expire in July 2009. We cannot guarantee that we will retain or replace this equity research revenue after that date. Because these contracts include both renewal and cancellation options and the firms named in the settlement are free to choose from a variety of research providers, we also cannot guarantee that we will retain this business for any period prior to July 2009.

***Our investment advisory operations may subject us to liability for any losses that result from a breach of our fiduciary duties.***

Our investment advisory operations involve fiduciary obligations that require us to act in the best interests of our clients. We may face liabilities for actual or claimed breaches of our fiduciary duties. We may not be able to prevent clients from taking legal action against us for an actual or claimed breach of a fiduciary duty. Because we currently provide investment advisory services on substantial assets, we could face substantial liability to our clients if we breach our fiduciary duties. In addition, we may face other legal liabilities based on the quality and outcome of our investment advisory recommendations, even in the absence of an actual or claimed breach of fiduciary duty.

***Changes in laws applicable to our investment advisory operations, compliance failures, or regulatory action could adversely affect our business.***

Our investment advisory operations are relatively new and a growing part of our overall business. Our acquisition of Ibbotson Associates in 2006 substantially increased our business in this area. The securities laws and other laws that govern our activities as a registered investment advisor are complex. The activities of our investment advisory operations are primarily subject to provisions of the Investment Advisers Act of 1940 (the Advisers Act) and the Employee Retirement Income Security Act of 1974 (ERISA). In addition, our investment management business is conducted through a broker-dealer registered under the Securities Exchange Act of 1934 (the Exchange Act) and is subject to the rules of the National Association of Securities Dealers (NASD). It is difficult to predict the future impact of the broad and expanding legislative and regulatory requirements affecting our business. The laws, rules, and regulations applicable to our business may change in the future and we may not be able to comply with any such changes. If we fail to comply with any applicable law, rule, or regulation, we could be fined, sanctioned, or barred from providing investment advisory services in the future, which could materially adversely affect our business, operating results, or financial condition.

***Our reputation and business may be harmed by possible conflicts of interest.***

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We offer products and services to our institutional clients, which include banks, brokerage firms, insurance companies, mutual fund companies, media outlets, and retirement plan providers and sponsors. Our institutional business generated revenue, before intersegment eliminations, of \$146.1 million, or 46.4% of our consolidated revenue in 2006 and \$95.9 million, or 42.2% of our consolidated revenue, in 2005. We also provide ratings, analyst research, and investment recommendations on mutual funds and other investment products offered and securities issued by our institutional clients. The fact that our institutional clients pay us for certain products and services may create the perception that our ratings, research, and recommendations are not impartial. This perception may undermine the confidence of our customers and potential customers in our reputation as a provider of independent research. Any such loss of confidence or damage to our reputation could hurt our business.

*Our failure to successfully integrate acquisitions could strain our resources.*

We completed several acquisitions in 2006, including Ibbotson Associates, which was our largest acquisition to date. We cannot guarantee that we will successfully integrate the employees, product lines, business systems, and operations following any acquisition. We expect to continue making acquisitions and establishing investments and joint ventures as part of our long-term business strategy. Acquisitions, investments, and joint ventures involve a number of risks. They can be time-consuming and may divert management's attention from day-to-day operations. Financing an acquisition could result in dilution from issuing equity securities or a weaker

balance sheet from incurring debt. Acquisitions might also result in losing key employees. We may fail to successfully complete any acquisitions, investments, or joint ventures. We may also fail to generate enough revenue or profits from an acquisition to earn a return on the associated purchase price.

***We could face liability for the information we publish, including information based on data we obtain from other parties.***

We may be subject to claims for securities law violations, defamation (including libel and slander), negligence, or other claims relating to the information we publish. For example, investors may take legal action against us if they rely on published information that contains an error, or a company may claim that we have made a defamatory statement about it or its employees. We could also be subject to claims based upon the content that is accessible from our Web site through links to other Web sites. We rely on a variety of outside parties as the original sources for the information we use in our published data. These sources include securities exchanges, fund companies, and transfer agents. Accordingly, in addition to possible exposure for publishing incorrect information that results directly from our own errors, we could face liability based on inaccurate data provided to us by others. Defending claims based on the information we publish could be expensive and time-consuming and could adversely impact our business, operating results, and financial condition.

***We could be subject to fines, penalties, or other sanctions as a result of investigations by the New York Attorney General's Office and the Department of Labor related to the investment consulting services Morningstar Associates, LLC provides to retirement plan providers, including fund lineup recommendations for retirement plan sponsors.***

As previously disclosed, the New York Attorney General's Office and the Department of Labor are conducting separate investigations related to some of the products and services offered by Morningstar Associates, LLC. See Item 3 Legal Proceedings for a description of these matters. We cannot predict the scope, timing, or outcome of these matters, which may include the institution of administrative, civil, injunctive, or criminal proceedings, the imposition of fines and penalties, and other remedies and sanctions, any of which could lead to an adverse impact on our stock price, the inability to attract or retain key employees, and the loss of customers. We also cannot predict what impact, if any, these matters may have on our business, operating results, or financial condition. We have not established any reserves relating to these matters.

***We could face liability as a result of a proceeding brought by Mr. Graham Rich, a former managing director, chief executive officer, and beneficial shareholder of Morningstar Research Pty Limited, and two companies controlled by Mr. Rich.***

In 2001, Mr. Graham Rich, the then managing director and chief executive officer of Morningstar Research Pty Limited (Morningstar Australia), and one of two companies controlled by Mr. Rich, filed a suit in the Supreme Court of New South Wales, Australia against Morningstar and certain of its officers and nominee directors on the board of Morningstar Australia. The claims seek various forms of relief, including monetary damages in the amount of Australian \$25.0 million, the setting aside of transactions which resulted in Morningstar obtaining control of Morningstar Australia, and an order either setting aside Morningstar's acquisition of shares formerly beneficially owned by Mr. Rich and his companies or determining a different price for this acquisition. In the alternative, Mr. Rich and his companies seek an order that they be entitled to purchase the shares in Morningstar Australia at a price to be determined by the court or book value (as defined in the shareholders agreement of Morningstar Australia). In February 2007, Mr. Rich and his companies notified Morningstar that they would be seeking the leave of the court to amend the claim to include a claim relating to Morningstar's acquisition of Aspect Huntley Pty Ltd. (Aspect) in 2006. The amended claim alleges various breaches of obligations owed by Morningstar to Morningstar Australia and seeks various forms of relief, including an equity interest in Aspect and compensatory damages. The court has not yet granted leave to allow the amendment to proceed. The parties have discussed settling the claims but have been unable to reach an agreement. In the fourth quarter of 2003, we offered to settle all claims for Australian \$1.3 million which then approximated U.S. \$0.9 million, and, in accordance with Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (SFAS No. 5), we recorded a

reserve in this amount. In December 2005, we increased our offer to settle all claims to approximately Australian \$2.5 million, which as of December 31, 2006 approximated U.S. \$2.0 million, and, in accordance with SFAS No. 5, have a reserve recorded for this amount. While Morningstar is vigorously contesting the claims against it, we cannot predict the outcome of the proceeding. We also cannot predict what impact, if any, this matter may have on our business, operating results, or financial condition.

*A prolonged outage of our database and network facilities could result in reduced revenue and the loss of customers.*

The success of our business depends upon our ability to deliver time-sensitive, up-to-date data and information. We rely on our computer equipment, database storage facilities, and other office equipment, which are mainly located in our Chicago headquarters or elsewhere in the Chicago area. Our operations and those of our suppliers and customers are vulnerable to interruption by fire, earthquake, power loss, telecommunications failure, terrorist attacks, wars, Internet failures, computer viruses, and other events

beyond our control, including disasters affecting Chicago. We maintain off-site back-up facilities for our database and network equipment, but these facilities could be subject to the same interruptions that may affect our headquarters. We do not currently have the capability to switch over all of our systems to a back-up facility immediately. If we suffer a significant database or network facility outage, our business could experience disruption until we fully implement our back-up systems. Any losses, service disruption, or damages incurred by us could have a material adverse effect on our business, operating results, or financial condition.

***Our business relies heavily on electronic delivery systems and the Internet. Any failures or disruptions could result in reduced revenue and the loss of customers.***

Many of our products and services depend heavily on our electronic delivery systems and the Internet. Our ability to deliver information using the Internet may be impaired because of infrastructure failures, service outages at third-party Internet providers, or increased government regulation. If disruptions, failures, or slowdowns of our electronic delivery systems or the Internet occur, our ability to distribute our products and services effectively and to serve our customers may be impaired.

***We could face liability related to our storage of personal information about our users.***

Customers routinely input personal investment and financial information, including portfolio holdings and credit card information, on our Web sites. We could be subject to liability if we were to inappropriately disclose any user's personal information or if third parties were able to penetrate our network security or otherwise gain access to any user's name, address, portfolio holdings, or credit card information. Any such event could subject us to claims for unauthorized credit card purchases, impersonation or other similar fraud claims, or claims for other misuses of personal information, such as unauthorized marketing or unauthorized access to personal portfolio information.

***Our future success depends on our ability to recruit and retain qualified employees, including our executive officers.***

We experience competition for analysts and other employees from financial institutions and financial services organizations. These organizations generally have greater resources than we do and therefore may be able to offer significantly more attractive compensation packages to potential employees. Competition for these employees is intense, and we may not be able to retain our existing employees or be able to recruit and retain other highly qualified personnel in the future.

Our future success also depends on the continued service of our executive officers, including Joe Mansueto, our chairman, chief executive officer, and controlling shareholder. The loss of one or more of our executive officers could hurt our business, operating results, or financial condition. We do not carry any life insurance on our executive officers. We do not have employment agreements or non-compete agreements in place with any of our executive officers. They may leave us and work for our competitors or start their own competing businesses.

***Our operations outside of the United States are expanding and involve special challenges that we may not be able to meet.***

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Over the past three years, our operations outside of the United States have generated an increasing amount of revenue, expanding from \$25.4 million in 2004 to \$44.3 million in 2006. There are certain risks inherent in doing business outside the United States, including difficulties in reaching new markets due to established competitors; difficulties in staffing, managing, and integrating non-U.S. operations; differences in laws and policies from country to country; exposure to varying legal standards, including intellectual property protection laws; and currency exchange rates and exchange controls. We do not currently hedge any of our currency exposure, which may adversely impact our financial results.

These risks could hamper our ability to expand around the world, which may hurt our financial performance and ability to grow.

In addition, we now have approximately 200 programmers and data analysts working in our development center in China. Over the past several years, we have been moving a significant percentage of our data collection and development operations to this location. Because China has a restrictive government under centralized control, we cannot predict the level of political and regulatory risk that may impact our operations. Any difficulties that we face in successfully maintaining our development center in China may harm our business and have a negative impact on the products and services we provide.

*Changes in market and economic conditions could lower demand for our products and services.*

We provide our products and services to individual investors, financial advisors, and institutional clients. Conditions in the financial and securities markets may have an impact on our performance. For example, in the event that the U.S. or international financial markets suffers a severe or prolonged downturn, demand for our products and services may decline, and our revenue and profitability levels could suffer. The financial markets and many businesses operating in the financial services industry are highly volatile and are

affected by factors, such as U.S. and foreign economic conditions and general trends in business and finance, that are beyond our control. In addition, as our fee-based asset management business increases as a percentage of total revenue, our results might become more closely tied to the performance of the market. We attempt to mitigate this potential risk by diversifying our business into various markets around the world, as well as different segments and price points within each area.

***Our results could suffer if the mutual fund industry experiences a downturn or a slowdown in growth.***

A significant portion of our revenue is generated from products and services related to mutual funds. The mutual fund industry has experienced substantial growth over the past 20 years. Mutual fund assets may not continue to expand at the same rate in future years. Settlements and regulatory actions in the mutual fund industry following the market-timing scandal that emerged in 2003, downturns in the financial markets, or a relative increase in usage of other investment vehicles could cause a decline in investor interest in mutual funds. If the mutual fund industry experiences a downturn or a slower growth rate than in the past, it could negatively impact demand for some of our products.

***Failure to protect our intellectual property rights could harm our brand-building efforts and ability to compete effectively.***

The steps we have taken to protect our intellectual property may not be adequate to safeguard our proprietary information. Further, effective trademark, copyright, and trade secret protection may not be available in every country in which we offer our services. Our continued ability to market one or more of our products under their current names could be adversely affected in those jurisdictions where another person registers, or has a pre-existing registration on, one or more of them. Failure to adequately protect our intellectual property could harm our brand, devalue our proprietary content, and affect our ability to compete in the marketplace.

***Control by a principal shareholder could adversely affect our other shareholders.***

As of December 31, 2006, Joe Mansueto, our chairman and chief executive officer, owned approximately 70% of our outstanding common stock. As a result, he has the ability to control substantially all matters submitted to our shareholders for approval, including the election and removal of directors and any merger, consolidation, or sale of our assets. He also has the ability to control our management and affairs. This concentration of ownership may delay or prevent a change in control; impede a merger, consolidation, takeover, or other business combination involving us; discourage a potential acquirer from making a tender offer or otherwise attempting to obtain control of us; or result in actions that may be opposed by other shareholders.

