



# Merck & Company (MRK)

Updated April 30<sup>th</sup>, 2019 by Nathan Parsh

## Key Metrics

<b>Current Price:</b>	\$78	<b>5 Year CAGR Estimate:</b>	4.7%	<b>Volatility Percentile:</b>	20.0%
<b>Fair Value Price:</b>	\$66	<b>5 Year Growth Estimate:</b>	5.0%	<b>Momentum Percentile:</b>	91.5%
<b>% Fair Value:</b>	118%	<b>5 Year Valuation Multiple Estimate:</b>	-3.2%	<b>Growth Percentile:</b>	35.9%
<b>Dividend Yield:</b>	2.9%	<b>5 Year Price Target</b>	\$85	<b>Valuation Percentile:</b>	26.2%
<b>Dividend Risk Score:</b>	C	<b>Retirement Suitability Score:</b>	C	<b>Total Return Percentile:</b>	19.6%

## Overview & Current Events

With a current market capitalization of \$198 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 generates annual revenues in excess of \$44 billion.

Merck released financial results for the first quarter on 4/30/2019. The company earned \$1.22 per share, \$0.17 above estimates and a 16% improvement from the prior year's first quarter. Revenue grew nearly 8% to \$10.8 billion, which was \$370 million higher than expected.

Merck's top selling product, *Keytruda*, grew 55% during the quarter to \$2.3 billion. *Keytruda*, which treats cancers such as melanoma that cannot be removed by surgery and non-small cell lung cancer, was approved by the U.S. Food and Drug Administration for use in several areas during the quarter, such as a first line treatment for patients with advanced renal cell carcinoma. *Keytruda* could reach \$15 to \$17 billion in peak sales. Sales for *Gardasil*, the company's HPV vaccine and third best-selling product, increased 27% to \$838 million. Much of this growth was due to the ongoing commercial launch of *Gardasil* in China. Revenues for *Januvia/Janumet* dropped 5% to \$1.4 billion. Pricing pressures in the U.S. more than offset growing international demand. *Januvia/Janumet* treats diabetes and is the company's second best-selling pharmaceutical. Animal Health revenues declined 4% to \$1 billion, mostly due to unfavorable currency translation. Excluding currency exchange, sales were up 3% for this division. Merck's gross margins improved 350 bps, primarily due lower acquisition, divestiture and restructuring related costs. Merck announced that it would be restructuring its global manufacturing and supply network. The company sees \$800 million to \$1.2 billion in pre-tax costs through 2023. The company expects approximately \$500 million in charges in 2019 due to restructuring.

Merck now expects to earn \$43.9 to \$45.1 billion in revenues in 2019, up from previous guidance of \$43.2 to \$44.7 billion. The company also expects to earn between \$4.67 to \$4.79 per share, up from \$4.57 to \$4.72 earlier. If the midpoints of this new guidance are achieved, this would represent 4.2% revenue growth and 9% earnings-per-share growth from 2018.

## Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
<b>EPS</b>	\$3.25	\$3.42	\$3.77	\$3.82	\$3.49	\$3.49	\$3.59	\$3.78	\$3.98	\$4.34	<b>\$4.73</b>	<b>\$6.04</b>
<b>DPS</b>	\$1.52	\$1.52	\$1.52	\$1.68	\$1.72	\$1.76	\$1.80	\$1.84	\$1.88	\$1.99	<b>\$2.20</b>	<b>\$2.81</b>
<b>Shares</b>	3108	3082	3041	3027	2928	2838	2781	2749	2697	2650	<b>2603</b>	<b>2500</b>

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 earnings-per-share grow by about 1% per year over the past ten years. Merck has struggled to grow earnings as patents for drugs have expired, but *Keytruda* has shown very high rates of growth in recent reporting periods. Due to this strength, as well as growth in other drugs, 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 25<sup>th</sup> of 2018 the company increased its dividend 14.6% to \$0.55/share quarterly.

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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	16.5	14.0
Avg. Yld.	5.1%	4.2%	4.4%	4.1%	3.7%	3.1%	3.2%	3.2%	3.0%	2.8%	2.9%	3.3%

Shares of Merck have increased \$1, or 1.3%, since our February 4<sup>th</sup> update. Based off of updated guidance for the current year, the stock has a forward price to earnings multiple of 16.5. 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 traded with a price-to-earnings ratio of 14 by 2024. If shares were to revert to this target by 2024, then valuation would be a 3.2% headwind to total returns over this time period. Merck's dividend yield is well above that of the S&P 500's yield.

## Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	47%	44%	40%	44%	49%	50%	50%	49%	47%	46%	47%	47%

