



# Merck & Company (MRK)

Updated February 5<sup>th</sup>, 2020 by Nathan Parsh

## Key Metrics

<b>Current Price:</b>	\$86	<b>5 Year CAGR Estimate:</b>	7.5%	<b>Market Cap:</b>	\$221 billion
<b>Fair Value Price:</b>	\$86	<b>5 Year Growth Estimate:</b>	5.0%	<b>Ex-Dividend Date:</b>	3/13/2020
<b>% Fair Value:</b>	101%	<b>5 Year Valuation Multiple Estimate:</b>	-0.1%	<b>Dividend Payment Date:</b>	4/7/2020
<b>Dividend Yield:</b>	2.8%	<b>5 Year Price Target</b>	\$109	<b>Years Of Dividend Growth:</b>	9
<b>Dividend Risk Score:</b>	C	<b>Retirement Suitability Score:</b>	D	<b>Last Dividend Increase:</b>	10.9%

## Overview & Current Events

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 \$49+ billion. On 2/5/2020, Merck announced that it was spinning off its women's health, legacy brands and biosimilar products into a separate company. These businesses represent ~\$6.5 billion of revenues. The transaction should be completed in the first half of 2021.

Merck reported earnings results for the fourth quarter and full-year on 2/5/2020. The company earned \$1.16 per share, beating estimates by \$0.01 and growing 11.5% from the previous year. Revenue grew 8% to \$11.9 billion, but missed estimates by \$60 million. For the year, adjusted earnings-per-share increased 19.6% to \$5.19 while revenue was higher by 11% to \$46.8 billion. Currency exchange reduced revenue results by 1% for the quarter and 2% for the year.

Pharmaceutical sales increased 8% for the quarter. *Keytruda*, Merck's top selling product, grew 45% for the quarter to \$3.1 billion. For the year, sales for *Keytruda* were up 55% to \$11.1 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. These approvals have led to higher uptake rates. *Keytruda* is expected to reach peak sales of \$16 billion by the middle of the next decade. sales for Merck's HPV vaccine *Gardasil* were down 17% in the quarter due to a borrowing of doses from the U.S. Centers for Disease Control. *Gardasil* had sales growth of 19% for the year. This product was recently launched in China so growth rates are expected to be robust for some time.

*Januvia/Janumet* continues to experience pricing pressure in the U.S., which led to a 3% decline in revenues during the quarter. *Januvia/Janumet*, which treats diabetes, continues to have increased demand in international markets. The Animal Health segment was up 8%, primarily due to livestock products from an acquisition that the company has made recently. Gross margins for the quarter were down 100 bps to 69.1%. For 2019, gross margins increased 180 bps to 69.9%. For 2020, Merck expects adjusted earnings-per-share of \$5.62 to \$5.77 on revenues of \$48.8 billion to \$50.3 billion. Guidance was higher than analysts had expected for both earnings and revenue.

## Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
<b>EPS</b>	\$3.42	\$3.77	\$3.82	\$3.49	\$3.49	\$3.59	\$3.78	\$3.98	\$4.34	\$5.19	<b>\$5.70</b>	<b>\$7.27</b>
<b>DPS</b>	\$1.52	\$1.52	\$1.68	\$1.72	\$1.76	\$1.80	\$1.84	\$1.88	\$1.99	\$2.20	<b>\$2.44</b>	<b>\$3.11</b>
<b>Shares<sup>1</sup></b>	3082	3041	3027	2928	2838	2781	2749	2697	2650	2603	<b>2540</b>	<b>2450</b>

Merck's earnings declined during the last recession and it took the company several years to return to growth. In fact, Merck has had earnings-per-share grow by about 4.2% 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. *Keytruda* has patent protection in the U.S. until 2028, in the European Union until 2030 and in Japan until 2032. 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 2025.

<sup>1</sup> In millions of shares

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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. We expect dividends to grow at a similar rate to earnings given the most recent increase and improvement in the company's fundamentals.

## Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/E	10.5	9.1	10.8	13.3	16.4	15.8	15.2	15.6	16.2	17.5	15.1	15.0
Avg. Yld.	4.2%	4.4%	4.1%	3.7%	3.1%	3.2%	3.2%	3.0%	2.8%	2.4%	2.8%	2.9%

Shares of Merck have increased \$1, or 1.2%, since our 10/29/2019 update. Based off of updated guidance for the current year, the stock has a forward price to earnings multiple of 15.1. Merck's long-term average price-to-earnings ratio is 12.6. Due to growth rates of key products, particularly *Keytruda*, we believe shares could trade with a price-to-earnings ratio of 15 by 2025, up from our prior estimate of 14. If shares were to revert to this target by 2025, then valuation would be a 0.1% headwind to total returns over this time period.

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

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	44%	40%	44%	49%	50%	50%	49%	47%	46%	42%	43%	43%

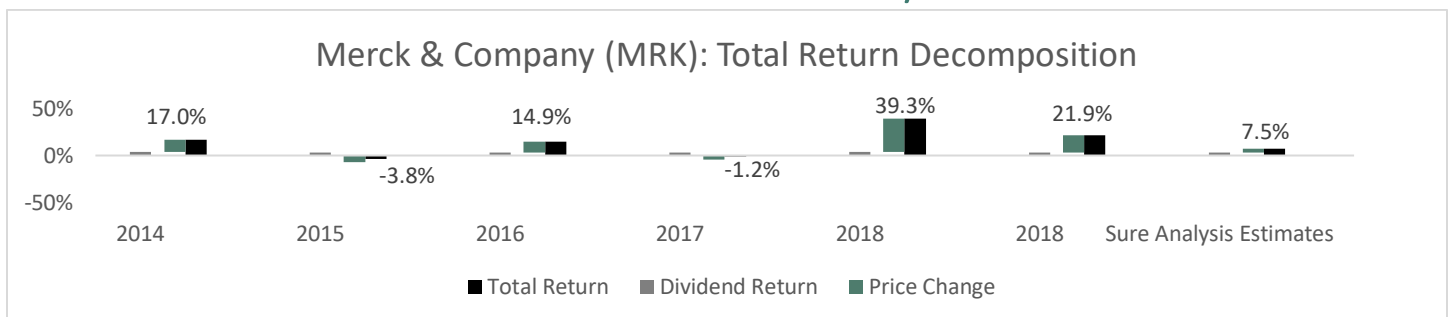
Many investors consider pharmaceutical companies "defensive" stocks because their products are in demand even in a protracted recession. The thinking goes that sick people will seek treatment for illnesses even in poor economic conditions, causing earnings to increase. While this is true for many names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

Merck & Company is projected to offer a total annual return of 7.5% through 2025, up from 4.3% previously. *Keytruda* remains in a high growth phase that doesn't appear to be slowing as the drug won't face biosimilar competition in key markets for at least 8 more years. This combined with receiving multiple approvals for use gives *Keytruda* a long runway for growth. That said, Merck's projected returns are slightly below our usual buy rating threshold of 10% annual returns. On a pullback, we would suggest investors looking to enter the name purchase shares of Merck. We have increased our 2025 price target \$17 to \$107 due to earnings estimates for the current year and an increase in target multiple.

## 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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