Moreover, because of Joe's substantial ownership, we are a controlled company for purposes of the NASDAQ Marketplace Rules. This means that, if in the future we elect to be treated as a controlled company under the NASDAQ Marketplace Rules, we will not be required by NASDAQ to have a majority of independent directors or to maintain compensation and nominating and corporate governance committees composed entirely of independent directors to continue to list our shares on NASDAQ.

***Fluctuations in our operating results may negatively impact our stock price.***



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We believe our business has relatively large fixed costs and low variable costs, which magnify the impact of revenue fluctuations on our operating results. As a result, a decline in our revenue may lead to larger decline in operating income. A substantial portion of our operating expense is related to personnel costs, marketing programs, and corporate overhead, none of which can be adjusted quickly. Our operating expense levels are based on our expectations for future revenue. If actual revenue falls behind our expectations, or if our expenses increase before revenues do, our operating results would be materially and adversely affected. In addition, we do not provide earnings guidance or hold one-on-one meetings with institutional investors and research analysts. Because of this policy and limited analyst coverage on our stock, our stock price may be volatile. If our operating results or other operating metrics fail to meet the expectations of outside research analysts and investors, the market price of our common stock may decline.

***The future sale of shares of our common stock may negatively impact our stock price.***

If our shareholders sell substantial amounts of our common stock, the market price of our common stock could fall. A reduction in ownership by Joe Mansueto or any other large shareholder could cause the market price of our common stock to fall. In addition, the average daily trading volume in our stock is relatively low. The lack of trading activity in our stock may lead to greater fluctuations in our stock price. Low trading volume may also make it difficult for shareholders to make transactions in a timely fashion.

***Our shareholders may experience dilution in their ownership positions.***

Morningstar has historically granted options to employees as a significant part of our overall compensation package. As of December 31, 2006, our employees and non-employee directors held options to acquire 8,969,904 shares of common stock, 7,255,862

of which were exercisable at a weighted average exercise price of \$10.90 per share and 1,714,042 were not exercisable and had an average exercise price of \$17.18 per share. To the extent that option holders exercise outstanding options to purchase common stock, there may be further dilution. Future grants of stock options or restricted stock units may also result in dilution. We may raise additional funds through future sales of our common stock. Any such financing may result in additional dilution to our shareholders.

**Item 1B. Unresolved Staff Comments**

We have not received any comments from the Staff of the Securities and Exchange Commission regarding our periodic or current reports under the Exchange Act.

## Item 2. Properties

Our headquarters and U.S.-based offices are located in Chicago, Illinois, and consist of approximately 171,000 square feet of leased space. We also lease approximately 77,500 square feet of office space in 14 countries around the world. We believe that our office facilities are adequate for our immediate needs and that additional or substitute space is available if needed to accommodate growth and expansion.

In December 2005, we signed a 15-year lease for approximately 210,000 square feet of office space in an office tower being constructed at 108 North State Street in Chicago, Illinois. We are scheduled to move into the new space when the lease starts in 2008.

## Item 3. Legal Proceedings

### *Morningstar Australia*

In 2001, Mr. Graham Rich, the then managing director and chief executive officer of Morningstar Research Pty Limited (Morningstar Australia), and one of two companies controlled by Mr. Rich, filed a suit in the Supreme Court of New South Wales, Australia against Morningstar and certain of its officers and nominee directors on the board of Morningstar Australia. Mr. Rich was also a beneficial owner of shares in Morningstar Australia. Mr. Rich and his company originally sought an injunction, which, if granted, would have precluded Morningstar Australia from terminating the services of Mr. Rich and from issuing additional shares to Morningstar in exchange for the provision of further funding by Morningstar to Morningstar Australia. Further, Mr. Rich and his company sought an order that a provisional liquidator be appointed for Morningstar Australia. The court rejected this injunction application, observing that Morningstar Australia would be insolvent without financial backing from Morningstar. The application for the appointment of a provisional liquidator also failed. The services of Mr. Rich were terminated in November 2001. Mr. Rich and his company were ordered to pay Morningstar's costs of the injunction proceedings.

Mr. Rich and the two companies controlled by Mr. Rich have additional pending claims, alleging, among other things, breaches by Morningstar of contracts and statutory and general law duties, misleading, deceptive, and unconscionable conduct by Morningstar, oppression by Morningstar and its nominee directors, claims under the Industrial Relations Act of New South Wales, breaches of directors' duties by Morningstar's nominee directors, and conflict of interest. The claims seek various forms of relief, including monetary damages in the amount of Australian \$25,000,000, the setting aside of transactions which resulted in Morningstar obtaining control of Morningstar Australia, and an order either setting aside Morningstar's acquisition of the shares formerly beneficially owned by Mr. Rich and his companies or determining a different price for this acquisition. In the alternative, Mr. Rich and his companies seek an order that they be entitled to purchase the shares in Morningstar Australia at a price to be determined by the court or book value (as defined in the Morningstar Australia shareholders agreement). Morningstar has denied the claims and filed counter-claims against Mr. Rich and certain of his companies, alleging breaches of statutory, general law, and contractual duties.

In July 2004, the court decided Morningstar's application for security for its potential additional costs in the litigation by ordering the two companies controlled by Mr. Rich to provide approximately Australian \$925,000 to the court as security for these potential costs. Morningstar has been paid some of its costs and will be entitled to be paid its costs in the future only if the court makes a determination to that effect. The court stayed the proceedings pending its receipt of the security and indicated that it would entertain an application by Morningstar for additional security at a later time in the proceedings.

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In May 2005, Mr. Rich obtained conditional leave of the court to begin a proceeding in the name of Morningstar Australia against Morningstar and its nominee directors. The leave was, however, subject to the following conditions: (i) Mr. Rich must pay and bear, and indemnify Morningstar Australia against, all costs, charges, and expenses of and incidental to the bringing and continuation of the proceeding (except as the court may otherwise direct or allow) and may not seek contribution or indemnity from Morningstar Australia for any of these costs, charges, or expenses; (ii) Morningstar Australia, or Mr. Rich on its behalf, together with the two companies controlled by Mr. Rich were required to provide to the court, as security for Morningstar's costs, approximately Australian \$925,000 as described in the preceding paragraph; and (iii) approximately Australian \$100,000 in costs owed by Mr. Rich and one of his companies to Morningstar in respect of the 2001 injunction proceedings were required to be paid to Morningstar. These conditions have been satisfied.

In September 2005, Mr. Rich and his companies filed a Second Further Amended Statement of Claim, consolidating the claims. Morningstar filed a Defence to that pleading and an Amended Cross-Claim against Mr. Rich, both his companies, and a third Australian company controlled by Mr. Rich.

In December 2006, Morningstar applied to the court for further security for its potential additional costs in the litigation. The court has not yet held a hearing for this application.

In February 2007, Mr. Rich and his companies notified Morningstar that they would be seeking the leave of the court to amend the Second Further Amended Statement of Claim to include a claim relating to Morningstar's acquisition of Aspect Huntley Pty Ltd. (Aspect) in 2006. The amended claim alleges various breaches of obligations owed by Morningstar to Morningstar Australia and seeks

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various forms of relief, including an equity interest in Aspect and compensatory damages. The court has not yet granted leave to allow the amendment to proceed.

The parties have discussed settling the claims but have been unable to reach an agreement. In the fourth quarter of 2003, Morningstar offered to settle all claims for Australian \$1,250,000, which then approximated U.S. \$942,000, and, in accordance with Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies*, Morningstar recorded a reserve in this amount. In December 2005, Morningstar increased its offer to settle all claims to approximately Australian \$2,500,000, which at December 31, 2006 approximated U.S. \$2,000,000, and, in accordance with SFAS No. 5, Morningstar has a reserve recorded in this amount. While Morningstar is vigorously contesting the claims against it, we cannot predict the outcome of the proceeding.

*Morningstar Associates, LLC Subpoenas from Securities and Exchange Commission, New York Attorney General's Office, and Department of Labor*

*Securities and Exchange Commission*

In February 2005, Morningstar Associates, LLC, a wholly owned subsidiary of Morningstar, Inc., received a request from the Securities and Exchange Commission (SEC) for the voluntary production of documents relating to the investment consulting services the company offers to retirement plan providers, including fund lineup recommendations for retirement plan sponsors. In July 2005, the SEC issued a subpoena to Morningstar Associates that was virtually identical to its February 2005 request.

Subsequently, the SEC focused on disclosure relating to an optional service offered to retirement plan sponsors (employers) that select 401(k) plan services from ING, one of Morningstar Associates' clients. In response to the SEC investigation, ING and Morningstar Associates revised certain documents for plan sponsors to further clarify the roles of ING and Morningstar Associates in providing that service. The revisions also help reinforce that Morningstar Associates makes its selections only from funds available within ING's various retirement products.

On January 24, 2007, the SEC notified Morningstar Associates that it ended its investigation, with no enforcement action, fines, or penalties.

*New York Attorney General's Office*

In December 2004, Morningstar Associates received a subpoena from the New York Attorney General's office seeking information and documents related to an investigation the New York Attorney General's office is conducting. The request is similar in scope to the SEC subpoena described above. Morningstar Associates has provided the requested information and documents and continues to cooperate fully with the New York Attorney General's office.

In January 2007, Morningstar Associates received a Notice of Proposed Litigation from the New York Attorney General's office. The Notice centers on the same issues that became the focus of the SEC investigation described above. The Notice gave Morningstar Associates the opportunity to explain why the New York Attorney General's office should not institute proceedings. Morningstar Associates promptly submitted

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its explanation. To date, the New York Attorney General's office has not taken any further action.

We cannot predict the scope, timing, or outcome of this matter, which may include the institution of administrative, civil, injunctive, or criminal proceedings, the imposition of fines and penalties, and other remedies and sanctions, any of which could lead to an adverse impact on our stock price, the inability to attract or retain key employees, and the loss of customers. We also cannot predict what impact, if any, this matter may have on our business, operating results, or financial condition.

### *United States Department of Labor*

In May 2005, Morningstar Associates received a subpoena from the United States Department of Labor, seeking information and documents related to an investigation the Department of Labor is conducting. The Department of Labor subpoena is substantially similar in scope to the SEC and New York Attorney General subpoenas.

In January 2007, the Department of Labor issued a request for additional documents pursuant to the May 2005 subpoena, including documents and information regarding Morningstar Associates' retirement advice products for plan participants. Morningstar Associates continues to cooperate fully with the Department of Labor.

We cannot predict the scope, timing, or outcome of this matter, which may include the institution of administrative, civil, injunctive, or criminal proceedings, the imposition of fines and penalties, and other remedies and sanctions, any of which could lead to an adverse impact on our stock price, the inability to attract or retain key employees, and the loss of customers. We also cannot predict what impact, if any, these matters may have on our business, operating results, or financial condition.

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

matters will have a material adverse effect on our business, operating results, or financial condition.

**Item 4. Submission of Matters to a Vote of Security Holders**

No matters were submitted to a vote of our security holders, through the solicitation of proxies or otherwise, during the quarter ended December 31, 2006.

**Part II**

**Item 5. Market for Registrant's Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities**

Our common stock is listed on the Nasdaq Global Select Market under the symbol MORN.

The following table shows the high and low price per share of our common stock for the periods indicated, as reported on the Nasdaq Global Select Market:

	2006		2005		
	High	Low	High	Low	
First Quarter (our stock was first publicly traded on May 3, 2005)	\$ 46.37	\$ 33.79	\$	\$	
Second Quarter	47.56	35.66	29.59	18.51	
Third Quarter	42.76	32.99	34.10	26.01	
Fourth Quarter	47.36	36.32	37.43	24.83	

As of March 1, 2007, the last reported price on the Nasdaq Global Select Market for our common stock was \$50.11 per share and there were approximately 40 shareholders of record of our common stock.

We do not currently pay cash dividends, nor have we paid cash dividends during the period covered by the financial statements included in this Annual Report on Form 10-K. Any determination to pay dividends in the future will be at the discretion of our board of directors and will be dependent upon our results of operations, financial condition, contractual restrictions, restrictions imposed by applicable law, and other factors deemed relevant by the board of directors. Future indebtedness and loan facilities may also prohibit or restrict our ability to pay dividends and make distributions to our shareholders.

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In May 2005, we completed our initial public offering of 7,612,500 shares of our common stock. These shares began trading on May 3, 2005 and now trade on the Nasdaq Global Select Market under the symbol MORN. All of these shares were sold by affiliates of SOFTBANK Finance Corporation, a wholly owned subsidiary of SOFTBANK Corp. We did not receive any proceeds from the sale of these shares. We granted the underwriters the option to purchase up to an additional 1,141,875 shares at the initial public offering price of \$18.50 per share to cover over-allotments. In May 2005, the underwriters exercised their over-allotment option in full. Our net proceeds from the exercise of the underwriters' over-allotment option were \$18.1 million, after deducting the underwriting discounts and commissions and approximately \$2.6 million of offering expenses. On March 1, 2006, we completed our acquisition of Ibbotson Associates for \$86.5 million in cash. We funded a portion of the purchase price with our net proceeds from the exercise of the underwriters' over-allotment option.

