



Merck & Company (MRK)

Updated July 30th, 2019 by Nathan Parsh

Key Metrics

Current Price:	\$83	5 Year CAGR Estimate:	3.9%	Volatility Percentile:	21.9%
Fair Value Price:	\$66	5 Year Growth Estimate:	5.0%	Momentum Percentile:	90.6%
% Fair Value:	122%	5 Year Valuation Multiple Estimate:	-3.8%	Growth Percentile:	37.0%
Dividend Yield:	2.7%	5 Year Price Target	\$87	Valuation Percentile:	19.7%
Dividend Risk Score:	B	Retirement Suitability Score:	C	Total Return Percentile:	15.4%

Overview & Current Events

With a current market capitalization of \$214 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 of \$45+ billion.

Merck released financial results for the second quarter on 7/30/2019. The company earned \$1.30 per share, which was \$0.14 above estimates and a 23% improvement from the prior year's first quarter. Revenue grew 12.3% to \$11.8 billion, which was \$820 million higher than expected. Currency exchange reduced revenues by 3%.

Keytruda, Merck's top selling product, grew 58% 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, has been approved for several additional indications over the past few quarters. This has led to higher uptake rates. *Keytruda* is expected to reach peak sales of \$16 billion by the middle of the next decade. Merck's HPV vaccine *Gardasil* grew revenues by 46% due to higher demand and pricing in the U.S. along with the ongoing commercial launch in China. Revenues for *Januvia/Janumet* continue to decline, falling by 6% in the quarter. *Januvia/Janumet*, which treats diabetes, has seen growth worldwide, but this has been offset by pricing pressure in the U.S. Animal Health sales grew 3% (9% in constant currency) on higher demand for livestock products. Gross margins improved 380 bps to 71.1%.

Merck now expects revenue to range from \$45.2 billion to \$46.2 billion for 2019, up from \$43.9 to \$45.1 billion previously. The company now expects adjusted earnings-per-share in a range of \$4.84 to \$4.94 for the year, up from \$4.67 to \$4.79 previously.

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	\$4.89	\$6.24
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	3082	3041	3027	2928	2838	2781	2749	2697	2650	2603	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 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 10/25/2018 the company increased its dividend 14.6% to \$0.55/share quarterly.

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	17.0	14.0
Avg. Yld.	5.1%	4.2%	4.4%	4.1%	3.7%	3.1%	3.2%	3.2%	3.0%	2.8%	2.7%	3.2%

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Shares of Merck have increased \$5, or 6.4%, since our 4/30/2019 update. Based off of updated guidance for the current year, the stock has a forward price to earnings multiple of 17. Merck’s long-term average price-to-earnings ratio is 12.6. Due to growth rates of *Keytruda* and other products, we believe shares could trade 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 3.8% 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%	45%	45%

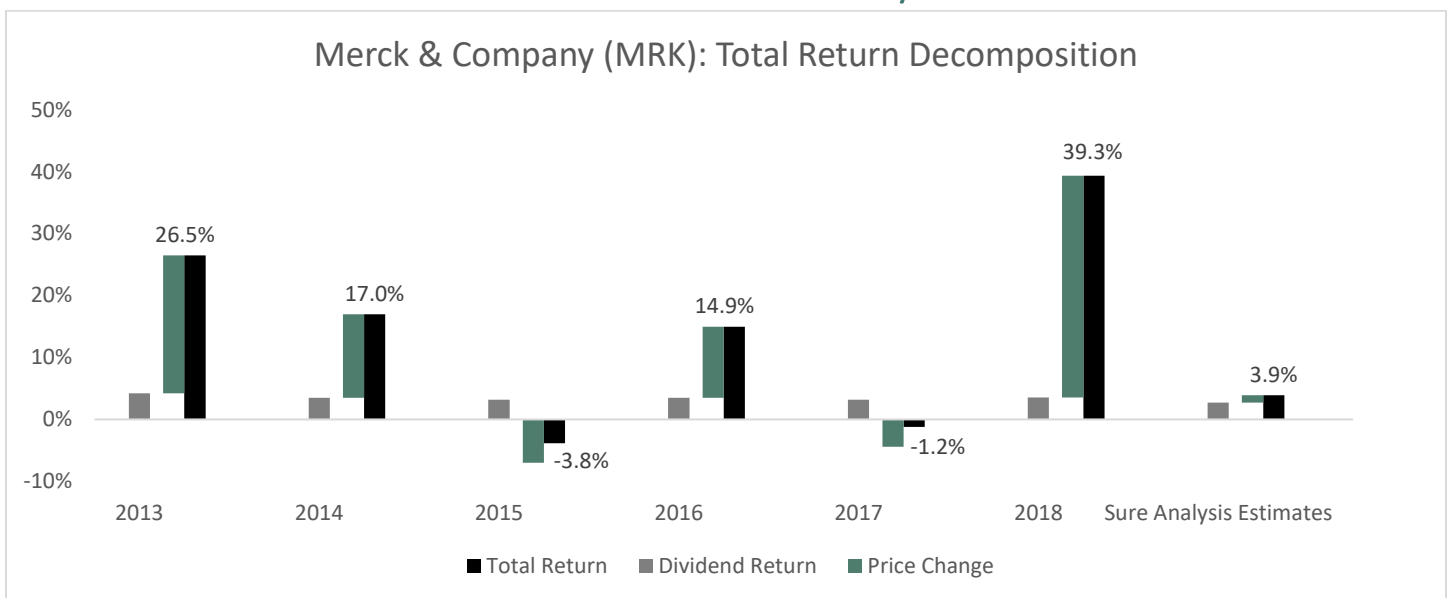
Many investors consider pharmaceutical companies “defensive” stocks because their products are in demand even in a protracted recession. The thinking goes that sick people will seek treatment for illnesses even in poor economic conditions, causing earnings to increase. While this is true for many names in this industry, Merck’s earnings declined 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

