Merck & Company (MRK)

Updated October 29th, 2018 by Nate Parsh

Key Metrics

Current Price:	$70	**5 Year CAGR Estimate:**	1.2%	**Volatility Percentile:**	22.6%
Fair Value Price:	$54	**5 Year Growth Estimate:**	3.0%	**Momentum Percentile:**	82.9%
% Fair Value:	130%	**5 Year Valuation Multiple Estimate:**	-4.9%	**Growth Percentile:**	10.6%
Dividend Yield:	3.1%	**5 Year Price Target**	$63	**Valuation Percentile:**	9.9%
Dividend Risk Score:	B	**Retirement Suitability Score:**	B	**Total Return Percentile:**	4.2%

Overview & Current Events

With a current market cap of $187 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 released 3rd quarter earnings results on October 25th. The company earned $1.19 per share, $0.05 above estimates and a 7.2% improvement year over year. Revenue grew 4.5% to $10.8 billion, $110 million below estimates.

Keytruda, which treats cancers such as melanoma that cannot be removed by surgery and non-small cell lung cancer, continues to show strong growth rates. After growing revenues by more than 80% during the quarter, *Keytruda* is Merck's top grossing pharmaceutical offering. The drug should generate nearly $7 billion in sales this year and could see peak sales of $15 billion. *Gardasil*, the company's HPV vaccine, had 55% revenue growth and is the third bestselling product Merck offers. These gains helped offset losses due to generic competition in other drugs, like *Januvia* (down 2.3%). The company raised the midpoint for earnings-per-share guidance to $4.33, up from $4.26 previously. Merck also announced a $10 billion stock buyback authorization, which would retire more than 5% of the current market cap. Included in this repurchase authorization is a $5 billion accelerated buyback.

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	***$4.33***	***$5.02***
DPS	$1.52	$1.52	$1.52	$1.52	$1.68	$1.72	$1.76	$1.80	$1.84	$1.88	***$2.20***	***$2.43***
Shares	2107.7	3108.2	3082.1	3040.8	3026.6	2927.5	2838.1	2781.1	2748.7	2696.6	***2650***	***2500***

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.

After pausing its dividend from 2005 through 2011, Merck has increased its dividend at an average rate of ~2% per year since. On October 25th, the company increased its dividend 14.6% to $0.55. Shares now yield 3.1% on an annualized basis. Still, 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	***16.2***	***12.6***
Avg. Yld.	4.1%	5.1%	4.2%	4.4%	4.1%	3.7%	3.1%	3.2%	3.2%	3.0%	***3.1%***	***3.4%***

Shares of Merck have increased $3, or 4.5%, since our August 8th update. Based off of updated guidance, the stock has a forward price to earnings multiple of 16.2. 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 4.9% annually through 2023, up from an estimated contraction of 4.3% earlier.

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

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%	***50.8%***	***38.6%***
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 healthcare corporation.

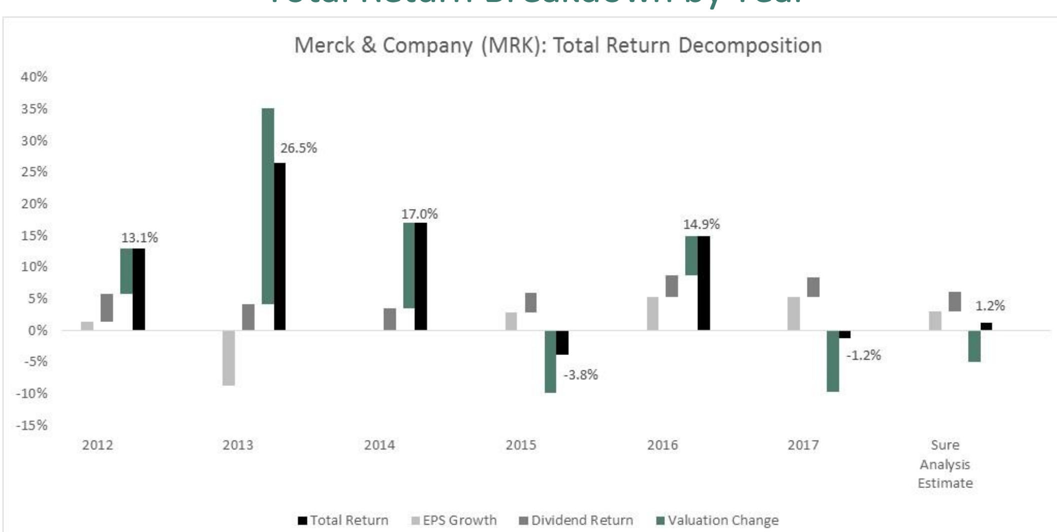
Merck's percentage of gross profits to asset ratio has yet to recover above 2008's total, though this ratio has climbed slightly higher over the past five years. The company's debt to asset ratio has also increased in recent years. Even so, Merck doesn't appear to be overleveraged and the dividend can 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 3rd quarter earnings, we now forecast that Merck could produce total returns of just 1.2% through 2023, down from 1.6% previously. This estimate is arrived at by a combination of growth (3%), dividends (3.1%) and multiple reversion of (4.9%). Merck's *Keytruda* continues to perform well and should produce blockbuster sales totals. The market has responded in kind and sent shares higher by almost 21% since our initial repot on May 29th. Due to low possible returns, we rate shares as a sell. We have increased our 2023 price target $1 to $63 due to EPS guidance updates. We feel that Pfizer (PFE), Amgen (AMGN) and AbbVie (ABBV) offer much better total returns than Merck.