### *Rule 10b5-1 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 plans entered into by our directors and executive officers that were in effect on March 1, 2007:

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 March 1, 2007	Projected Beneficial Ownership (1)
Jack Noonan Director	08/22/06	12/10/07	60,000	Monthly increments of up to 4,000 shares	20,000	76,000
Don Phillips Managing Director	05/09/06	08/26/07	450,000	Semimonthly increments of up to 15,000 shares	180,000	1,413,628

(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 his Rule 10b5-1 plan identified above. This information reflects the beneficial ownership of our



common stock on December 31, 2006, and includes shares of our common stock subject to options that were then exercisable or that will have become exercisable by March 1, 2007. The estimates do not reflect any changes to beneficial ownership that may have occurred since December 31, 2006. Each director and executive officer identified in the table may amend or terminate his Rule 10b5-1 plan and may adopt additional Rule 10b5-1 plans in the future.

In his letter to shareholders in our 2005 Annual Report, Joe Mansueto, our chairman and chief executive officer, stated that he expects to sell approximately 4% of his Morningstar shares annually under a Rule 10b5-1 plan. As of the date of this report Joe has not yet established a Rule 10b5-1 plan for 2007, but we expect that he will do so.

**Item 6. Selected Financial Data**

The selected historical financial data shown below should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and our Consolidated Financial Statements and related notes included elsewhere in this Annual Report on Form 10-K. We have derived our Consolidated Statements of Operations Data and Other Consolidated Financial Data for the years ended December 31, 2006, 2005, and 2004 and Consolidated Balance Sheet Data as of December 31, 2006 and 2005 from our audited Consolidated Financial Statements included in this Annual Report on Form 10-K. The Consolidated Statements of Operations Data and Other Consolidated Financial Data for the years ended December 31, 2003 and 2002 and Consolidated Balance Sheet Data as of December 31, 2004, 2003, and 2002 were derived from our audited Consolidated Financial Statements that are not included in this Annual Report on Form 10-K.

**Consolidated Statements of Operations Data**

(in thousands except per share amounts)	2002	2003	2004	2005	2006
Revenue	\$ 109,619	\$ 139,496	\$ 179,658	\$ 227,114	\$ 315,175
Operating expense	117,959	150,250	161,923	180,634	237,648
Operating income (loss)	(8,340)	(10,754)	17,735	46,480	77,527
Non-operating income, net	4,463	1,110	1,805	3,199	4,164
Income (loss) before income taxes, equity in net income of unconsolidated entities, minority interest in net loss of consolidated entities, extraordinary gain, and cumulative effect of accounting change	(3,877)	(9,644)	19,540	49,679	81,691
Income tax expense (benefit)	(311)	2,950	11,574	20,224	32,975
Equity in net income of unconsolidated entities	750	697	843	1,662	2,787
Minority interest in net loss of consolidated entities	178				
Income (loss) before extraordinary gain and cumulative effect of accounting change	(2,638)	(11,897)	8,809	31,117	51,503
Extraordinary gain - acquisition	3,084				
Cumulative effect of accounting change, net of tax of \$171					259
Net income (loss)	\$ 446	\$ (11,897)	\$ 8,809	\$ 31,117	\$ 51,762
Basic income (loss) per share:					
Income (loss) before extraordinary gain and cumulative effect of accounting change	\$ (0.07)	\$ (0.31)	\$ 0.23	\$ 0.79	\$ 1.25
Extraordinary gain - acquisition	0.08				
Cumulative effect of accounting change					0.01
Basic income (loss) per share	\$ 0.01	\$ (0.31)	\$ 0.23	\$ 0.79	\$ 1.26
Weighted average common shares outstanding - basic	38,345	38,382	38,418	39,392	41,176
Diluted income (loss) per share:					
Income (loss) before extraordinary gain and cumulative effect of accounting change	\$ (0.17)	\$ (0.31)	\$ 0.21	\$ 0.70	\$ 1.10
Extraordinary gain - acquisition	0.08				
Cumulative effect of accounting change					0.01
Diluted income (loss) per share	\$ (0.09)	\$ (0.31)	\$ 0.21	\$ 0.70	\$ 1.11
Weighted average common shares outstanding - diluted	40,361	38,382	41,858	44,459	46,723
<b>Other Consolidated Financial Data (\$000)</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
Stock-based compensation expense (income) under the liability method	\$ (3,283)	\$ 17,796	\$ 8,963	\$ 2,810	
Stock-based compensation expense under the equity method	10,575	11,233	7,760	8,085	8,575
Total stock-based compensation expense (1)	\$ 7,292	\$ 29,029	\$ 16,723	\$ 10,895	\$ 8,575
Sales tax expense (2)	\$ 2,837	\$ 3,079	\$	\$	
Cash used for investing activities	(6,068)	(29,634)	(22,750)	(16,913)	(129,002)
Cash provided by (used for) financing activities	(1,952)	(26)	(6,367)	25,256	33,983

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Cash provided by operating activities	\$	16,542	\$	29,705	\$	32,862	\$	48,445	\$	98,677
Capital expenditures		(5,989)		(8,607)		(7,730)		(7,451)		(4,722)
Free cash flow (3)	\$	10,553	\$	21,098	\$	25,132	\$	40,994	\$	93,955

**Consolidated Balance Sheet Data**

<b>As of December 31 (\$000)</b>		<b>2002</b>		<b>2003</b>		<b>2004</b>		<b>2005</b>		<b>2006</b>
Cash, cash equivalents and investments	\$	64,796	\$	76,158	\$	95,463	\$	153,190	\$	163,751
Working capital (deficit) (4)		10,005		(5,206)		16,902		90,374		70,021
Total assets		152,781		180,265		213,361		296,311		447,838
Deferred revenue (4)		47,731		55,554		63,363		71,155		100,525
Long-term liabilities (5)		21,243		25,486		30,128		6,756		10,952
Total shareholders' equity (5) (6)		48,132		44,821		64,381		173,714		269,423

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(1) Effective January 1, 2006, we adopted Statement of Financial Accounting Standards (SFAS) No. 123 (Revised 2004), *Share-Based Payment* (SFAS No. 123(R)). Prior to this date, we accounted for our equity plans in accordance with the fair value provisions of SFAS No. 123, *Stock-based Compensation*. The total expense for stock-based compensation is distributed with other employee compensation costs in the appropriate expense categories of our Consolidated Statements of Operations. Prior to our initial public offering in May 2005, in accordance with SFAS No. 123, we used two accounting methods. For options granted under plans that may have required us to settle the options in cash, we used the liability method. Under this method we recorded a liability for a vested option equal to the difference between the option exercise price and the fair value of the shares of common stock underlying the option at the end of the reporting period. If this fair value increased over the reporting period, we recorded an expense and, if it decreased, we recorded income. For options granted under plans that did not require us to settle the options in cash, we used the equity method. Under this method we calculated the fair value of the option at the time of grant using a Black-Scholes model and recorded expense over the vesting period. In each year, our aggregate stock-based compensation expense reflects the impact of options granted in prior years.

Subsequent to our initial public offering, we no longer settle stock options for cash. As a result, all of our options are currently accounted for under the equity method. Refer to Note 11 of the Notes to our Consolidated Financial Statements for more information on our stock-based compensation.

(2) In 2003, we began participating in voluntary disclosure or similar programs related to state sales tax. Through these programs, we identified sales tax amounts attributed to 2003 and prior years and negotiated or are in discussions with local tax authorities to settle these amounts. We recorded total expense of \$9.0 million in 2000, 2001, 2002, and 2003, the years to which these sales tax amounts apply. Based on the most current information available, the actual sales tax expense was not materially different from the estimates recorded in those periods.

(3) Free cash flow is considered a non-GAAP financial measure under SEC regulations. We present this measure as supplemental information to help investors better understand trends in our business results over time. Our management team uses free cash flow to evaluate the performance of our business. Free cash flow is not equivalent to any measure of performance required to be reported under U.S. generally accepted accounting principles (U.S. GAAP), nor should this data be considered an indicator of our overall financial performance or liquidity. Moreover, the free cash flow definition we use may not be comparable to similarly titled measures reported by other companies.

(4) We frequently invoice or collect cash in advance of providing services or fulfilling subscriptions for our customers. These amounts are recorded as deferred revenue on our Consolidated Balance Sheets. As a result of recording deferred revenue, our working capital may at times be negative.

(5) In the second quarter of 2005, upon completion of our initial public offering, we reclassified \$24.9 million related to stock options accounted for as long-term liabilities, in accordance with SFAS No. 123, to additional paid-in capital.

(6) In May 2005, we completed our initial public offering of 7,612,500 shares of our common stock. These shares commenced trading on May 3, 2005 and now trade on the Nasdaq Global Select Market under the symbol MORN. All of these shares were sold by affiliates of SOFTBANK Finance Corporation, a wholly owned subsidiary of SOFTBANK Corp. We did not receive any proceeds from the sale of these shares. In addition, we granted the underwriters the right to purchase up to an additional 1,141,875 shares at the initial public offering price to cover over-allotments. In May 2005, the underwriters exercised their over-allotment option in full. We received net proceeds of \$18.1 million based on our initial public offering price of \$18.50 per share, after deducting the underwriting discounts and commissions and approximately \$2.6 million of offering expenses.



## **Item 7. 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 Annual Report on Form 10-K, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to future events or to our future financial performance and involve known and unknown risks, uncertainties, and other factors that may cause our actual results, levels of activity, performance, or achievements to be materially different from any future results, levels of activity, performance, or achievements expressed or implied by these forward-looking statements. In some cases, you can identify forward-looking statements by the use of words such as may, could, expect, intend, plan, seek, anticipate, believe, estimate, predict, potential, or continue or the negative of these terms or other comparable terminology. You should not place undue reliance on forward-looking statements because they involve known and unknown risks, uncertainties, and other factors that are, in some cases, beyond our control and that could materially affect actual results, levels of activity, performance, or achievements.*

*Other factors that could materially affect actual results, levels of activity, performance, or achievements can be found in Item 1A Risk Factors of this Annual Report on Form 10-K. If any of these risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may vary significantly from what we projected. Any forward-looking statement you read in this Annual Report on Form 10-K reflects our current views with respect to future events and is subject to these and other risks, uncertainties, and assumptions relating to our operations, results of operations, growth strategy, and liquidity. We assume no obligation to publicly update or revise these forward-looking statements for any reason, whether as a result of new information, future events, or otherwise.*

### **Understanding Our Company**

Our mission is to create great products that help investors reach their financial goals. We offer an extensive line of Internet, software, and print-based products for individual investors, financial advisors, and institutional clients. We also offer asset management services for advisors, institutions, and retirement plan participants. We have historically generated recurring revenue because many of our products are sold through subscriptions or license agreements. We believe that while the fixed costs of the investments in our business are relatively high, the variable cost of adding customers is considerably lower, particularly as our products and services focus more on Internet-based platforms and assets under management. We strive to realize this operating leverage by selling a wide variety of products and services to multiple investor segments, through multiple media, and in many geographic markets.

We manage Morningstar to maximize our long-term results, while staying focused on our mission of helping investors and adhering to our company values. We invest significantly in new product development and in enhancements to our current offerings. It typically takes many years to recoup these investments, but we believe they are critical to building long-term value for our shareholders.

We emphasize a decentralized approach to running our business to empower our managers and to create a culture of responsibility and accountability. We operate our decentralized business structure in three global business segments: Individual, Advisor, and Institutional. Early in our history, our product lineup emphasized products for individual investors. As a result, the Individual segment contributed a majority of our revenue. In the early 1990s, our Advisor segment became a more important part of our business. More recently, we've begun serving more investors through our Institutional segment, which was the largest of our three segments in terms of revenue in 2006, 2005, and 2004. In all three of these segments, we believe our work helps individual investors make better investment decisions.











## Key Business Characteristics

We believe our business has the following characteristics:

### *Recurring Revenue*

We have historically generated recurring revenue because many of our products are sold through subscriptions or license agreements. These subscriptions and licenses generally come up for renewal after one- to three-year terms. Many of the license agreements in our Advisor and Institutional segments span multiple years. Because of this recurring revenue, we generally have subscriptions and license agreements in place for a meaningful percentage of our total annual revenue at the beginning of each year. We think of this as our walk-in revenue.

We separate our annual revenue into three categories, defined as follows:

*New revenue.* We define new revenue as revenue from selling additional products to current customers or from selling to new customers;

*Renewal revenue.* We define renewal revenue as revenue from renewals of subscriptions or licenses; and

*Walk-in revenue.* We define walk-in revenue as revenue we expect to recognize during the year from subscriptions and license agreements in place as of January 1 of each year adjusted for cancellations, currency translations, and other routine adjustments during the year.

Beginning in 2007, we no longer plan to report quarterly information on new, renewal, and walk-in revenue. We are currently evaluating potential new metrics that may be more useful to investors.

