Morningstar, Inc. (MORN)

Updated July 28th, 2019 by Josh Arnold

Key Metrics

Current Price:	$155	**5 Year CAGR Estimate:**	0.9%	**Volatility Percentile:**	55.9%
Fair Value Price:	$115	**5 Year Growth Estimate:**	6.0%	**Momentum Percentile:**	67.1%
% Fair Value:	135%	**5 Year Valuation Multiple Estimate:**	-5.8%	**Growth Percentile:**	52.0%
Dividend Yield:	0.7%	**5 Year Price Target**	$154	**Valuation Percentile:**	18.4%
Dividend Risk Score:	B	**Retirement Suitability Score:**	D	**Total Return Percentile:**	9.2%

Overview & Current Events

Morningstar was founded in 1984 as a way for investors to seek information about hundreds of popular mutual funds that was out of reach prior to the company's Sourcebook product. Since that time Morningstar has grown tremendously, serving about 9 million clients today. It has about $1 billion in annual revenue and a market capitalization of $5.7 billion.

Morningstar reported Q2 earnings on 7/25/19 and results were once again strong on a top line basis, but rising expenses crimped earnings, leading us to lower our estimate for this year.

Revenue was up 8.5% year-over-year in Q2 to $274 million, gaining 10% on an organic basis. The balance was due to a 1.5% headwind from forex translation.

License-based revenue was up 9%, led by PitchBook, Morningstar Data, and Morningstar Direct strength. Domestic strength was seen in PitchBook, which continues its torrid pace of growth, while Data and Direct revenue grew thanks to international markets. Positive equity market performance drove asset-based revenue as average assets under management and advisement rose 5.6% year-over-year.

Transaction-based revenue rose 5.2% in Q2 as new issue volume in structured finance securities drove Morningstar Credit Ratings revenue 23.3% higher. Advertising revenue, however, fell 14.8% at Morningstar.com.

Operating expenses rose 12.2% in Q2, primarily attributable to increases in compensation, production costs, facilities, and stock-based compensation. Morningstar continues to invest heavily in key growth areas, but this growth comes at a high price over time. Higher compensation expense is attributable to achieving growth targets related to PitchBook and other products, which is a sign of success, but costly nevertheless.

Operating income was down 5.2% in Q2 to $51 million thanks to higher expenses. On a percentage of revenue basis, operating income fell from 21.2% to 18.5% in Q2, which was much lower than we expected. Earnings-per-share were $0.98 in Q2, essentially flat with $0.97 in the year-ago period.

Higher expenses have caused us to cut our estimate for this year to $4.25 in earnings-per-share, down from $4.50.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	$1.66	$1.70	$1.92	$2.10	$2.66	$2.54	$3.00	$3.72	$2.88	$4.25	***$4.25***	***$5.69***
DPS	---	$0.05	$0.25	$0.53	$0.38	$0.70	$0.79	$0.88	$0.92	$1.00	***$1.12***	***$1.60***
Shares	50	50	50	46	45	44	43	43	43	43	***43***	***43***

Morningstar's earnings-per-share history is very strong considering the wide array of economic conditions that have existed in the past decade. The company saw a small dip in earnings at the height of the crisis in 2009 and there have been a couple of other small blips, but it has managed an average growth rate of 6%. We see this level of growth continuing moving forward, and are therefore forecasting 6% earnings-per-share growth for the coming years.

One-time gains related to tax reform won't be present beginning this year so growth should normalize in 2019 and beyond. Still, we think low to mid-single-digit revenue growth and a bit of further margin growth potential make 6% earnings-per-share growth look feasible. This growth estimate is also dependent on the company's appetite for

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acquisitions moving forward. With that said, its long-term revenue and earnings growth includes many acquisitions over time, so we see this estimate as including some additional M&A that has not occurred yet. Morningstar's position in its niche is well established and we see its future as very bright looking forward. It also continues to experience tremendous success with its PitchBook and other licensed products, which occurred once again in Q2.

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	25.0	27.5	30.3	28.7	27.7	28.2	25.8	21.4	28.1	27.2	***36.5***	***27.0***
Avg. Yld.	---	0.1%	0.4%	0.9%	0.5%	1.0%	1.0%	1.1%	1.1%	0.9%	***0.7%***	***1.0%***

Morningstar's average price-to-earnings ratio has been very high in the past decade as its trough value was 21.4, set in 2016. Investors have always been willing to pay a premium for this stock and that is not going to change. Morningstar, and other businesses like it with lucrative subscription models, tend to receive premium valuations due to their high rates of recurring revenue and superior profitability. However, today's price-to-earnings ratio of 36.5 is well in excess of our estimate of fair value, which we see as 27. That means the security could experience a 5.8% headwind to total returns as the valuation returns to more normalized levels. We see the yield as remaining around where it is today as the dividend keeps pace with earnings; Morningstar is not an income stock.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	---	3%	10%	25%	14%	27%	25%	24%	32%	24%	***26%***	***28%***