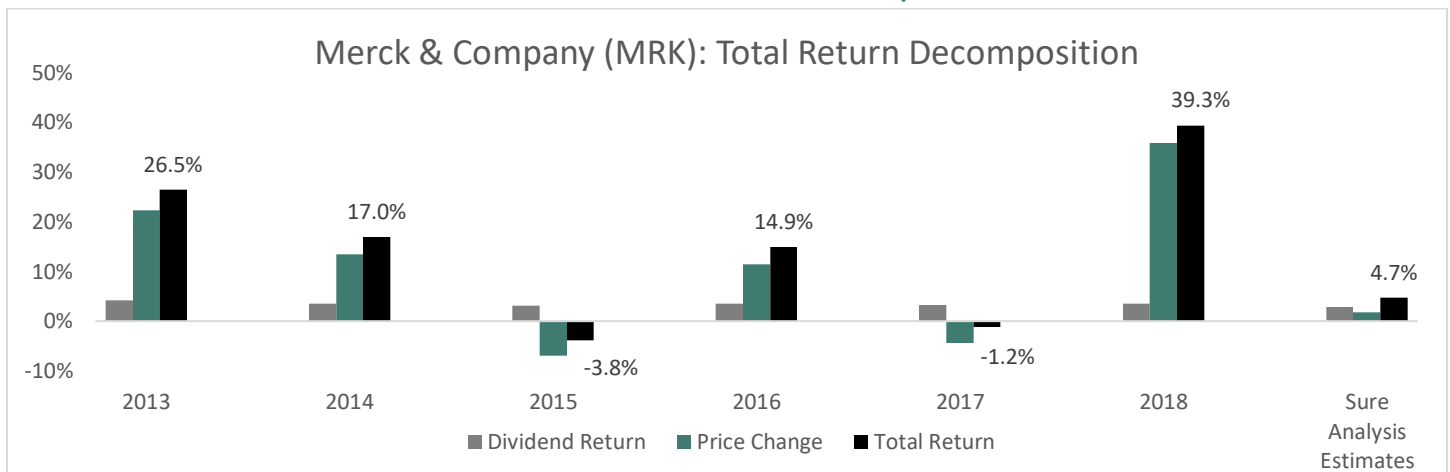
Many investors consider pharmaceutical companies' "defensive" stocks because their products are in demand even in a protracted recession. The thinking goes that sick people will seek treatment for illnesses even in poor economic conditions, causing earnings to increase. While this is true for many names 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's key competitive advantage is that it 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

We now forecast that Merck can offer a total annual return of 4.7% through 2024, up from 4.6% previously. *Keytruda* continues to show impressive growth rates and is expected to see peak annual sales at least double current levels. We are also increasing our 2024 target price \$2 to \$85 due to updated earnings-per-share estimates for the current year. That being said, Merck receives a sell recommendation from Sure Dividend at this time 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	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
<b>Revenue</b>	27428	45987	48047	47267	44033	42237	39498	39807	40122	42294
<b>Gross Profit</b>	18409	27591	31176	30821	27079	25469	24564	25777	27210	28785
<b>Gross Margin</b>	67.1%	60.0%	64.9%	65.2%	61.5%	60.3%	62.2%	64.8%	67.8%	68.1%
<b>SG&amp;A Exp.</b>	8543	13125	13733	12776	11911	11606	10313	10017	10074	10102
<b>D&amp;A Exp.</b>	2576	7381	7427	6978	6988	6691	6375	5471	4676	4519
<b>Operating Profit</b>	4021	3355	8976	9877	7665	6683	7547	5499	6797	8931
<b>Op. Margin</b>	14.7%	7.3%	18.7%	20.9%	17.4%	15.8%	19.1%	13.8%	16.9%	21.1%
<b>Net Profit</b>	12899	861	6272	6168	4404	11920	4442	3920	2394	6220
<b>Net Margin</b>	47.0%	1.9%	13.1%	13.0%	10.0%	28.2%	11.2%	9.8%	6.0%	14.7%
<b>Free Cash Flow</b>	1931	9144	10660	8068	10106	5672	11255	8762	4563	8307
<b>Income Tax</b>	2268	671	942	2440	1028	5349	942	718	4103	2508

## Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
<b>Total Assets (\$B)</b>	112.3	105.8	105.1	106.1	105.6	98.2	101.7	95.4	87.9	82.6
<b>Cash &amp; Equivalents</b>	9311	10900	13531	13451	15621	7441	8524	6515	6092	7965
<b>Acc. Receivable</b>	6603	7344	8261	7672	7184	6626	6484	7018	6873	7071
<b>Inventories</b>	8048	5868	6254	6535	6226	5571	4700	4866	5096	5440
<b>Goodwill &amp; Int.</b>	59795	51834	46457	41217	36102	33378	40325	35467	32467	29684
<b>Total Liabilities</b>	50829	48976	48185	50669	53319	49376	56910	55069	53303	55755
<b>Accounts Payable</b>	2244	2308	2023	1753	2274	2625	2533	2807	3102	3318
<b>Long-Term Debt</b>	17474	17882	17515	20569	25060	21403	26412	24842	24410	25114
<b>Total Equity</b>	59058	54376	54517	53020	49765	48647	44676	40088	34336	26701
<b>D/E Ratio</b>	0.30	0.33	0.32	0.39	0.50	0.44	0.59	0.62	0.71	0.94

## Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
<b>Return on Assets</b>	16.2%	0.8%	5.9%	5.8%	4.2%	11.7%	4.4%	4.0%	2.6%	7.3%
<b>Return on Equity</b>	33.2%	1.5%	11.5%	11.5%	8.6%	24.2%	9.5%	9.2%	6.4%	20.4%
<b>ROIC</b>	24.3%	1.1%	8.4%	8.2%	5.7%	16.2%	6.3%	5.8%	3.9%	11.2%
<b>Shares Out.</b>	3108	3082	3041	3027	2928	2838	2781	2749	2697	2650
<b>Revenue/Share</b>	12.07	14.74	15.53	15.37	14.70	14.43	13.90	14.28	14.60	15.79
<b>FCF/Share</b>	0.85	2.93	3.45	2.62	3.37	1.94	3.96	3.14	1.66	3.10

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

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