In addition to looking at walk-in, renewal, and new revenue, we calculate a retention rate to evaluate how successful we have been in maintaining existing business for products and services that have renewable revenue. We use two different methods for calculating retention. For subscription-based products (including our print newsletters, Morningstar.com Premium Membership service, and Principia software), we track the number of subscriptions retained during the year. For products sold through contracts and licenses, we use the contract value method, which is based on tracking the dollar value of renewals compared with the total dollar value of contracts up for renewal during the period. We include changes in the contract value in the renewal amount, unless the change specifically results from adding a new product that we can identify. We also include variable contracts in this calculation and use the previous quarter's actual revenue as the base rate for calculating the renewal percentage. The retention rate excludes setup and customization fees, migrations to other Morningstar products, and contract renewals that were pending as of January 31, 2007.

### *Significant Operating Leverage*

Our business requires significant investments to create and maintain proprietary databases and content. We strive to leverage these costs by selling a wide variety of products and services to multiple investor segments, through multiple media, and in many geographic markets. We believe that while the fixed costs of the investments in our business are relatively high, the variable cost of adding customers is considerably lower, particularly as our products and services focus more on Internet-based platforms and assets under management. In the past, we have made investments in building our databases and content that have hurt our short-term operating results for certain periods. In the past several years, our profitability has improved because we've been able to increase revenue without increasing our cost base at the same rate. We look for this operating leverage to be evident in our operations over the long term.

### *Deferred Revenue*

We frequently collect cash in advance of providing services or fulfilling subscriptions for our customers. As a result, we can use some of this cash to fund our operations and invest in new product development. Although we may need to issue refunds for the unused portion of the subscription if a customer cancels, we generally have used cash collected in advance of providing services or fulfilling subscriptions to fund many of our other activities. The deferred revenue shown on our balance sheet as of December 31, 2006 totaled \$100.5 million, including deferred revenue from acquisitions. As of December 31, 2005, we had \$71.2 million in deferred revenue. The \$29.3 million increase in deferred revenue from 2005 to 2006 includes the impact of acquisitions.

## **How Our Business Works**

### *Revenue*

We earn revenue by selling a variety of investment-related products and services. Many of our offerings, such as our newsletters, Principia software, and Premium service on Morningstar.com, are sold via subscriptions. These subscriptions are mainly offered for a one-year term, although we also offer terms over other periods ranging from one month to three years. We also sell advertising on our Web sites throughout the world. Several of our other products are sold through license agreements, including Morningstar Advisor Workstation, Morningstar Equity Research, Morningstar Direct, Morningstar EnCorr, Retirement Advice, and Licensed Data. Our license agreements typically range from one to three years. For some of our other institutional services, mainly Investment Consulting, our fees are generally based on the scope of work and the level of service we provide and calculated as a percentage of assets under management. We also collect fees relating to Morningstar Managed Portfolios and the managed retirement accounts offered through Morningstar Retirement Manager and Advice by Ibbotson that are calculated as a percentage of assets under management.

### *Operating Expense*

We classify our expenses into separate categories for cost of goods sold, development, sales and marketing, general and administrative, and depreciation and amortization, as described below. We include stock-based compensation expense, as appropriate,



in each of these categories.

*Cost of goods sold.* This category includes the compensation expense for employees who produce the products we deliver to our customers. For example, this category covers the cost of production teams and analysts who write investment research reports. Cost of goods sold also includes other expenses such as postage, printing, and CD-ROM replication, as well as shareholder servicing fees for Morningstar Managed Portfolios and costs for outsourced product implementation expense for development projects associated with the Advice by Ibbotson service.

*Development.* This category mainly includes compensation expense for programmers, designers, and other employees who develop new products and make enhancements to existing products. In some cases, we capitalize the compensation costs associated with certain development projects. This reduces the expense that we would otherwise report in this category. We amortize these capitalized costs over the estimated economic life of the software, which is generally three years, and include this expense in depreciation and amortization.

*Sales and marketing.* This category includes compensation expense for our sales teams, product managers, and other marketing professionals. We also include the cost of advertising, direct mail campaigns, and other marketing programs to promote our products.

*General and administrative.* This category consists mainly of compensation expense for each segment's management team, as well as human resources, finance, and support employees for each segment. The category also includes compensation expense for senior management and corporate expenses, including corporate systems, accounting, legal, and facilities expense.

*Depreciation and amortization.* Our capital expenditures consist mainly of computers, leasehold improvements, and capitalized product development costs related to certain software development projects. We recognize depreciation and amortization costs for these items over their estimated useful lives, generally ranging from three to seven years. We also include amortization related to intangible assets, which is mainly driven by acquisitions, in this category.

#### *International Operations*

We consolidate the results of our majority-owned operations outside the United States. We account for our minority-owned investments in Japan, Korea, Denmark, and Sweden using the equity method.

## How We Evaluate Our Business

When our analysts evaluate a stock, they focus on assessing the company's estimated intrinsic value—the value of the company's future cash flows, discounted to their worth in today's dollars. Our approach to evaluating our own business works the same way. Our goal is to increase the intrinsic value of our business over time, which we believe is the best way to create value for our shareholders.

We do not make public financial forecasts for our business because they are, by their nature, subjective and could have an effect on our company's stock price. We want to avoid creating any incentive within our company to "make the numbers."

We provide three specific measures that can help investors generate their own assessment of how our intrinsic value has changed over time:

Revenue;

Operating income (loss); and

Free cash flow, which we define as cash provided by operating activities less capital expenditures.

Free cash flow is considered a non-GAAP financial measure under Securities and Exchange Commission (SEC) regulations. We present this measure as supplemental information to help investors better understand trends in our business results over time. Our management team uses free cash flow to evaluate the performance of our business. Free cash flow is not equivalent to any measure of performance required to be reported under U.S. generally accepted accounting principles (U.S. GAAP), and should not be considered an indicator of our overall financial performance or liquidity. Moreover, the free cash flow definition we use may not be comparable to similarly titled measures reported by other companies.

## Industry Overview

We monitor developments in the economic and financial information industry on an ongoing basis and use these insights to help

inform our company strategy, product development plans, and marketing initiatives.

*Investment Landscape, Research, and Data*

After a strong rally toward the end of 2006, Morningstar's U.S. Market Index, a broad stock market benchmark, finished the year with a total return of 15.7%, compared with a 6.5% gain in 2005. Markets outside of the United States posted similarly strong results. With the investment climate generally favorable and all diversified equity-fund categories posting positive total returns for the year, mutual funds based in the United States enjoyed positive net inflows for the year, and cash flows into equity funds were about 16% higher than in 2005. Net cash flows into hybrid funds were lower than in 2005, but cash inflows to taxable bond, municipal bond, and money market funds all increased over 2005 levels. The number of mutual funds increased slightly to about 8,100 during 2006, and total fund assets increased by about 17% to \$10.4 trillion as of year-end. The Investment Company Institute estimates that about 54.7 million households in the United States, or 48% of all households, own mutual funds. This total is still down slightly from the peak level in 2001, but higher than the totals in each of the previous four years.

We believe that continued asset growth and widespread usage of mutual funds is significant because a relatively large portion of Morningstar's business has historically focused on this area. However, this percentage has been declining as we've expanded into equity research and other areas.

The SEC issued interpretive guidance in July 2006 regarding the use of soft dollar payments, which are arrangements in which investment advisors receive research or other services from broker-dealers in exchange for executing trades through that broker. More recently, the Department of Labor proposed regulations that would require brokerage firms to report separately the cost of brokerage and research services provided to pension funds. Pension funds would also be required to disclose soft dollar research payments.

Also related to soft dollars, asset managers in the United Kingdom recently began disclosing the amount of brokerage commissions used for transaction costs and research. Trade associations for fund managers and brokers based in France recently issued recommendations to government regulators related to the amount and usage of brokerage commissions, and financial regulators in Canada have also proposed new soft dollar regulations that would require asset managers to itemize soft dollar costs and allocate them to clients.

We believe these developments are important because they underscore a longer-term trend toward greater pricing transparency and are prompting debate about the cost and value of securities research. In addition, we believe the trend toward unbundled commissions may place additional pressure on budgets for sell-side research, leading to further cuts in coverage lists and increased demand for independent research from companies such as Morningstar.

In September 2006, President Bush signed the Credit Agency Reform Act, which will allow companies that meet certain standards to register with the SEC as rating organizations, broadening competition from current restrictions that only allow credit ratings by five firms currently designated as nationally recognized rating agencies. We believe that increased competition in the credit ratings industry would be favorable for investors, and we're continuing to monitor the potential impact of this development on our business.



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We continued to see strong interest in alternative asset classes during 2006. Hedge funds, in particular, continued to enjoy strong growth. Based on estimates published by Hennessee Group, hedge fund industry assets increased to \$1.44 trillion in December 2006, a 17.5% increase from \$1.2 trillion at the beginning of the year. The number of hedge funds and funds of funds continued to balloon, with more than 19,000 funds in existence as of December 2006 based on a study from PerTrac Financial Solutions, compared with about 12,250 as of December 2005. We substantially increased the size of our hedge fund database with our acquisition of the institutional hedge fund and separate account database division of InvestorForce. We re continuing to expand the information we provide on hedge funds to meet investors need for information on this growing asset class.

Several firms, including Moody s, Standard & Poor s, and Fitch, have announced plans to introduce hedge-fund ratings in response to investor interest in this area. We continue to monitor developments in the industry and have continued to expand our analyst coverage on hedge funds. We re also continuing to evaluate the possibility of providing a rating system for hedge funds.

Following an appeals court ruling that overturned a previous SEC rule requiring hedge funds to register as investment advisors, numerous hedge fund firms have withdrawn their previous registrations. At the same time, losses experienced by individual funds have led some industry leaders to call for increased regulation. The SEC has also voiced concern about potential insider trading on the part of hedge funds, as well as the potential risks to hedge fund shareholders. Near the end of 2006, the SEC proposed increasing the

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minimum net worth requirement for hedge fund investors to \$2.5 million, from \$1.0 million previously. As debate about hedge fund regulation goes on, we plan to continue our efforts to make the industry more transparent for investors.

Asset growth in separately managed accounts was also relatively strong in 2005. Based on data from the Money Management Institute, assets in separate accounts increased by about 25% to reach \$806 billion as of September 30, 2006, compared with \$646 billion as of September 30, 2005.

Assets in exchange-traded funds (ETFs) increased 40% to reach about \$422 billion as of December 2006, compared with \$301 billion as of December 2005, based on data from the Investment Company Institute. ETFs continued to gain share from mutual funds in some specialized areas of the market because of their lower annual costs, particularly in passive investing strategies. To meet greater investor demand for information on ETFs, we have increased our analyst coverage in this area and introduced a new rating system for ETFs in March 2006. In addition, we recently launched an ETF newsletter and expanded our annual softcover reference guide, the *Morningstar ETFs 100*, to become the *Morningstar ETFs 150*.

### *Individual Investor Market*

With market conditions generally positive, the environment for advertising sales has been relatively healthy. A recent report from the Interactive Advertising Bureau estimated that spending on Internet advertising totaled about \$16 billion in 2006, a 28% increase over \$12.5 billion in 2005. Many advertisers have continued to shift traditional print, radio, and television placements to the Internet. Based on research from Nielsen/NetRatings, page views to most retail investment Web sites remained fairly consistent in 2006. Page views to Morningstar.com remained lower than those of larger competing sites such as Yahoo! Finance, AOL Money & Finance, and MSN Money, but the time spent per visit and average page views per visit statistics remained higher than those of competing sites. We believe this indicates that investors view our site as useful and find value in the information we provide. We also appeal to a highly qualified audience based on income levels and investable assets.

### *Financial Advisor Market*

The aging of the American population and the corresponding need for more information and advice on retirement income planning has been an important trend in the Advisor segment. To meet this need, in 2006 we launched Retirement Income Strategist, a Web-based software application that helps advisors analyze retirement income for clients who are retired or nearing retirement. Retirement Income Strategist helps advisors analyze whether an individual's savings will last during retirement and explore alternative scenarios for sustaining income during retirement. We also created a Retirement Income Education Center, a hosted Web site offering educational content and tools about retirement income for financial advisors affiliated with institutions.

Many advisors have also sought to streamline and simplify their operations; to meet this need, some advisors have been outsourcing investment management so they can spend more time on planning-related issues and client management. We've also seen a continuing consolidation trend among broker-dealers and other firms in the Advisor segment. For example, UBS increased the size of its advisor force by purchasing Piper Jaffray's brokerage unit in 2006. We believe that this ongoing acquisition trend is being driven by the desire to increase scale and maximize cost

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efficiencies. Independent financial advisors have continued to gain market share among high-net-worth investors, but larger institutions are benefiting from their lower cost structures and economies of scale. As the financial advisory landscape continues to evolve, we believe advisors will continue to demand comprehensive research platforms and integrated portfolio tools.

### *Institutional Market*

In August 2006, President Bush signed the Pension Protection Act of 2006, which includes provisions for offering investment advice programs for participants in defined contribution plans. The investment advice provision went into effect for employer-sponsored retirement plans on January 1, 2007.

Among other things, the new act allows plan service providers, mutual fund companies, and brokerage firms to offer investment advice to plan participants using their own computer models (including advising them to invest in their own proprietary funds), subject to certification of the computer model by an independent expert. We're continuing to monitor the potential impact of this provision on our business. Although more companies may rely on retirement plan providers to offer investment advice to their employees, we believe there will be ongoing demand for third-party advice as well. In particular, we believe there may be opportunities for us to continue to license our computer-driven advice model to plan providers.

