Merck & Company (MRK)

Updated February 4th, 2019 by Nathan Parsh

Key Metrics

Current Price:	$77	**5 Year CAGR Estimate:**	4.6%	**Volatility Percentile:**	17.5%
Fair Value Price:	$65	**5 Year Growth Estimate:**	5.0%	**Momentum Percentile:**	96.8%
% Fair Value:	118%	**5 Year Valuation Multiple Estimate:**	-3.3%	**Growth Percentile:**	33.3%
Dividend Yield:	2.9%	**5 Year Price Target**	$83	**Valuation Percentile:**	20.4%
Dividend Risk Score:	C	**Retirement Suitability Score:**	C	**Total Return Percentile:**	15.1%

Overview & Current Events

With a current market cap of $199 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.

Merck released financial results for the fourth quarter and full year on February 1st. The company earned $1.04 per share during the quarter, $0.01 above estimates and a 6.1% improvement year-over-year. Revenue grew 5.5% to $11 billion, $150 million above estimates. For 2018, the company earned $4.34 per share, an increase of 9% from the prior year and $0.01 above Merck's midpoint for guidance. Revenues increased 5% to $42.3 billion.

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. Merck's top selling product grew 66% during the quarter and 88% for the year. *Keytruda* received several approvals during the quarter, including approval as a first-line treatment in patients with non-small cell lung cancer. *Keytruda* topped $7 billion in sales in 2018 and could reach $15-$17 billion in peak sales. Sales for *Gardasil*, the company's HPV vaccine and third best-selling product, increased 32% in the quarter and 37% in the full year. *Januvia/Janumet* revenues decreased 2% in the fourth quarter and were flat year-over-year due to increased generic competition. *Januvia/Janumet* treats diabetes and is the company's second best-selling pharmaceutical. Animal Health revenues grew 6% in the quarter and 9% for the year. This division had $4.2 billion in sales for 2018. Growth for Animal Health was primarily due to companion animal products, such as *Bravecto*, which kills fleas and ticks in dogs and cats. Between share repurchases and dividends, Merck returned $14 billion to shareholders during the year.

Merck expects revenue of $43.2-$44.7 billion in 2019. The company has an earnings-per-share midpoint of $4.65. If achieved, this would represent almost 4% revenue growth and more than 7% earnings-per-share growth.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	$3.25	$3.42	$3.77	$3.82	$3.49	$3.49	$3.59	$3.78	$3.98	$4.34	***$4.65***	***$5.93***
DPS	$1.52	$1.52	$1.52	$1.68	$1.72	$1.76	$1.80	$1.84	$1.88	$1.99	***$2.20***	***$2.81***
Shares	3108.2	3082.1	3040.8	3026.6	2927.5	2838.1	2781.1	2748.7	2696.6	2650	***2625***	***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 had struggled to grow earnings as patents for drugs have expired, but *Keytruda* has shown very high rates of growth in the most recent financial reporting. Due to this strength, as well as growth in other drugs and the company's Animal Health division, we estimate that Merck can grow earnings-per-share by at least 5% through 2024.

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 of 2018 the company increased its dividend 14.6% to $0.55/share quarterly.

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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Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	9.1	10.5	9.1	10.8	13.3	16.4	15.8	15.2	15.6	16.2	***16.6***	***14***
Avg. Yld.	5.1%	4.2%	4.4%	4.1%	3.7%	3.1%	3.2%	3.2%	3.0%	2.8%	***2.9%***	***3.4%***

Shares of Merck have increased $7, or 10%, since our October 29th update. Based off of guidance for the current year, the stock has a forward price to earnings multiple of 16.6. Merck's long term average price-to-earnings ratio is 12.6. Due to growth rates of *Keytruda* and other products, we believe shares were trade with a price-to-earnings ratio of 14 by 2024. If shares were to revert to this target, the multiple could contract 3.3% per year through 2024.

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	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	46.8%	44.4%	40.3%	44%	49.3%	50.4%	50.1%	48.7%	47.2%	45.9%	***47.3%***	***47.4%***

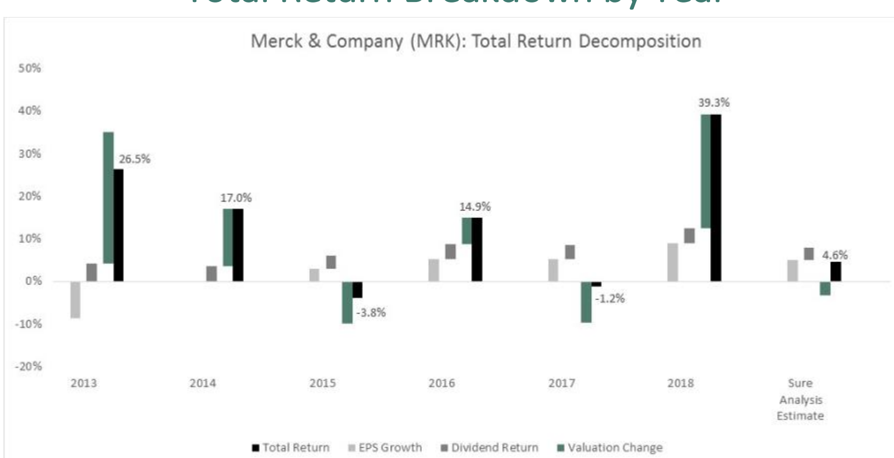
Many investors consider pharmaceutical companies "defensive" stocks because their products are in demand even in a protracted recession. The thinking goes that sick people will seek treatment for illnesses even in poor economic conditions, causing earnings to increase. While this is true for many names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

With that said, Merck is seeing strong growth rates in key product areas. While generic competition is putting pressure on certain pharmaceuticals, we find *Keytruda's* growth rate and peak sales expectations very appealing. Merck is also one of the largest pharmaceutical companies in the world, which gives the company size and scale. If needed, the company would likely have the ability to acquire other assets. Merck has also spent heavily (~16%-19% of sales) on research and development over the past five years.

Final Thoughts & Recommendation

Following the release of fourth quarter and full year results, we estimate that Merck offers a total annual return of 4.6% through 2024. We have increased our 2024 price target $20 to $83 due to an increase in our expected growth rates and target valuation. The stock is rated as a sell at current prices due to mediocre expected total returns. We suggest investors look at AbbVie (ABBV) for pharmaceutical industry exposure as an alternative.

Total Return Breakdown by Year



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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.

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