Merck & Company (MRK)

Updated February 9th, 2021 by Nathan Parsh

Key Metrics

Current Price:	$75	**5 Year CAGR Estimate:**	13.5%	**Market Cap:**	$190 billion
Fair Value Price:	$99	**5 Year Growth Estimate:**	5.0%	**Ex-Dividend Date:**	3/12/2021
% Fair Value:	76%	**5 Year Valuation Multiple Estimate:**	5.6%	**Dividend Payment Date:**	4/7/2021
Dividend Yield:	3.5%	**5 Year Price Target**	$126	**Years Of Dividend Growth:**	10
Dividend Risk Score:	B	**Retirement Suitability Score:**	B	**Last Dividend Increase:**	6.6%

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 ~$52 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 released fourth quarter and full year results on 2/4/2021. Revenue increased 5.4% to $12.5 billion, but was $140 million lower than expected. Reported net income was a loss of $2,094M, or -$0.83 per share, compared to net income of $2,357M, or $0.92 per share, in the previous year. Net income and earnings-per-share this included significant charges related to acquisitions and intangible asset impairments. Adjusted net income of $3,350M, or adjusted earnings-per-share of $1.32, compared favorably to adjusted net income of $2,978M, or $5.94 per share, in the previous year. Adjusted EPS was $0.07 lower than expected. For the year, revenue grew 2% to $48 billion. Reported net income of $7,067M, or $2.78 per share, compared unfavorably to $9,843M, or $3.81 per share, in the prior year. Again, reported net income and earnings-per-share included significant charges related to acquisitions and intangible asset impairments. Adjusted net income of $15.1 billion, or $5.94 per share, was a double-digit percentage better than the prior year's adjusted net income of $13.4 billion, or $5.19 per share. Adjusted EPS was $0.02 below our estimates for the year.

Merck estimates that COVID-19 negatively impacted fourth quarter results by $400 million and 2020 results by $2.5 billion. Pharmaceutical revenues improved 8% to $11.4 billion in the fourth quarter and 3% to $43 billion for the year. *Keytruda*, which treats cancers such as melanoma that cannot be removed by surgery and non-small cell lung cancer, remains an excellent source of growth as revenues were higher by 28% for the quarter and 30% for the year. The product eclipsed the $14 billion mark for revenue in 2020. Increased demand for *Keytruda* in the use of treatment in non-small-cell lung cancer indications continues. Merck's HPV vaccine *Gardasil* returned to growth in the fourth quarter as sales improved 44% due to replenishment of doses that were borrowed in the fourth quarter of 2019 from the CDC Pediatric Vaccine Stockpile. Excluding borrowing activity, sales improved 8% as demand for *Gardasil* was considerably higher in China. *Januvia/Janumet*, which treats diabetes and is Merck's second highest grossing product, declined 6% due to pricing pressure, an ongoing theme for the product. Animal Health improved 4% to $1.2 billion, though this quarter reflected an additional month of sales in Q4 related to the 2019 acquisition of Antelliq Corporation. Merck expects adjusted EPS of in a range of $6.48 to $6.68 and revenue of $51.8 billion to $53.8 billion for 2021. We have initiated our expectations for the year accordingly.

Growth on a Per-Share Basis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
EPS	$3.77	$3.82	$3.49	$3.49	$3.59	$3.78	$3.98	$4.34	$5.19	$5.94	***$6.58***	***$8.40***
DPS	$1.52	$1.68	$1.72	$1.76	$1.80	$1.84	$1.88	$1.99	$2.20	$2.48	***$2.60***	***$3.32***
Shares[1]	3041	3027	2928	2838	2781	2749	2697	2650	2603	2536	***2536***	***2450***

[1] In millions of shares

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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 5% 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 2026. Merck paused its dividend from 2005 through 2011, but announced a 6.6% dividend increase for the 4/7/2021 payment date.

Valuation Analysis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Now	2026
Avg. P/E	9.1	10.8	13.3	16.4	15.8	15.2	15.6	16.2	17.5	13.8	***11.4***	***15.0***
Avg. Yld.	4.4%	4.1%	3.7%	3.1%	3.2%	3.2%	3.0%	2.8%	2.4%	3.0%	***3.5%***	***2.6%***

Shares of Merck have decreased $3, or 3.8%, since our 10/27/2020 update. Based off of guidance for the current year, the stock has a forward price to earnings multiple of 11.4. 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 2026. If shares were to revert to this target by 2026, then valuation would be a 5.6% tailwind to total annual returns.