The legislation also contains provisions that may encourage automatic enrollment and the use of managed retirement accounts as a default investment option. Therefore, we believe this development may have a positive impact on the managed retirement accounts that we offer through Morningstar Associates and Ibbotson Associates, two of our investment advisory subsidiaries.

Continuing an industry-wide trend toward separating the manufacturing and distribution of investment portfolios, Merrill Lynch spun off its investment management group in 2006, selling its asset management group to BlackRock, an asset management firm. Also in 2006, Principal Financial completed its acquisition of Washington Mutual's mutual fund management arm, along with its distributor and shareholder-services business. In early 2007, the parent company of Putnam Investments (Marsh & McLennan Companies) reached an agreement to sell its asset-management unit. We continue to monitor mergers and acquisitions in the asset management industry because of their potential impact on specific areas of our business.

### **Performance Summary**

The list below summarizes the key accomplishments and disappointments that our management team has highlighted related to our 2006 performance:

#### **Accomplishments**

We successfully completed and integrated several acquisitions, including Ibbotson Associates, a leading provider of asset allocation research and services; Aspect Huntley, a leading provider of equity information, research, and financial trade publishing in Australia; and the hedge fund and separate account database division of InvestorForce.

We significantly expanded our hedge fund, separate account, and European and offshore mutual fund databases. We created a pension and life fund database in the United Kingdom and established mutual fund databases in Taiwan and Singapore. We introduced new Investor Return data, also known as dollar-weighted return, to capture how the average investor fared in a fund.

We launched several new Web-based software applications, including Retirement Income Strategist, which analyzes an investor's income needs in retirement; and Morningstar Portfolio Builder, which helps advisors quickly create portfolio proposals.

We achieved meaningful sales of Morningstar Direct outside of the United States, with nearly 25% of Direct's revenue now coming from international markets. We also introduced several new products overseas, including Portfolio Builder and Morningstar Hypothetical Illustrator, a tool that creates customized historical investment

illustrations.

**Disappointments**

Software development for our major upgrade of Morningstar Direct took longer than we expected.

The regulatory investigations into Morningstar Associates, which began in late 2004 and early 2005, continued to consume management's time in 2006 as we held ongoing discussions with regulators in an attempt to work toward a resolution.

**Consolidated Results**

(\$000)	2006	2005	2004	2006 Change	2005 Change
Revenue	\$ 315,175	\$ 227,114	\$ 179,658	38.8%	26.4%
Operating income (loss)	77,527	46,480	17,735	66.8%	162.1%
Operating margin (%)	24.6%	20.5%	9.9%	4.1pp	10.6pp
Cash used for investing activities	\$ (129,002)	\$ (16,913)	\$ (22,750)	662.7%	(25.7)%
Cash provided by (used for) financing activities	33,983	25,256	(6,367)	34.6%	NMF
Cash provided by operating activities	\$ 98,677	\$ 48,445	\$ 32,862	103.7%	47.4%
Capital expenditures	(4,722)	(7,451)	(7,730)	(36.6)%	(3.6)%
Free cash flow	\$ 93,955	\$ 40,994	\$ 25,132	129.2%	63.1%

NMF not meaningful

pp percentage point(s)

As noted in *How We Evaluate Our Business*, free cash flow, which we define as cash provided by operating activities less capital expenditures, is considered a non-GAAP financial measure. This measure is not equivalent to any measure of performance required to be reported under U.S. GAAP and may not be comparable to similarly titled measures reported by other companies.

**Consolidated Revenue**

In 2006, our consolidated revenue increased by 38.8% over 2005. We finished the year with more than \$300 million in consolidated revenue. This past year was notable for us because we made three key acquisitions: Ibbotson Associates, Aspect Huntley, and the hedge fund and separate account database division of InvestorForce. Adding these operations to our existing business contributed \$36.4 million of revenue in 2006, the majority of which was from Ibbotson. While acquisitions helped expand our revenue base in 2006, we also generated strong organic growth. Without the impact of acquisitions and foreign currency translations, organic revenue increased 22.4% in 2006. Organic revenue is considered a non-GAAP financial measure. The table below presents a reconciliation from consolidated revenue to revenue excluding acquisitions and the impact of foreign currency translations (organic revenue):

(\$000)	2006	2005	Change
Consolidated revenue	\$ 315,175	\$ 227,114	38.8%
Less: acquisitions	(36,434)		NMF
Less: impact of foreign currency	(793)		NMF
Revenue excluding acquisitions and foreign currency translations	\$ 277,948	\$ 227,114	22.4%

In contrast to 2006, acquisitions had only a minor impact on our results in 2005. We acquired Variable Annuity Research Database Services (VARDS) from Finetre Corporation in January 2005, and this business contributed revenue of \$2.4 million in 2005.

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In both 2006 and 2005, our growth was diversified by segment, with all three segments generating meaningful revenue growth. Our Institutional segment is the largest of our three segments, so it has the greatest impact on our overall results. The Institutional segment generated a large percentage of our total revenue increase in both 2006 and 2005. Institutional segment revenue increased \$50.2 million in 2006, accounting for about 56% of Morningstar's total revenue increase before eliminating intersegment revenue. In 2005, Institutional segment revenue increased by \$17.5 million, generating about 38% of our total revenue increase before eliminating intersegment revenue. The Advisor segment accounted for approximately 25% of the revenue increase in both periods. Individual segment revenue increased \$17.3 million, or 27.2%, in 2006 and \$16.4 million, or 35.0%, in 2005.

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Revenue by Segment (\$000)	2006		2005		2004	
	Amount	%	Amount	%	Amount	%
Individual	\$ 80,706	25.6%	\$ 63,448	27.9%	\$ 46,996	26.2%
Advisor	94,694	30.0	72,689	32.0	60,880	33.9
Institutional	146,085	46.4	95,947	42.2	78,402	43.6
Elimination of intersegment revenue	(6,310)	(2.0)	(4,970)	(2.1)	(6,620)	(3.7)
Consolidated revenue	\$ 315,175	100.0%	\$ 227,114	100.0%	\$ 179,658	100.0%

On a product level, Investment Consulting was the largest driver behind our revenue increase in 2006 and was also a major contributor to revenue growth in 2005. Newly added revenue from Ibbotson's consulting business generated more than 40% of the 2006 growth in Investment Consulting, with the remaining amount from Morningstar's existing consulting business. In both 2006 and 2005, we continued to expand our relationships and increase assets under management with existing clients for the asset allocation services we provide for funds of funds and variable annuities. Investment Consulting surpassed Licensed Data and Morningstar Advisor Workstation to become our single largest product based on revenue in 2006.

Advisor Workstation was the second-largest driver of the revenue increase in 2006 and the largest contributor in 2005. About 90% of the growth in this product was driven by the Enterprise Edition, which we offer to financial advisors affiliated with larger firms, with the remaining amount contributed by the Office Edition for independent financial advisors. Total licenses for Advisor Workstation in the United States increased by about 36 % in 2006, and our average revenue per license also increased.

Newly incorporated revenue from EnCorr, an asset allocation software package we acquired with Ibbotson, was another major contributor to revenue growth in 2006. Morningstar.com and Licensed Data were the fourth and fifth largest drivers of revenue growth in both 2006 and 2005, although Morningstar.com's contribution was slightly larger relative to Licensed Data in 2006.

Principia was the only one of our top five products based on revenue that didn't experience revenue growth in 2006 and 2005 because many of our customers have been adopting Advisor Workstation, our newer Web-based investment planning system. Principia revenue was essentially flat in 2006 and declined about 2% in 2005. Our strategy for Principia is to continue increasing revenue per user to maintain the product's revenue base.

Equity Research, which mainly consists of revenue related to the Global Analyst Research Settlement, was another key contributor to revenue growth in both 2006 and 2005, but to a greater extent in 2005. We began recognizing revenue for our equity research related to the settlement in July 2004, which led to a favorable year-over-year comparison in 2005. In addition, we entered into an equity research agreement with a sixth investment bank involved in the settlement in September 2005 and began recognizing this new revenue in the fourth quarter of that year. Our revenue in this area also benefited in 2006 and 2005 because we've continued to increase the number of stocks under coverage, leading to higher contract values for some of the agreements related to the settlement.



Revenue from non-U.S. operations increased \$14.9 million, or 50.4%, to \$44.3 million in 2006. Our acquisitions of Aspect Huntley and Ibbotson contributed \$8.3 million of the increase. Non-U.S. revenue made up about 14% of consolidated revenue in 2006, compared with about 13% in 2005. In 2005, our U.S. revenue grew at a faster pace than non-U.S. revenue, partly because of the new revenue related to the Global Analyst Research Settlement and growth in our Investment Consulting business in the United States. Foreign currency translations contributed \$0.8 million of the increase in non-U.S. revenue in 2006 and \$0.7 million in 2005. Excluding the impact of acquisitions and foreign currency translations, our non-U.S. revenue increased approximately 20% and 13% in 2006 and 2005, respectively.

The table below presents a reconciliation from international revenue to international revenue excluding acquisitions and the impact of foreign currency translations (organic revenue):

(\$000)		2006		2005	Change
International revenue	\$	44,276	\$	29,442	50.4%
Less: acquisitions		(8,268)			NMF
Less: impact of foreign currency translations		(793)			NMF
Revenue excluding acquisitions and foreign currency translations	\$	35,215	\$	29,442	19.6%

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(\$000)		2005		2004	Change
International revenue	\$	29,442	\$	25,410	15.9%
Less: impact of foreign currency transaction translations		(694)			NMF
Revenue excluding acquisitions and foreign currency translations	\$	28,748	\$	25,410	13.1%

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Our five largest products based on revenue Investment Consulting, Morningstar Advisor Workstation, Licensed Data, Morningstar.com, and Principia represented 59.5% of our consolidated revenue in 2006, compared with 60.7% in 2005 and 61.5% in 2004. While the percentage of our revenue made up by our top five products has remained relatively consistent, the order of the products within the top five has changed each year. In 2005, Principia, historically our largest product, was surpassed by Licensed Data and Advisor Workstation. Investment Consulting became our largest product in 2006.

<b>Top Five Products (Segment) 2006</b>	<b>Revenue (\$000)</b>	<b>% of Consolidated Revenue</b>
Investment Consulting (Institutional)	\$ 46,597	14.8%
Advisor Workstation (Advisor)	43,140	13.7
Licensed Data (Institutional)	37,730	12.0
Morningstar.com (Individual)	31,311	9.9
Principia (Advisor)	28,735	9.1

<b>Top Five Products (Segment) 2005</b>	<b>Revenue (\$000)</b>	<b>% of Consolidated Revenue</b>
Licensed Data (Institutional)	\$ 32,435	14.3%
Advisor Workstation (Advisor)	29,280	12.9
Principia (Advisor)	28,788	12.7
Morningstar.com (Individual)	25,502	11.2
Investment Consulting (Institutional)	21,904	9.6

<b>Top Five Products (Segment) 2004</b>	<b>Revenue (\$000)</b>	<b>% of Consolidated Revenue</b>
Principia (Advisor)	\$ 29,231	16.3%
Licensed Data (Institutional)	27,203	15.1
Morningstar.com (Individual)	20,670	11.5
Advisor Workstation (Advisor)	19,464	10.8
Investment Consulting (Institutional)	13,853	7.7

### *Revenue Composition*

As discussed in the *Recurring Revenue* section of Key Business Characteristics, we separate our revenue into three categories: new revenue, renewal revenue, and walk-in revenue.

The following graph illustrates the composition of our revenue over the past four years.

Our 2006 revenue consisted of \$45.1 million in new revenue, or 16.2%, of our revenue excluding acquisitions for the year. Renewal revenue accounted for \$101.2 million, or 36.3%, of revenue excluding acquisitions. Walk-in revenue accounted for \$132.5 million, or 47.5%, of this amount.

As of January 1, 2007, our estimate of 2007 walk-in revenue was \$182.9 million, which includes \$21.2 million from acquisitions completed in 2006. This estimate is subject to change based on cancellations during the year, the impact of currency translations, and other routine adjustments. In comparison, our walk-in revenue as of January 1, 2006, was \$138.8 million. In the second quarter of 2006, we reclassified a portion of our revenue composition, reducing 2006 walk-in revenue by \$5.0 million, to more accurately reflect the cancellation terms of certain institutional contracts. Cancellations, foreign currency translations, and other routine adjustments subsequently reduced this revenue by \$1.3 million, or approximately 1%, to \$132.5 million by the end of 2006. This amount includes the positive impact of a one-time payment we received in the third quarter of 2006 because two clients merged and eliminated a redundant license. The walk-in revenue figure does not include variable revenue from asset-related services such as Morningstar Managed Portfolios, managed retirement account services, and Investment Consulting that are calculated as a percentage of total assets under management. These areas of our business have been increasing over the past several years.

