Merck & Company (MRK)

Updated August 8th, 2018 by Nate Parsh

Key Metrics

Current Price:	$67	**5 Year CAGR Estimate:**	1.6%	**Volatility Percentile:**	25.2%
Fair Value Price:	$54	**5 Year Growth Estimate:**	3.0%	**Momentum Percentile:**	47.6%
% Fair Value:	124%	**5 Year Valuation Multiple Estimate:**	-4.3%	**Valuation Percentile:**	24.9%
Dividend Yield:	2.9%	**5 Year Price Target**	$62	**Total Return Percentile:**	9.2%

Overview & Current Events

With a current market cap of $179 billion, Merck & Company is one of the largest healthcare companies in the world. Merck manufactures prescription medicines, vaccines, biologic therapies and animal health products. Merck employs 69,000 people around the world and generated sales of more than $40 billion in 2017.

Merck reported 1st quarter earnings results on July 27th. The company earned $1.06 per share, $0.03 above estimates and a 5% improvement year over year. Revenue grew 5.4% to $10.5 billion, $180 million higher than estimates.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$3.64	$3.25	$3.42	$3.77	$3.82	$3.49	$3.49	$3.59	$3.78	$3.98	***$4.26***	***$4.94***
DPS	$1.52	$1.52	$1.52	$1.52	$1.68	$1.72	$1.76	$1.80	$1.84	$1.88	***$1.92***	***$2.12***

Merck's earnings declined during the last recession and it took the company several years to return to growth. In fact, Merck has only seen EPS grow by less than 1% per year over the past ten years. Merck has struggled to grow earnings as patents for drugs have expired.

Keytruda, which treats cancers such as melanoma that cannot be removed by surgery and non-small cell lung cancer, could help put an end to anemic earnings growth. During the second quarter, it was announced that *Keytruda* was under review by the FDA for use as a first-line treatment for certain types of lung cancer. After tripling sales last quarter, *Keytruda* revenues grew 89% to $1.7 billion in the 2nd quarter. Annual sales could reach $8 billion by 2020. Thanks to *Keytruda*, vaccines and a few other promising oncology drugs set to be released in the coming years, we forecast that Merck can grow EPS at a rate of at least 3% per year over the next five years. On the conference call, Merck's management raised its expected earnings per share midpoint to $4.26 from $4.22.

After pausing its dividend from 2005 through 2011, Merck has increased its dividend at an average rate of just over 2% per year since. The last dividend raise occurred on 11/28/2017, which raised the dividend 2.1%. We forecast dividend growth of 2% annually through 2023 based on the company's dividend history.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	10.2	9.1	10.5	9.1	10.8	13.3	16.4	15.8	15.2	15.6	***15.7***	***12.6***
Avg. Yld.	4.1%	5.1%	4.2%	4.4%	4.1%	3.7%	3.1%	3.2%	3.2%	3.0%	***2.9%***	***3.4%***

Shares of Merck have increased $9, or 15.5%, since our May 29th update. Based off of updated guidance, the stock has a forward price to earnings multiple of 15.7. Merck's long term average price to earnings multiple is 12.6. This is far below the multiple of the S&P 500, but this is evidence of the market not willing to pay up for a very low earnings growth rate. If shares were to revert to their historical valuation, the multiple could contract 4.3% annually through 2023, up from an estimated contraction of 1.6% previously.

Merck's dividend yield is well above that of the S&P 500's yield and slightly ahead of the 10-Year Treasury Bond. In a rising interest rate environment, Merck's yield might not be as attractive to income investors to the risk free Treasury Bond.

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

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	38.7%	16.4%	26.1%	29.7%	29%	25.6%	25.9%	24.2%	27.2%	31.1%	***30.4%***	***27.4%***
Debt/A	55.2%	45.3%	46.3%	45.8%	47.7%	50.5%	50.3%	56%	57.7%	60.7%	***58.8%***	***51.5%***
Int. Cov.	---	63	3.7	14.6	19.6	11.8	38.7	15.9	14.7	19.7	***20.3***	***22.4***
Payout	41.8%	46.8%	44.4%	40.3%	44%	49.3%	50.4%	50.1%	48.7%	47.2%	***45.1%***	***42.9%***
Std. Dev.	29%	31.4%	18.2%	22.1%	16.2%	13.4%	14.7%	17.6%	14.2%	17.6%	***18%***	***19.4%***

Many investors consider pharmaceutical companies "defensive" stocks because their products are in demand even in a protracted recession. The thinking goes that sick people will seek treatment for illnesses even in poor economic conditions, causing earnings to increase. While this is true for many names in this industry, Merck's earnings decline in 2009, subsequent long road back to profitability and lack of any real growth shows that this is not necessarily true for every company.