Following second quarter results, we estimate that Merck can offer a total annual return of 3.9% through 2024, up from 4.6% previously. *Keytruda* keeps growing at aggressive rates and is well on its way to becoming a blockbuster drug. Merck’s vaccines are also performing well. Despite this, we maintain our sell rating on Merck due to mediocre projected growth over the next five years. If the stock were to pullback closer to fair value on a market wide sell off, we would be inclined to change our opinion on the stock. Until then, we encourage investors to consider other companies in this sector. Do to revised guidance, we are raising our 2024 price target \$2 to \$87.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	27428	45987	48047	47267	44033	42237	39498	39807	40122	42294
Gross Profit	18409	27591	31176	30821	27079	25469	24564	25777	27210	28785
Gross Margin	67.1%	60.0%	64.9%	65.2%	61.5%	60.3%	62.2%	64.8%	67.8%	68.1%
SG&A Exp.	8543	13125	13733	12776	11911	11606	10313	10017	10074	10102
D&A Exp.	2576	7381	7427	6978	6988	6691	6375	5471	4676	4519
Operating Profit	4021	3355	8976	9877	7665	6683	7547	5499	6797	8931
Op. Margin	14.7%	7.3%	18.7%	20.9%	17.4%	15.8%	19.1%	13.8%	16.9%	21.1%
Net Profit	12899	861	6272	6168	4404	11920	4442	3920	2394	6220
Net Margin	47.0%	1.9%	13.1%	13.0%	10.0%	28.2%	11.2%	9.8%	6.0%	14.7%
Free Cash Flow	1931	9144	10660	8068	10106	5672	11255	8762	4563	8307
Income Tax	2268	671	942	2440	1028	5349	942	718	4103	2508

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets (\$B)	112.3	105.8	105.1	106.1	105.6	98.2	101.7	95.4	87.9	82.6
Cash & Equivalents	9311	10900	13531	13451	15621	7441	8524	6515	6092	7965
Acc. Receivable	6603	7344	8261	7672	7184	6626	6484	7018	6873	7071
Inventories	8048	5868	6254	6535	6226	5571	4700	4866	5096	5440
Goodwill & Int.	59795	51834	46457	41217	36102	33378	40325	35467	32467	29684
Total Liabilities	50829	48976	48185	50669	53319	49376	56910	55069	53303	55755
Accounts Payable	2244	2308	2023	1753	2274	2625	2533	2807	3102	3318
Long-Term Debt	17474	17882	17515	20569	25060	21403	26412	24842	24410	25114
Total Equity	59058	54376	54517	53020	49765	48647	44676	40088	34336	26701
D/E Ratio	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
Return on Assets	16.2%	0.8%	5.9%	5.8%	4.2%	11.7%	4.4%	4.0%	2.6%	7.3%
Return on Equity	33.2%	1.5%	11.5%	11.5%	8.6%	24.2%	9.5%	9.2%	6.4%	20.4%
ROIC	24.3%	1.1%	8.4%	8.2%	5.7%	16.2%	6.3%	5.8%	3.9%	11.2%
Shares Out.	3108	3082	3041	3027	2928	2838	2781	2749	2697	2650
Revenue/Share	12.07	14.74	15.53	15.37	14.70	14.43	13.90	14.28	14.60	15.79
FCF/Share	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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