In 2006, we estimate that our retention rate for subscription-based products, such as Principia, Premium Membership service, and print and online newsletters, averaged between 60% to 65%, consistent with the level shown in 2005. For contract-based products and services, we estimate that our weighted average renewal rate was between 95% and 100% in 2006, compared with an estimated 100% to 105% in 2005. The

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figure for contract-based products includes the impact of price changes and changes to the contract value upon renewal, as well as changes in the value of variable contracts. The renewal rate for contract-based products and services declined

slightly in 2006 for three main reasons: 1) the impact of outstanding renewals in our data services business; 2) our strategy of discontinuing some lower-margin contracts in our Retirement Advice business; and 3) a smaller increase in the number of incremental users added upon renewal in 2006 relative to 2005 for certain products, such as Morningstar Direct. While we're satisfied with the retention and renewal rates we achieved in 2006, we constantly strive to improve these measures because the cost of maintaining existing customers is lower than the cost of acquiring new customers to replace business that doesn't renew.

### Consolidated Operating Expense

(\$000)		2006		2005		2004	2006 Change	2005 Change
Operating expense	\$	237,648	\$	180,634	\$	161,923	31.6%	11.6%
% of revenue		75.4%		79.5%		90.1%	(4.1)pp	(10.6)pp

Our consolidated operating expense increased \$57.0 million in 2006. Two key factors impacted all of our operating expense categories: compensation-related costs (including incentive compensation) and recent acquisitions. Bonus expense recorded in 2006 increased \$15.8 million because of continued improvements in our financial performance, as well as increased headcount. A majority of our bonus pool is based on growth in our operating income, which may or may not recur.

Other compensation-related expense, mainly including salaries, benefits, and sales commissions, increased \$19.9 million because of an increase in headcount, as well as annual salary increases. We had approximately 1,440 employees worldwide as of December 31, 2006, compared with approximately 1,130 as of December 31, 2005. About half of the increase in headcount was related to acquisitions, and a good portion of the remaining increase was from continued hiring in our development center in China.

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Lower stock-based compensation expense partially offset increases in all of our operating expense categories, but to a limited extent. Stock-based compensation expense decreased \$2.3 million in 2006 because we are no longer required to record expense under the liability method. In the first quarter of 2005, we recorded \$2.8 million of stock-based compensation expense under this method, which did not recur in 2006.

In addition to higher compensation-related expenses, the increase in operating expense includes \$6.2 million of amortization expense for the intangible assets acquired with Ibbotson, Aspect Huntley, and the hedge fund and separate account database division of InvestorForce. We expect that amortization of these intangible assets will be an ongoing cost through the useful lives of these assets, which generally range from three to 25 years.

Our consolidated operating expense increased \$18.7 million in 2005. Approximately half of this increase was from higher cost of goods sold; the remaining portion of the increase occurred across other operating expense categories. The increase in consolidated operating expense was largely driven by a \$15.6 million increase in compensation-related costs, including salaries, bonus, benefits, and sales commissions, stemming from higher headcount. We record these costs in the various operating expense categories as appropriate. We had approximately 1,130 employees worldwide as of December 31, 2005, compared with approximately 1,000 as of December 31, 2004. Approximately 60% of the increase in headcount was driven by technical staffing in our development center in China. Most of the remaining increase in headcount consists of additional stock analysts in our U.S. operations and increased staffing in our corporate departments to meet the requirements of being a public company. An increase in spending for corporate initiatives and legal fees and a decline in capitalized internal product development costs also contributed to the increase in operating expense. A decline in stock-based compensation expense of \$5.8 million in 2005 partially offset the increase in compensation costs and other operating expenses.

### *Cost of Goods Sold*

(\$000)		2006		2005		2004	2006 Change	2005 Change
Cost of goods sold	\$	86,975	\$	64,408	\$	54,709	35.0%	17.7%
% of revenue		27.6%		28.4%		30.5%	(0.8)pp	(2.1)pp
Gross profit	\$	228,200	\$	162,706	\$	124,949	40.3%	30.2%
Gross margin		72.4%		71.6%		69.5%	0.8pp	2.1pp

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Cost of goods sold has generally been our largest category of operating expense, and that pattern continued in 2006. Our business relies heavily on human capital, and cost of goods sold includes the compensation expense for employees who produce the products and services we deliver to our customers. Cost of goods sold increased \$22.6 million in 2006, which was mainly driven by higher bonus expense and other compensation-related expense from increased headcount. While compensation and bonus expense increased across all three of our business segments, the increase was more pronounced in our Institutional segment because a larger portion of the headcount additions from recent acquisitions occurred in this segment.

Acquisitions, primarily Ibbotson, also contributed to the increase in cost of goods sold. In 2006, we recorded \$2.8 million of outsourced product implementation expense associated with the Advice by Ibbotson service. Costs for outsourced product implementation may or may not recur, depending on client requests for development projects in a given period.

Our gross margin in 2006 increased to 72.4%, compared with 71.6% in 2005, reflecting revenue growth that outpaced the increase in cost of goods sold.

Cost of goods sold increased \$9.7 million in 2005. Compensation expense increased in all three segments, but mainly reflects additional costs for newly hired stock analysts in our Individual segment. Shareholder servicing fees related to Morningstar Managed Portfolios, which increased because of higher assets under management, contributed \$1.5 million to the increase in cost of goods sold.

As a percentage of revenue, cost of goods sold declined by about 2 percentage points in 2005. This partly reflects the timing of hiring expenses for our independent equity research. We began incurring incremental compensation costs at the beginning of 2004 as we increased staffing in preparation for the ramp-up of our equity research efforts. We continued to increase staffing in 2005, but had already completed the majority of the staffing increase in 2004. As a result, cost of goods sold increased less dramatically in 2005.

Because cost of goods sold declined as a percentage of revenue in 2005, gross margin showed a corresponding increase. Gross margin has been steadily increasing over the past several years, to 72.4% in 2006 from 69.5% in 2004.

### *Development Expense*

(\$000)		2006	2005	2004	2006 Change	2005 Change
Development expense	\$	29,494	\$19,654	\$16,167	50.1%	21.6%
% of revenue		9.4%	8.7%	9.0%	0.7pp	(0.3)pp

Development expense increased \$9.8 million in 2006. This increase was mainly driven by higher compensation costs, including incentive compensation and other compensation-related expense. We continued to increase hiring for our programming and development staff, and we also increased headcount in this area through acquisitions. We had about 340 programmers and other technology staff as of year-end 2006, compared with about 300 at the end of 2005. Because hiring and acquisitions both increased our cost base in this area, development expense increased as a percentage of revenue over 2005 levels.



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Development expense increased \$3.5 million in 2005 because of increased hiring for programming and development staff (primarily in our Advisor and Institutional segments) and a reduction in the amount of expense capitalized related to development projects. We capitalize compensation costs associated with certain development projects, which reduces the costs included in development expense. Many of the projects for which we capitalized product development costs in 2004 have now been placed into service, and the ongoing costs are no longer capitalized. Instead, we expense these costs as incurred. In 2005, we capitalized \$0.4 million of development costs, compared with \$2.8 million in 2004. As a percentage of revenue, development expense was slightly lower in 2005 compared with 2004.

### *Sales and Marketing Expense*

(\$000)	2006	2005	2004	2006 Change	2005 Change
Sales and marketing expense	\$50,614	\$39,071	\$36,034	29.5%	8.4%
% of revenue	16.1%	17.2%	20.1%	(1.1)pp	(2.9)pp

Sales and marketing expense increased \$11.5 million in 2006. More than a third of this increase was driven by added compensation expense from increased hiring for sales and marketing staff, mainly in our Advisor and Institutional segments. Higher incentive compensation and, to a lesser extent, commission expense and marketing costs, also drove the increase in this cost category. Incremental costs added by acquisitions also contributed to the growth in this category because of increases in headcount and the number of products and services sold. As a percentage of revenue, sales and marketing expense continued to decline as revenue

growth outpaced the increase in cost, but less than in 2005.

Sales and marketing expense increased \$3.1 million in 2005 because of higher sales commissions, salaries, and benefits expense. We incurred additional commission costs because of both increased sales volume, primarily in our Advisor and Institutional segments, and changes to the incentive structure for certain products in the Advisor segment, including Principia and Advisor Workstation Office Edition. Salaries and benefits included in this expense category also increased, mainly because of an increase in headcount for the sales and marketing team in our Advisor segment. Because our revenue base increased at a faster pace than our sales and marketing expense, sales and marketing expense as a percentage of revenue declined by about 3 percentage points in 2005.

#### *General and Administrative Expense*

(\$000)	2006	2005	2004	2006 Change	2005 Change
General and administrative expense	\$ 55,590	\$ 49,235	\$ 46,788	12.9%	5.2%
% of revenue	17.6%	21.7%	26.0%	(4.1)pp	(4.3)pp

General and administrative expense has generally been our second largest category of operating expense following cost of goods sold. That pattern continued in 2006, but general and administrative costs continued to decline as a percentage of revenue. General and administrative expense increased \$6.4 million in 2006, mainly driven by increases in incentive compensation and incremental expense added by acquisitions. This increase was partially offset by a \$1.8 million decrease in stock-based compensation expense, which dropped because we did not record any stock-based compensation expense under the liability method in 2006. In addition, legal expense was essentially flat in 2006. Overall, most costs included in this category rose at a lower rate than revenue, and general and administrative expense as a percentage of revenue declined by about 4 percentage points in 2006.

In 2005, the \$2.4 million increase in general and administrative expense mainly included higher compensation costs, which increased primarily because we added staff in our corporate departments to meet the requirements of being a public company. Higher incentive compensation also contributed to the increase in this area in 2005. We also incurred \$2.0 million more for spending on corporate initiatives and legal fees related to regulatory investigations in 2005 than in 2004. In addition, we increased our offer to settle various claims related to Morningstar Research Pty Limited (Morningstar Australia). Refer to Note 16 of the Notes to our Consolidated Financial Statements for more information regarding this litigation. Stock-based compensation expense included in general and administrative expense decreased \$4.3 million in 2005, which largely offset the increases in other areas. The decrease in stock-based compensation expense was driven by a decline in expense for options accounted for under the liability method, as described below. Because our general and administrative expense increased at a slower pace compared with our revenue growth, general and administrative expense as a percentage of revenue declined by about 4 percentage points in 2005.

#### *Depreciation and Amortization Expense*

(\$000)	2006	2005	2004	2006 Change	2005 Change
	\$ 14,975	\$ 8,266	\$ 8,225	81.2%	0.5%

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Depreciation and amortization expense					
% of revenue	4.8%	3.6%	4.6%	1.2pp	(1.0)pp

Depreciation and amortization expense rose \$6.7 million in 2006. This increase was almost entirely driven by amortization expense from intangible assets acquired with Ibbotson, Aspect Huntley, and the hedge fund and separate account database division of InvestorForce. We expect that amortization of these intangible assets will be an ongoing cost for the remaining life of the assets. The increase in amortization expense was slightly offset by a decrease in depreciation and amortization expense for certain capitalized internal product development costs and computer equipment that are now fully depreciated.

Depreciation and amortization expense increased slightly in 2005 primarily because of amortization of the intangible assets related to the VARDS acquisition. This increase was offset by a decrease in depreciation and amortization expense for capitalized software, computer equipment, and capitalized internal product development costs, as many of the assets in these categories are now fully depreciated.

### *Stock-Based Compensation Expense*

The majority of our stock-based compensation expense relates to employee stock option grants. Beginning in May 2006, we began granting restricted stock units instead of stock options.

We have historically used two different methods of accounting for employee stock options: the liability method, which involves recording a liability for vested options equal to the difference between the option exercise price and the fair value per share of the

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common stock, and the equity method, which is based on the Black-Scholes value of the option at the time of the grant and recorded over the vesting period of the option. Following our initial public offering in May 2005, we are no longer required to settle stock options in cash, and therefore are no longer required to record stock-based compensation expense under the liability method.

The following table summarizes our stock-based compensation expense:

(\$000)		2006		2005		2004	2006 Change	2005 Change
Stock-based compensation expense liability method	\$	\$		2,810	\$	8,963	(100.0)%	(68.6)%
Stock-based compensation expense equity method		8,575		8,085		7,760	6.1%	4.2%
Total stock-based compensation expense	\$	8,575	\$	10,895	\$	16,723	(21.3)%	(34.9)%
% of revenue		2.7%		4.8%		9.3%	(2.1)pp	(4.5)pp

Total stock-based compensation expense declined \$2.3 million in 2006, largely because we did not record any stock-based compensation expense under the liability method in 2006. Stock-based compensation expense recorded under the equity method increased, but by only a small amount. An increase in expense related to our annual equity grant in May 2006, which consisted of restricted stock units, was substantially offset by lower expense recorded for stock options granted in previous years, as certain options became fully vested and no longer require us to record additional expense.

In 2007, we expect to record approximately \$8.8 million of stock-based compensation expense for all stock-based awards outstanding as of December 31, 2006.

In 2005, total stock-based compensation expense declined \$5.8 million compared with 2004. Stock-based compensation expense recorded under the liability method declined \$6.2 million in 2005. The expense recorded under the liability method in 2005 reflects the expense recorded through the first quarter, when we adjusted the liability to reflect our initial public offering price of \$18.50 per share compared with a fair value of \$17.50 per share as of December 31, 2004. The expense recorded under the liability method in 2004 reflects a \$2.80 increase in the fair value per share of our common stock to \$17.50 per share as of December 31, 2004 from \$14.70 per share as of December 31, 2003.