Safety, Quality, Competitive Advantage, & Recession Resiliency

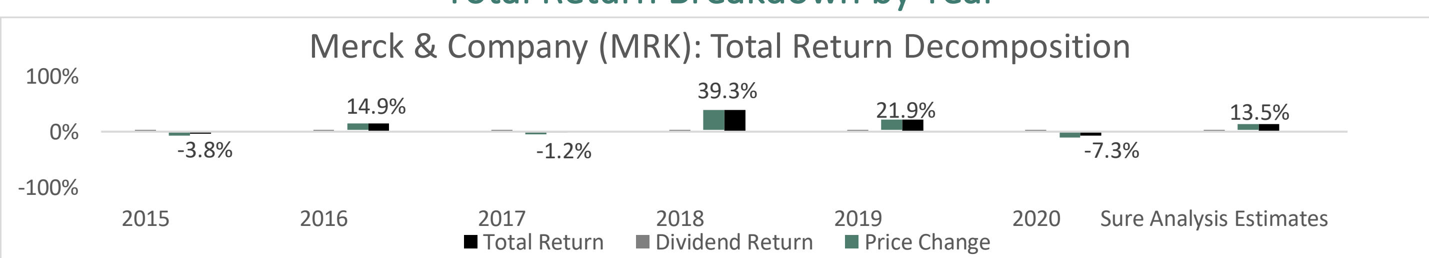
Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
Payout	40%	44%	49%	50%	50%	49%	47%	46%	42%	42%	***40%***	***40%***

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 now expected to offer a total annual return of 13.5% through 2026, up from our previous estimate of 10.5%. This projected return stems from annual expected EPS growth of 5%, a starting yield of 3.5% and a mid-single-digit contribution from multiple expansion. *Keytruda* continues to drive growth for Merck and should be one of the bestselling pharmaceuticals of this decade. We have raised our five-year price target $12 to $126 due to expected EPS for 2021 and continue to rate shares of Merck as a buy.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	45987	48047	47267	44033	42237	39498	39807	40122	42294	46840
Gross Profit	27591	31176	30821	27079	25469	24564	25777	27210	28785	32728
Gross Margin	60.0%	64.9%	65.2%	61.5%	60.3%	62.2%	64.8%	67.8%	68.1%	69.9%
SG&A Exp.	13125	13733	12776	11911	11606	10313	10017	10074	10102	10615
D&A Exp.	7381	7427	6978	6988	6691	6375	5471	4676	4519	3652
Operating Profit	3355	8976	9877	7665	6683	7547	5499	6797	8931	12241
Op. Margin	7.3%	18.7%	20.9%	17.4%	15.8%	19.1%	13.8%	16.9%	21.1%	26.1%
Net Profit	861	6272	6168	4404	11920	4442	3920	2394	6220	9843
Net Margin	1.9%	13.1%	13.0%	10.0%	28.2%	11.2%	9.8%	6.0%	14.7%	21.0%
Free Cash Flow	9144	10660	8068	10106	5672	11255	8762	4563	8307	9967
Income Tax	671	942	2440	1028	5349	942	718	4103	2508	1687

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets ($B)	105781	105128	106132	105645	98167	101677	95377	87872	82637	84397
Cash & Equivalents	10900	13531	13451	15621	7441	8524	6515	6092	7965	9676
Acc. Receivable	7344	8261	7672	7184	6626	6484	7018	6873	7071	6778
Inventories	5868	6254	6535	6226	5571	4700	4866	5096	5440	5978
Goodwill & Int.	51834	46457	41217	36102	33378	40325	35467	32467	31357	33621
Total Liabilities	48976	48185	50669	53319	49376	56910	55069	53303	55755	58396
Accounts Payable	2308	2023	1753	2274	2625	2533	2807	3102	3318	3738
Long-Term Debt	17882	17515	20569	25060	21403	26412	24842	24410	25114	26346
Total Equity	54376	54517	53020	49765	48647	44676	40088	34336	26701	25907
D/E Ratio	0.33	0.32	0.39	0.50	0.44	0.59	0.62	0.71	0.94	1.02

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	0.8%	5.9%	5.8%	4.2%	11.7%	4.4%	4.0%	2.6%	7.3%	11.8%
Return on Equity	1.5%	11.5%	11.5%	8.6%	24.2%	9.5%	9.2%	6.4%	20.4%	37.4%
ROIC	1.1%	8.4%	8.2%	5.7%	16.2%	6.3%	5.8%	3.9%	11.2%	18.9%
Shares Out.	3082	3041	3027	2928	2838	2781	2749	2697	2650	2603
Revenue/Share	14.74	15.53	15.37	14.70	14.43	13.90	14.28	14.60	15.79	18.16
FCF/Share	2.93	3.45	2.62	3.37	1.94	3.96	3.14	1.66	3.10	3.86

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