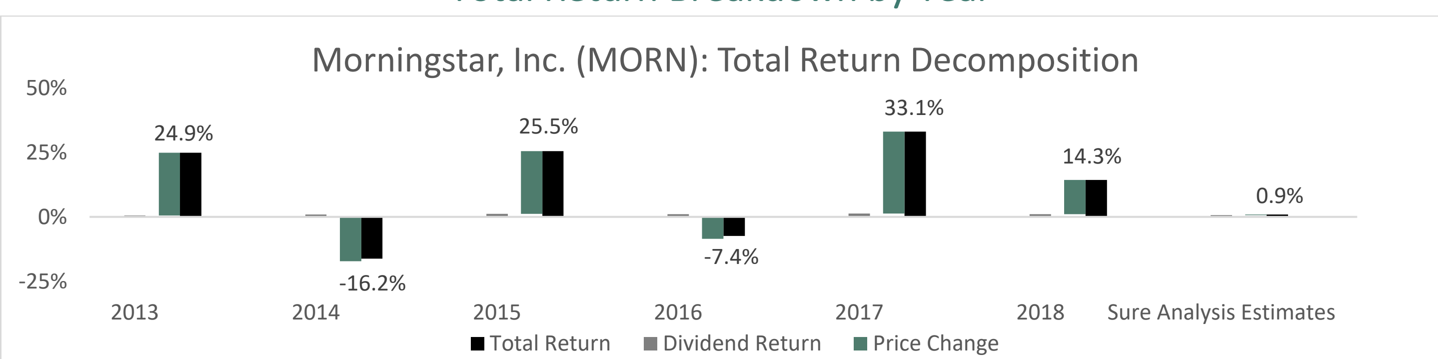
The payout ratio is not likely to crest 30% anytime soon, barring a major shift in capital allocation strategy, so we see the yield as staying around 1% for the foreseeable future. Certainly, management has been more interested in investing for future growth, and that strategy isn't going to change anytime soon.

Morningstar's competitive advantage is in its very long operating history in a niche of the investment world it helped create. The company's subscription service, particularly with its PitchBook product, is a key differentiator and we see it powering future growth for many years to come.

Final Thoughts & Recommendation

Overall, we see Morningstar as a stock with a strong moat but also one that has had a major run, making it less compelling at present. We are forecasting just 0.9% total annual returns moving forward, consisting of the current 0.7% yield, 6% earnings-per-share growth and a 5.8% headwind from the valuation resetting. Morningstar's future is very bright, but given the low expected returns, we are downgrading it to a sell rating.

Total Return Breakdown by Year



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Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.

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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	479	555	631	658	698	760	789	799	912	1020
Gross Profit	350	398	396	412	427	442	459	454	525	609
Gross Margin	73.1%	71.7%	62.7%	62.5%	61.1%	58.1%	58.2%	56.9%	57.6%	59.7%
SG&A Exp.	155	188	215	218	211	220	204	203	264	296
D&A Exp.	32	40	43	43	46	55	64	71	91	97
Operating Profit	125	121	138	151	171	167	191	181	170	216
Operating Margin	26.0%	21.8%	21.9%	22.9%	24.4%	21.9%	24.2%	22.6%	18.6%	21.2%
Net Profit	82	86	98	108	124	78	133	161	137	183
Net Margin	17.1%	15.6%	15.6%	16.4%	17.7%	10.3%	16.8%	20.2%	15.0%	17.9%
Free Cash Flow	89	109	142	116	153	78	184	151	184	239
Income Tax	47	43	44	53	56	36	63	64	43	48

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	919	1086	1172	1042	1031	1010	1029	1351	1406	1454
Cash & Equivalents	130	180	200	164	168	185	207	259	308	369
Accounts Receivable	82	111	113	114	114	137	139	146	148	172
Goodwill & Int. Ass.	385	487	458	438	430	466	438	678	660	631
Total Liabilities	253	305	315	315	339	356	388	654	601	519
Accounts Payable	N/A	N/A	41	44	42	34	39	45	49	54
Long-Term Debt	0	0	0	0	0	30	35	250	180	70
Shareholder's Equity	665	780	855	726	690	654	640	697	805	935
D/E Ratio	0.00	0.00	0.00	0.00	0.00	0.05	0.05	0.36	0.22	0.07

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	9.5%	8.6%	8.7%	9.8%	11.9%	7.7%	13.0%	13.5%	9.9%	12.8%
Return on Equity	13.7%	12.0%	12.0%	13.7%	17.4%	11.7%	20.5%	24.1%	18.2%	21.0%
ROIC	13.7%	11.9%	12.0%	13.6%	17.4%	11.4%	19.5%	19.8%	14.2%	18.4%
Shares Out.	50	50	50	46	45	44	43	43	43	43
Revenue/Share	9.62	10.99	12.38	13.39	15.02	16.93	17.81	18.44	21.20	23.72
FCF/Share	1.79	2.15	2.78	2.36	3.29	1.74	4.16	3.49	4.27	5.55

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.