Stock-based compensation expense recorded under the equity method increased \$0.3 million in 2005. This increase mainly reflects the impact of approximately 1.1 million options granted in 2005, as well as ongoing expense associated with options granted in 2004 and prior years. This increase was partially offset by lower expense for options granted in previous years, which are now fully vested and no longer require recording additional expense.

### *Bonus Expense*

(\$000)		2006		2005		2004	2006 Change	2005 Change
Bonus expense	\$	38,341	\$	22,511	\$	21,037	70.3%	7.0%
% of revenue		12.2%		9.9%		11.7%	2.3pp	(1.8)pp

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Bonus expense recorded in 2006 increased \$15.8 million, with the increase driven by improved financial performance versus 2005 and incremental bonus expense from acquisitions. We pay annual bonuses in proportion to our operating income. We include bonus expense in each of our operating expense categories. Because the two factors mentioned above caused a substantial increase in the size of the bonus pool, bonus expense as a percentage of revenue increased by about 2 percentage points in 2006.

Bonus expense increased \$1.5 million in 2005. This category of expense increased primarily because our financial performance in 2005 exceeded our financial performance in 2004. The impact of this increase was partially offset because our bonus expense in 2004 included a special bonus for our analyst team that did not recur in 2005.

### Consolidated Operating Income

(\$000)		2006		2005		2004	2006 Change	2005 Change
Operating income	\$	77,527	\$	46,480	\$	17,735	66.8%	162.1%
% of revenue		24.6%		20.5%		9.9%	4.1pp	10.6pp

Consolidated operating income increased \$31.0 million in 2006. Despite incremental costs added by acquisitions, such as amortization of intangible assets and increased compensation-related expense, our operating margin continued to improve because our revenue base expanded at a faster rate than operating expenses. The lower rate of growth in general and administrative costs, in particular, allowed us to realize operating leverage in our consolidated results. We also realized operating leverage from revenue growth in products that have had slower-growing costs, such as Investment Consulting, Advisor Workstation, Licensed Data, and Morningstar.com. Our operating margin was also positively impacted by a \$2.3 million decrease in stock-based compensation expense.

Our operating margin increased more dramatically in 2005. This increase was primarily driven by the timing of revenue and expense associated with the Global Analyst Research Settlement, the \$5.8 million decrease in stock-based compensation expense, and the operating leverage inherent in our business. 2005 was the first full year of revenue from equity research associated with the Global Analyst Research Settlement. In 2005, we were able to increase costs associated with this revenue at a lower rate because much of the cost increases occurred in 2004 as we built our staff in anticipation of this revenue. In addition, revenue growth for many of our Institutional products, such as Investment Consulting and Licensed Data, increased during the year. We were able to increase costs in most of the related expense categories at a lower rate than this revenue growth.

#### **Consolidated Free Cash Flow**

We generated free cash flow of \$94.0 million in 2006, reflecting cash provided by operating activities of \$98.7 million and capital expenditures of \$4.7 million. Free cash flow more than doubled compared with 2005, primarily reflecting a \$50.3 million increase in cash provided by operating activities. In addition, capital expenditures declined by approximately \$2.7 million compared with 2005. We spent less on leasehold improvements in 2006 after completing major build-outs of our office space in London and China in 2005. The increase in cash provided by

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operating activities was primarily driven by higher net income, as well as a reduction in income tax payments and an increase in accrued compensation. In 2006, we paid \$9.9 million less for income taxes than we did in 2005 because of the cash tax benefits we received from the Ibbotson acquisition. Free cash flow as a percentage of revenue was 29.8% in 2006, compared with 18.0% in 2005.

In 2005, we generated free cash flow of \$41.0 million, reflecting cash provided by operating activities of \$48.4 million and capital expenditures of \$7.4 million. Free cash flow increased by \$15.9 million in 2005, reflecting a \$15.6 million increase in cash provided by operating activities, which was driven by an increase in net income, as well as an approximately \$0.3 million reduction in capital expenditures. As a percentage of revenue, free cash flow was 18.0% of revenue in 2005, compared with 14.0% in 2004. The decrease in capital expenditures in 2005 primarily reflects lower capitalized internal product development costs. Because several products for which costs were previously capitalized have now been put into service, we expense the ongoing costs as we incur them.

The table below presents a reconciliation between the increase in net income and the increase in cash flow provided by operating activities:

(\$000)	2006	2005	2004	2006 Change	2005 Change
Net income	\$ 51,762	\$ 31,117	\$ 8,809	\$ 20,645	\$ 22,308
Adjustments to reconcile net income to net cash flows from operating activities:					
Non-cash items included in net income	3,707	20,647	23,899	(16,940)	(3,252)
Changes in operating assets and liabilities, net of effects of acquisitions:					
Accrued compensation	16,426	6,997	-	9,429	6,997
Income taxes payable	26,696	(2,438)	3,763	29,134	(6,201)
Accounts receivable	(9,261)	(14,989)	(10,866)	5,728	(4,123)
Deferred revenue	10,967	7,364	7,038	3,603	326
Other	(1,620)	(253)	219	(1,367)	(472)
Cash provided by operating activities	\$ 98,677	\$ 48,445	\$ 32,862	\$ 50,232	\$ 15,583

The \$50.3 million increase in cash provided by operating activities in 2006 outpaced the \$20.7 million increase in net income. The increase in net income and a reduction in net operating assets and liabilities (working capital excluding cash) were the two main factors driving this trend. The \$46.5 million reduction in working capital excluding cash was mainly caused by an increase in income taxes payable and accrued compensation. The increase in income taxes payable reflects the increase in taxable income, mainly in the United States, and a \$9.9 million reduction in the amount of cash paid for income taxes in 2006, as we were able to reduce income tax payments because of the cash tax benefits related to the cancellation of Ibbotson's stock options. The growth in accrued compensation reflects the increase in the size of the bonus liability partially offset by a \$5.0 million increase in the amount of cash paid for bonuses. A reduction in non-cash items included in net income partially offset these positive factors. We anticipate making bonus payments of approximately \$35 million in the first quarter of 2007, compared with \$23.0 million of bonus payments made in the first quarter of 2006.

In 2005, the increase in cash provided by operating activities of \$15.6 million lagged the \$22.3 million increase in net income. Several items contributed to lower relative growth in cash provided by operating activities in 2005. Income tax payments and bonus payments had the largest impact on the gap between cash provided by operating activities and net income. Income tax payments in 2005 increased \$12.9 million compared with the previous year. In 2004, we used the majority of our U.S. net operating losses, reducing the amount of taxes paid. Bonus payments in 2005 increased \$5.7 million compared with 2004, reflecting strong business performance during 2004, as well as the last installment of a special bonus established for our analyst team in 2004. In addition, non-cash items included in net income decreased primarily because of lower deferred income tax expense. While income tax payments, bonus payments, and non-cash items included in net income lowered our cash flow provided by operating activities, they were largely offset by a greater cash flow benefit in 2005 arising from changes in operating assets and liabilities. More than half of this benefit reflects increases in accounts payable and accrued expenses; the remaining increase was driven by accrued income taxes and accrued compensation, excluding the payments discussed above.



**Segment Results**

(\$000)	2006	2005	2004	2006 Change	2005 Change
<b>Revenue</b>					
Individual	\$ 80,706	\$ 63,448	\$ 46,996	27.2%	35.0%
Advisor	94,694	72,689	60,880	30.3%	19.4%
Institutional	146,085	95,947	78,402	52.3%	22.4%
Elimination of intersegment revenue	(6,310)	(4,970)	(6,620)	27.0%	(24.9)%
Consolidated revenue	\$ 315,175	\$ 227,114	\$ 179,658	38.8%	26.4%
<b>Operating income</b>					
Individual	\$ 22,921	\$ 15,005	\$ 2,603	52.8%	476.5%
Advisor	26,734	14,617	8,999	82.9%	62.4%
Institutional	37,244	20,544	7,133	81.3%	188.0%
Corporate items and eliminations	(9,372)	(3,686)	(1,000)	154.3%	268.6%
Consolidated operating income	\$ 77,527	\$ 46,480	\$ 17,735	66.8%	162.1%
<b>Operating margin</b>					
Individual	28.4%	23.6%	5.5%	4.8pp	18.1pp
Advisor	28.2%	20.1%	14.8%	8.1pp	5.3pp
Institutional	25.5%	21.4%	9.1%	4.1pp	12.3pp
Consolidated operating margin	24.6%	20.5%	9.9%	4.1pp	10.6pp

**Individual Segment**

Our Individual segment focuses on products and services for individual investors. The largest product in this segment based on revenue is our U.S.-based Web site, Morningstar.com, which includes both paid Premium Membership service and sales of Internet advertising space. Our Individual segment also includes Morningstar Equity Research, which we distribute through several channels. Investors can access our equity research through our Premium Membership offering on Morningstar.com. In addition, our equity research is distributed through six major investment banks to meet the requirements for independent research under the Global Analyst Research Settlement, as well as to several other companies who provide our research to their affiliated financial advisors or to individual investors.

We also offer a variety of print publications on stocks and mutual funds, including our monthly newsletters, *Morningstar FundInvestor* and *Morningstar StockInvestor*, and our twice-monthly publication, *Morningstar Mutual Funds*. We sell several annual reference guides, including the *Morningstar Funds 500*, the *Morningstar Stocks 500*, the *Morningstar ETFs 150*, and the *Stocks, Bonds, Bills, and Inflation Yearbook*. Since we acquired Aspect Huntley in July 2006, this segment also includes several newsletters and other publications for Australian investors. Also, with the addition of Aspect Huntley, our Individual segment now includes revenue from both U.S. and non-U.S. operations. In 2006, 2005, and 2004 this segment represented, before intersegment eliminations, 25.6%, 27.9%, and 26.2%, respectively, of our consolidated revenue.

In 2006, revenue for the Individual segment increased \$17.3 million compared with 2005. Our acquisitions of Aspect Huntley and Ibbotson contributed \$5.1 million to 2006 revenue, with Aspect Huntley contributing about 70% of this incremental revenue. In 2005, our revenue increased \$16.4 million compared with 2004, with all of the revenue growth generated organically. Excluding acquisitions, the product contributing the most to segment revenue in 2006 was Morningstar.com, which includes Premium Membership and Internet advertising sales. This product was the second-largest driver of segment revenue growth during 2005. The number of subscriptions for Morningstar.com Premium service has significantly expanded over the past three years to 165,957 as of December 31, 2006, compared with 147,010 as of December 31, 2005 and 131,035 as of December 31, 2004. In addition, consistent with the trend over the past few years, we moderately increased subscription prices for Premium Membership in both January 2006 and 2005. Internet advertising sales growth was also strong in both years, increasing about 25% in 2006 and 35% in 2005.

Morningstar Equity Research, which mainly includes revenue related to the Global Analyst Research Settlement, was the second-largest contributor to revenue growth in 2006, and the largest driver in 2005. We began recognizing revenue for our equity research related to the settlement in July 2004, which led to a favorable year-over-year comparison in 2005. In addition, we entered into an equity research agreement with a sixth investment bank involved in the settlement in September 2005 and began recognizing this new revenue in the fourth quarter of that year. Our revenue in this area also benefited in 2006 and 2005 because we've continued to increase the number of stocks under coverage, leading to higher contract values for some of the agreements related to the settlement.

In 2006, operating income for the Individual segment increased \$7.9 million compared with 2005, and in 2005, operating income increased \$12.4 million compared with 2004. The increase in operating income in both years reflects revenue that grew at a faster rate than operating expense, though this leverage was more pronounced in 2005. The \$9.4 million and \$4.0 million of growth in operating expense in 2006 and 2005, respectively, was mainly driven by higher compensation-related expense, particularly in cost of goods sold. Hiring for our equity analyst team, whose compensation costs are included in cost of goods sold, contributed to this increase. The team expanded to 113 analysts worldwide as of December 31, 2006, compared with 87 as of December 31, 2005 and 73 as of December 31, 2004. An increase in bonus expense in 2006 as well as incremental expense added by acquisitions were also significant drivers of operating expense growth in that year. Bonus expense decreased in 2005 because this category included a special bonus for our analyst team in 2004 that did not recur in 2005. A decrease in stock-based compensation expense of \$1.1 million in 2006 and \$1.8 million in 2005 partially offset expense increases in both years.

Because our revenue grew at a faster pace than operating expense in both 2006 and 2005, our operating margin improved 4.8 percentage points in 2006 and 18.1 percentage points in 2005. Our margin improvement in 2005 was more significant partly because of a difference in the timing between revenue and expense associated with the Global Analyst Research Settlement. Beginning in 2004, we invested heavily in the hiring of our analyst team in anticipation of the revenue associated with the settlement. We began recognizing revenue from the settlement at the end of July 2004. This resulted in higher compensation-related costs with no corresponding increase in revenue for the first seven months of 2004. In 2005, however, we had a full year of revenue to cover costs. As a result, operating margin significantly improved in 2005 compared with 2004. The decrease in stock-based compensation expense in both 2006 and 2005 had a favorable impact on operating margins.

