How Bright Can Morningstar Shine?

The independent research firm is planning an IPO, but the days of rapid growth in the demand for its services may be over

When companies announce plans to go public, questions often linger about whether they have a viable business model. That's certainly not the case with Morningstar, the Chicago investment-research house, which filed for a $100 million initial public offering with the Securities & Exchange Commission on May 6. Analysts expect the IPO in the next few months.

Morningstar is no startup. Founded in 1984, it has chalked up an annual growth rate of 28% for each of the past five years. Revenues were $139.5 million in 2003, up 27% from 2002, although it lost $11.9 million in 2003 after investing heavily in building its online and stock-research businesses. In 2002 it cleared a profit of $446,000.

In the filing, Morningstar claimed as customers 3 million individual investors, 100,000 financial advisers, and 500 institutions (mostly mutual-fund companies) in 16 countries around the world. It tracks nearly 55,000 mutual funds and more than 500 stocks.

"ANEMIC" GROWTH. Rather than concerns about Morningstar's business model, the biggest question centers on how much growth lies ahead for the business of tracking the scandal-tainted mutual-fund industry. Morningstar is the king of mutual-fund research. Its five-star fund-rating system and trenchant portfolio analyses have become the most important measures for many individuals and financial advisers to evaluate funds. But the best growth years for the fund business, as well as for the once-booming financial-planning field, now seem to be past.

Morningstar has "a lot of clout, but I don't know if they have a lot of growth," says Geoff Bobroff, a mutual-fund consultant in East Greenwich, R.I. As he sees it, "The growth potential for the industry is anemic for the next several years. The growth they saw in the '90s isn't going to reoccur."

Morningstar's near-term prospects lie not so much with following mutual funds as with its three-year-old stock-research arm. Both Goldman Sachs (GS) and Merrill Lynch (MER) have plans to spend millions buying Morningstar research as part of their settlement with securities regulators. In April, 2003, 10 Wall Street firms set aside a total of $430 million to buy and distribute independent research (hand-in-hand with their in-house research) over the next five years. Other firms are likely to announce contracts with independent firms over the next few weeks. And Morningstar seems to be winning a commanding chunk of this business.

IMPROVEMENT NEEDED. "This could be a big step up for them," says David Menlow, president of independent research provider IPOfinancial.com (which is also trying sell his IPO research to the big brokerages). Menlow believes Morningstar's filing was timed to build on upcoming announcements of more research wins.

"There's a lot of money out there," says Menlow, who notes that the big firms will spread about $15 million a year to a handful of independent research outfits over the next five years. "As more firms sign on, that's going to help them with their top line." Although each deal's terms haven't been released, out of that $430 million pot, Morningstar could potentially reap an extra $25 million to $50 million a year for the next five years from research fees.

In its SEC filing, Morningstar didn't offer much information about its plans for the IPO funds. It said the proceeds would be used for "general corporate purposes, including working capital." But it will clearly have to invest more in its stock-research arm to provide strong, independent analysis on all the companies Goldman, Merrill, and other Wall Street brokerages now cover.

FIVE-YEAR WINDOW. Can Morningstar shine in this competitive field? "As it stands now, Morningstar's stock research is not at a caliber you would expect for a portfolio manager to make investment decisions," cautions Tom Taulli, an author and principal at Newport Beach (Calif.) investment firm Bridgewater Capital. But he has faith that Morningstar, given its reputation for quality, can improve it.

Taulli believes the firm may follow the same path with stock research as it did with its mutual-fund research: first attract professional clients, then move to sell the research to consumers. Indeed, Morningstar has a strong track record of seizing opportunities well before they become apparent to most financial firms, notes Taulli, who adds: "It caught onto the mutual-fund wave, then saw the Internet as an opportunity, and successfully transitioned its business."

Ultimately, however, the market for independent research, while in a whole new stage of development due to the settlement with regulators, is still limited, many analysts believe. Investors are already drawing much of their fund research from Morningstar, and they remain accustomed to getting their stock research from brokerage houses. "There's only so far you can take this market," says Taulli, who believes that limited numbers of consumers will actually buy research. And Wall Street outfits are required to buy research from independent sources for only the next five years.

NO GOOGLE. The next step for Morningstar will be to file the terms of the deal, which it will likely do in the next few weeks. When investors see how many shares Morningstar actually decides to offer and at what price, then they can judge if it's worth getting in at the offering. Clearly, nobody would confuse Morningstar with Google. The online search engine has captivated investors with its $2.7 billion IPO, revenues in the $1.6 billion range, and seemingly unlimited growth opportunities (for an S&P analysis of the Google offering, see BW Online, 6/11/04, **"Google: What Lies Beyond Search?"**).

Analysts think Morningstar's IPO will have to wait until the fall, after Wall Street's summer doldrums pass. Plus, it may take a few more research wins to get investors excited about Morningstar's growth prospects. Says Taulli: "I think they get the deal done, but I don't see it being a barn burner." Morningstar may have to settle for a few sparks.

Stone is a senior writer at BusinessWeek Online and covers the markets as a **Street Wise** columnist

Edited by Douglas Harbrecht