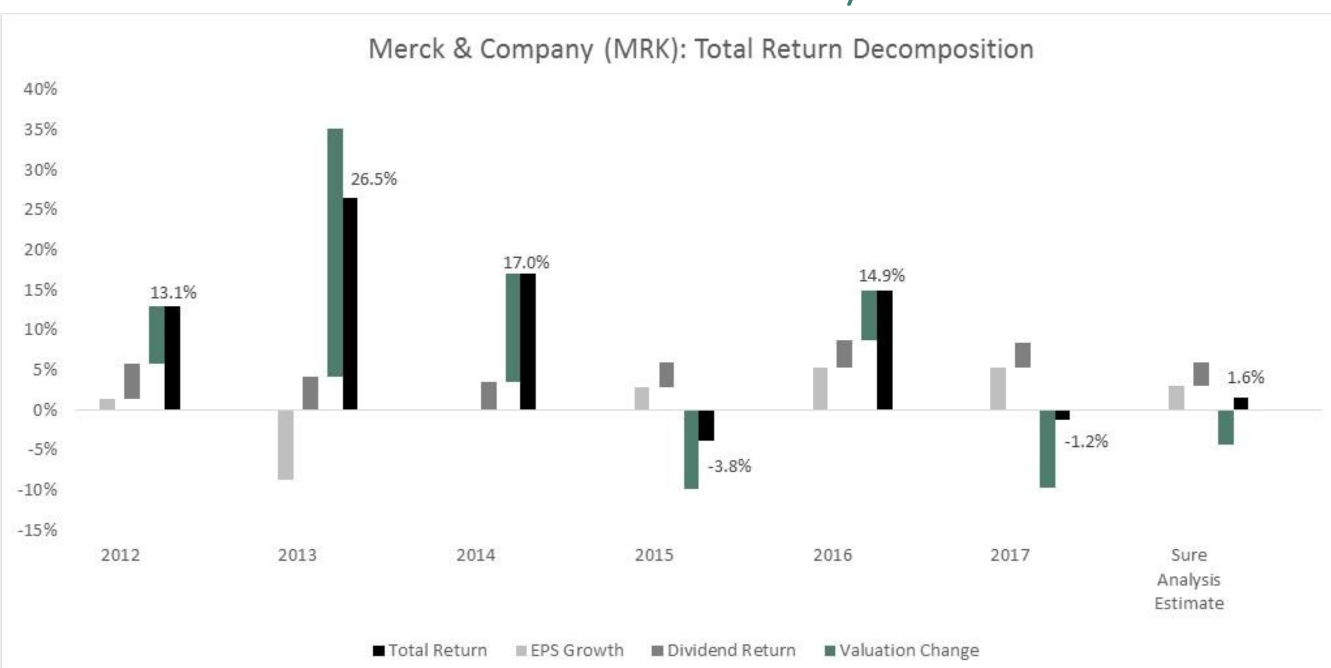
Merck's percentage of gross profits to asset ratio has yet to recover above 2008's total, though this ratio has climbed slightly higher over the past five years. The company's debt to asset ratio has also increased in recent years. Even so, Merck doesn't appear to be overleveraged and the dividend can be considered both stable and safe.

As earnings have barely budged over the last decade, Merck did the reasonable thing and paused dividend growth. This helped to keep the payout ratio low and has allowed Merck to continue to pay its dividend even as earnings stagnated.

Final Thoughts & Recommendation

After factoring in 2nd quarter earnings, we forecast that Merck can offer total returns of just 1.6% per year for the next five years, down from 4.7% earlier. This estimate is arrived at by a combination of growth (3%), dividends (2.9%) and multiple reversion of (4.3%). The 15%+ gain in share price over the last two months has removed much of the total return we feel that the stock can offer investors today. While the yield is decent, we feel that there are other pharmaceutical companies that offer more promising returns than Merck. The company earns a sell recommendation at current prices, although we maintain our 2023 price target of $63.

Total Return Breakdown by Year



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