### **Advisor Segment**

Our Advisor segment focuses on products and services for financial advisors. Key products in this segment based on revenue are Morningstar Advisor Workstation and Morningstar Principia. Advisor Workstation is a Web-based investment planning system that provides financial advisors with a comprehensive set of tools for conducting their core business, including investment research, planning, and presentations. Advisor Workstation is available in two editions: the Office Edition for independent financial advisors and the Enterprise Edition for financial advisors affiliated with larger firms. Principia is our CD-ROM-based investment research and planning software for financial advisors. In addition, we offer Morningstar Managed Portfolios, a fee-based discretionary asset management service that includes a series of mutual fund and exchange-traded fund portfolios tailored to different investment time horizons and risk levels that financial advisors can use for their clients taxable and tax-deferred accounts.

Following our acquisition of Ibbotson, we began offering a series of NASD-reviewed Financial Communications materials that advisors can use to educate clients about asset allocation and demonstrate other key investment concepts, as well as data and graphs that financial advisors can license for use in published materials. Following our acquisition of Aspect Huntley, this segment also includes investment conferences and software that we sell to financial planners and other market participants in Australia. In 2006, 2005, and 2004, this segment represented, before intersegment eliminations, 30.0%, 32.0%, and 33.9%, respectively, of our consolidated revenue.

In 2006, revenue for the Advisor segment increased \$22.0 million compared with 2005. Acquisitions contributed \$6.2 million of revenue in 2006, primarily from sales of Financial Communications materials and advisor-focused Ibbotson software tools. In 2005, revenue for the Advisor segment increased \$11.8 million compared with 2004. Acquisitions had a smaller impact on revenue growth in 2005, with our acquisition of VARDS contributing \$0.4 million. In both 2006 and 2005, the increase in revenue was primarily driven by Morningstar

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Advisor Workstation. We continued to see strong growth in licenses of the Enterprise Edition of Morningstar Advisor Workstation, and we entered into numerous new agreements in both years. In addition, we also experienced strong renewals for the product during 2006 and 2005, and several contracts that were scheduled to expire renewed at significantly higher price points, reflecting both higher user counts and an increase in the amount of functionality licensed. In 2005, revenue from Advisor Workstation surpassed revenue from Principia, which historically had been our largest product, to become our second-largest product company-wide, and it continued to hold this ranking in 2006. The number of U.S. licenses for Morningstar Advisor Workstation increased to 153,838 as of December 31, 2006, compared with 113,461 as of December 31, 2005 and 80,235 as of December 31, 2004.

Morningstar Managed Portfolios also contributed to revenue growth in both 2006 and 2005, but to a lesser degree than Advisor Workstation. Assets under management for Morningstar Managed Portfolios increased to \$1.8 billion as of December 31, 2006, compared with \$1.4 billion as of December 31, 2005 and \$936.0 million as of December 31, 2004. Principia revenue remained flat in 2006 and declined slightly in 2005. The number of subscriptions for Principia has been declining over the past few years to 47,835 as of December 31, 2006 from 49,728 as of December 31, 2005 and 51,308 as of December 31, 2004. While the number of subscriptions has decreased, average revenue per subscription increased in both years because of an increase in the number of higher-priced advanced modules sold, previous price increases, and, in 2005, reductions in certain discount programs.

In 2006, operating income increased \$12.1 million compared with 2005, and in 2005, operating income increased \$5.6 million compared with 2004. In both years, the increase in operating income reflects an increase in revenue partially offset by higher operating expense in all categories. Operating expense increased \$9.9 million and \$6.2 million, respectively, in 2006 and 2005. An increase in cost of goods sold was the biggest driver in both years, contributing almost half of the expense increase in 2006 and more than one-third of the expense increase in 2005. Higher cost of goods sold in both years partly reflects increased compensation costs from additional headcount. In 2006, an increase in bonus expense as well as incremental costs added by acquisitions were also major drivers behind the cost increase in this category. In 2005, an increase in shareholder servicing fees related to higher levels of assets under management for Morningstar Managed Portfolios was a major contributor to higher cost of goods sold.

The remaining operating expense growth in 2006 primarily reflects an increase in sales and marketing expense, driven by compensation-related expense, including bonuses. Incremental costs added by acquisitions also contributed to expense growth in all categories. In 2005, an increase in general and administrative expense, driven by higher corporate overhead expense, contributed a little less than one-third of the increase in operating expense. The remaining increase in operating expense in 2005 primarily reflects increased sales and marketing expense, which was driven by higher compensation-related expense and commissions for sales of Advisor Workstation and Principia. The higher sales commissions reflect increased sales volume in Advisor Workstation and changes to the incentive structure for both products.

A decrease in stock-based compensation of \$0.7 million and \$1.7 million in 2006 and 2005, respectively, lowered operating expense in all categories and contributed to the improvement in operating income. Our operating margin improved by 8.1 percentage points in 2006, to 28.2%, and 5.3 percentage points in 2005, to 20.1%, reflecting the impact of higher revenue and our operating leverage. Operating margin growth in both years was partly driven by Advisor Workstation Enterprise Edition; revenue for this product has grown at a more rapid pace than operating expense. A decrease in stock-based compensation in 2006 and 2005 also had a positive impact on operating margins.

### **Institutional Segment**

Our Institutional segment focuses on products and services for institutions, including banks, insurance companies, mutual fund companies, brokerage firms, media firms, and retirement plan providers and sponsors. Key products and services in this segment based on revenue are Investment Consulting, which focuses on investment monitoring and asset allocation for funds of funds, including mutual funds and variable annuities; Licensed Data, a set of investment data spanning eight core databases, available through electronic data feeds; Retirement Advice,

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including the Morningstar Retirement Manager and Advice by Ibbotson platforms; Morningstar Direct, a Web-based institutional research platform that provides advanced research and tools on the complete range of securities in Morningstar's global database; Licensed Tools and Content, a set of online tools and editorial content designed for institutions to use in their Web sites and software; Investment Profiles & Guides, which are designed for institutions to use in communicating investment information to individual investors; the Morningstar Annuity Research Center (formerly VARDS Online); and Morningstar EnCorr, an asset allocation software package (acquired with Ibbotson).

With the addition of Aspect Huntley, this segment now includes financial information as well as other data feeds on Australian stocks that we sell to stock brokers, information providers, and financial Web sites. The Institutional segment also includes the hedge fund and separate account database division we acquired from InvestorForce in August 2006. In 2006, 2005, and 2004, this segment represented, before intersegment eliminations, 46.4%, 42.2%, and 43.6%, respectively, of our consolidated revenue. We expect that the Institutional segment will continue to account for the largest portion of our consolidated revenue for the foreseeable future.

In 2006, revenue for the Institutional segment increased \$50.2 million compared with 2005. Acquisitions contributed \$25.1 million of revenue to this segment in 2006, mainly from Investment Consulting services and EnCorr. In 2005, revenue for the Institutional segment increased \$17.5 million compared with 2004. Acquisitions increased revenue to a much lesser extent in 2005, with VARDS contributing \$2.0 million in segment revenue during the year.

For the segment overall, the increase in revenue in both 2006 and 2005 was driven by Investment Consulting, which includes asset-allocation and investment selection services for funds of funds and variable annuities. Investment Consulting contributed about 50% and 40% of the total increase in segment revenue in 2006 and 2005, respectively. In 2006, more than 40% of the increase in Investment Consulting revenue was contributed by newly incorporated revenue from Ibbotson. In 2005, we expanded existing relationships and our scope of responsibilities with two major clients.

In both 2006 and 2005, revenue also increased because we receive asset-based fees for our services, and assets under advisement in this area significantly increased in both years. We provided advisory services on approximately \$55.5 billion in assets (including \$40.5 billion from Morningstar Associates and \$15.0 billion from Ibbotson Associates) as of December 31, 2006, compared with approximately \$22.1 billion in assets as of December 31, 2005 and approximately \$12.6 billion as of December 31, 2004 (Morningstar Associates only). These totals include consulting relationships as well as agreements where we act as a portfolio construction manager for a mutual fund or variable annuity and receive a basis point fee. In addition, we also provide Investment Consulting services for some assets under management for which we receive a flat fee.

Excluding 2006 acquisitions, Licensed Data and Morningstar Direct were the next largest contributors to revenue growth in both 2006 and 2005. Both products have benefited from expanded sales efforts in Europe and other non-U.S. markets, as well as continued strength in the United States. The number of licenses for Morningstar Direct increased to 1,348 worldwide as of December 31, 2006, compared with 985 as of December 31, 2005 and 775 as of December 31, 2004. Revenue growth in Morningstar Direct in both 2006 and 2005 exceeded growth in the number of licenses because of the continued impact of a new pricing model implemented during 2004. Several key contracts whose terms ended

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during 2006 and 2005 renewed for a smaller number of licenses, but at a greater price per license.

EnCorr and Advice by Ibbotson were also significant contributors to revenue growth during 2006. The Ibbotson acquisition significantly expanded our asset base in managed retirement accounts, and we are now among the largest providers in this area. We had \$8.6 billion in combined assets under management in the managed retirement accounts offered through Advice by Ibbotson (\$8.0 billion) and Morningstar Retirement Manager (\$647.0 million) as of December 31, 2006, compared with \$285.0 million as of December 31, 2005 and \$123.9 million as of December 31, 2004 (Morningstar Retirement Manager only). As of December 31, 2006, more than 17 million retirement plan participants had access to our retirement advice services through approximately 108,000 plan sponsors and 31 plan providers. These totals include more than 9 million retirement plan participants, 71,000 plan sponsors and 24 plan providers who had access to Morningstar Retirement Manager, and nearly 8 million retirement plan participants, 37,000 plan sponsors and seven plan providers who had access to Advice by Ibbotson.

Revenue for our online advice service for retirement plan participants declined in both 2006 and 2005. We have been transitioning clients to our new user interface, which gives retirement plan participants streamlined, easy-to-use access to a broader range of advisory services. In particular, we are focusing our efforts on managed accounts, which may appeal to a broader segment of retirement plan participants. Revenue for the managed retirement accounts offered through Morningstar Retirement Manager increased in both 2006 and 2005, as assets under management more than doubled in both 2006 and 2005.

In 2006, operating income for the Institutional segment increased \$16.7 million compared with 2005, and in 2005, operating income increased \$13.4 million compared with 2004. The increase in operating income in both years was primarily driven by revenue growth in Investment Consulting and Licensed Data. Contract values in both areas and asset-based fees in Investment Consulting have increased, while the cost base for these services has increased at a lower rate.

Operating expense increased approximately \$33.4 million in 2006 and \$4.1 million in 2005. In both years, the largest increase in expense was driven by cost of goods sold, which contributed about 40% and 75% of the expense increase in 2006 and 2005, respectively. In both years, incremental costs added by acquisitions also contributed to the increase in this expense category, but to a



larger extent in 2006. During 2006, we incurred approximately \$2.8 million of product implementation fees related to our Advice by Ibbotson service. In addition, a large portion of incremental headcount from acquisitions was added to the Institutional segment in 2006, which contributed to higher compensation and bonus expense in this category. Compensation-related costs excluding acquisitions increased in both years because of added headcount and higher bonuses.

The remaining increase in operating expense in 2006 was spread across the other expense categories and reflects higher compensation and bonus expense as well as incremental expense added from acquisitions. The remaining increase in operating expense in 2005 was driven by growth in sales and marketing expense, reflecting higher compensation and sales commission expense. A decrease of \$0.7 million and \$2.2 million in stock-based compensation expense in 2006 and 2005, respectively, partially offset these expense increases, and in turn, positively impacted operating income. Our operating margin improved 4.1 percentage points in 2006 and 12.3 percentage points in 2005, reflecting the impact of revenue growth that exceeded the increase in operating expense.

### Corporate and Eliminations

Corporate items and eliminations include capitalized internal product development costs and related amortization expense. In addition, this category includes amortization expense related to intangible assets, primarily recorded as part of acquisition-related purchase price allocations. The following table shows the components of corporate and eliminations expense (income) that impacted our consolidated operating income:

(\$000)	2006	2005	2004	2006 Change	2005 Change
Depreciation and amortization	\$ 9,669	\$ 3,576	\$ 3,342	170.4%	7.0%
Capitalized internal product development costs	(178)	(375)	(2,802)	(52.5)%	(86.6)%
Other	(119)	485	460	NMF	5.4%
Corporate items and eliminations	\$ 9,372	\$ 3,686	\$ 1,000	154.3%	268.6%

In 2006, corporate items and eliminations increased \$5.7 million primarily because of an increase in amortization expense related to intangible assets we acquired with Ibbotson, Aspect Huntley, and the hedge fund and separate account database division of InvestorForce. In 2005, corporate items and eliminations increased \$2.7 million, reflecting a decrease of \$2.4 million in capitalized internal product development costs and a \$0.3 million increase in depreciation and amortization.

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



**Equity in Net Income of Unconsolidated Entities**

(\$000)

2006

2005