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	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue	23850	27428	45987	48047	47267	44033	42237	39498	39807	40122
Gross Profit	18267	18409	27591	31176	30821	27079	25469	24564	25916	27347
Gross Margin	76.6%	67.1%	60.0%	64.9%	65.2%	61.5%	60.3%	62.2%	65.1%	68.2%
SG&A Exp.	7377	8543	13125	13733	12776	11911	11606	10313	9762	9830
D&A Exp.	1631	2576	7381	7427	6978	6988	6691	6375	5441	4637
Operating Profit	6085	4021	3355	8976	9877	7665	6683	7547	6030	7309
Op. Margin	25.5%	14.7%	7.3%	18.7%	20.9%	17.4%	15.8%	19.1%	15.1%	18.2%
Net Profit	7808	12899	861	6272	6168	4404	11920	4442	3920	2394
Net Margin	32.7%	47.0%	1.9%	13.1%	13.0%	10.0%	28.2%	11.2%	9.8%	6.0%
Free Cash Flow	5274	1931	9144	10660	8068	10106	5672	11255	8762	4559
Income Tax	1999	2268	671	942	2440	1028	5349	942	718	4103

Balance Sheet Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Assets ($B)	47.20	112.31	105.78	105.13	106.13	105.65	98.17	101.68	95.38	87.87
Cash & Equivalents	4368	9311	10900	13531	13451	15621	7441	8524	6515	6092
Acc. Receivable	2908	6603	7344	8261	7672	7184	6626	6484	7018	6873
Inventories	2091	8048	5868	6254	6535	6226	5571	4700	4866	5096
Goodwill & Int.	1964	59795	51834	46457	41217	36102	33378	40325	35467	32467
Total Liabilities	26029	50829	48976	48185	50669	53319	49376	56910	55069	53303
Accounts Payable	618	2244	2308	2023	1753	2274	2625	2533	2807	3102
Long-Term Debt	6240	17474	17882	17515	20569	25060	21403	26412	24842	24410
Total Equity	18758	59058	54376	54517	53020	49765	48647	44676	40088	34336
D/E Ratio	0.33	0.30	0.33	0.32	0.39	0.50	0.44	0.59	0.62	0.71

Profitability & Per Share Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Return on Assets	16.3%	16.2%	0.8%	5.9%	5.8%	4.2%	11.7%	4.4%	4.0%	2.6%
Return on Equity	42.3%	33.2%	1.5%	11.5%	11.5%	8.6%	24.2%	9.5%	9.2%	6.4%
ROIC	29.1%	24.3%	1.1%	8.4%	8.2%	5.7%	16.2%	6.3%	5.8%	3.9%
Shares Out.	2108	3108.2	3082.1	3040.8	3026.6	2927.5	2838.1	2781.1	2748.7	2696.6
Revenue/Share	11.13	12.07	14.74	15.53	15.37	14.70	14.43	13.90	14.28	14.60
FCF/Share	2.46	0.85	2.93	3.45	2.62	3.37	1.94	3.96	3.14	1.66

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