Merck & Company (MRK)

Updated August 1st, 2021 by Nathan Parsh

Key Metrics

Current Price:	$77	**5 Year CAGR Estimate:**	9.4%	**Market Cap:**	$195 billion
Fair Value Price:	$83	**5 Year Growth Estimate:**	5.0%	**Ex-Dividend Date:**	9/14/2021
% Fair Value:	93%	**5 Year Valuation Multiple Estimate:**	1.5%	**Dividend Payment Date:**	10/7/2021
Dividend Yield:	3.4%	**5 Year Price Target**	$106	**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 73,000 people around the world and generates annual revenues of ~$47 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 represented ~$6.5 billion of revenues. On 6/2/2021, Merck completed its previously announced spinoff of its women's health and biosimilar portfolio into Organon & Co (OGN).

Merck reported second quarter earnings results on 7/29/2021. Revenue grew 22% to $11.4 billion, beating analysts' estimates by $200 million. Adjusted net income of $3,321M, or $1.31 per share, compared favorably to adjusted net income of $2,586M, or $1.02 per share, in the prior year. Adjusted earnings-per-share was $0.04 below estimates.

Unlike prior quarters, COVID-19 was a tailwind to results. The company estimates that the pandemic added $600 million to pharmaceutical revenue compared to a negative $900 million in the prior year. Pharmaceutical revenues were higher by 18% to $9,980M, with currency exchange a 4% drag on results. *Keytruda*, which treats cancers such as melanoma that cannot be removed by surgery and non-small cell lung cancer, continues to perform well, with sales up 20% to $4,176M. The product eclipsed the $14 billion mark for revenue in 2020. *Keytruda* continues to see higher uptick rates across a number of indications. Sales for Merck's HPV vaccine *Gardasil* surged 78% to $1,234 million due the ongoing recovery in the U.S. and China. *Januvia/Janumet*, which treats diabetes and is Merck's second highest grossing product, fell 10% to $1,251M as U.S. pricing pressure remains a headwind for this product. Animal Health improved 27% to $1,472M due to strength in global demand for companion animal products, such as the parasiticide line, and companion animal vaccines. Merck offered revised guidance for 2021. Following the Organon spinoff, the company now expects revenue of $46.4 billion to $47.4 billion for the year, up from $45.8 billion to $47.8 billion previously. This would be a 12% to 14% improvement year-over-year. Adjusted earnings-per-share is projected to be in a range of $5.47 to $5.57.

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	***$5.52***	***$7.05***
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***

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. In addition, the company's spinoff of Organon should allow for a higher growth as Merck focuses on its pharmaceutical, vaccines and animal health businesses. For now, we maintain out estimate of 5% earnings growth over the next five

[1] In millions of shares

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.

years. 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	14.8	15.9	13.6	***13.9***	***15.0***
Avg. Yld.	4.4%	4.1%	3.7%	3.1%	3.2%	3.2%	3.0%	3.0%	2.7%	3.0%	***3.4%***	***3.1%***

Shares of Merck have increased $2, or 2.7%, since our 5/2/2021 update. Based off of guidance for the current year, the stock has a forward price to earnings multiple of 13.9. Merck's long-term average price-to-earnings ratio is 14.1. 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 1.5% tailwind to total annual returns.

Safety, Quality, Competitive Advantage, & Recession Resiliency

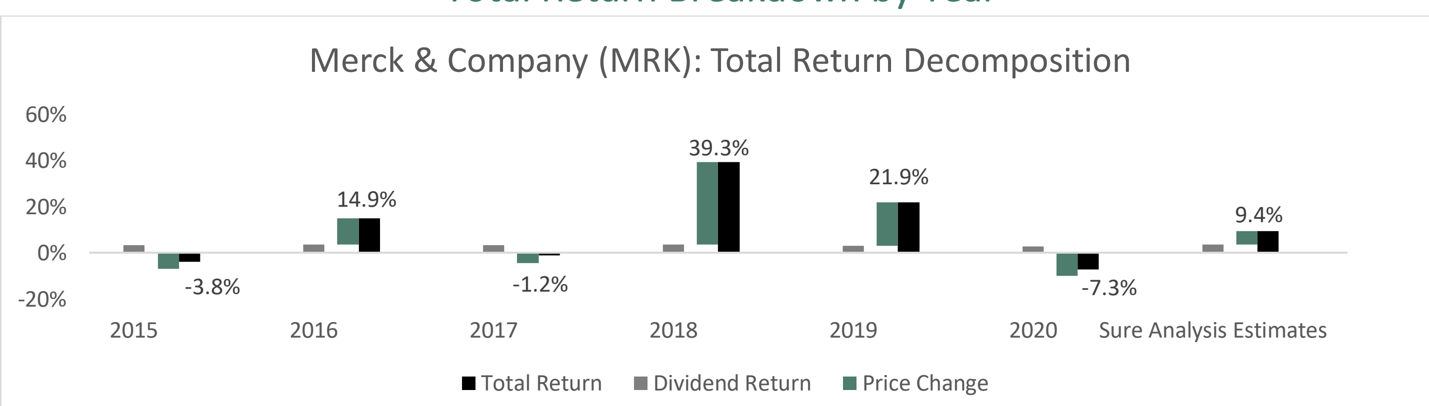
Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
Payout	40%	44%	49%	50%	50%	49%	47%	46%	42%	42%	***47%***	***47%***

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 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 expected to offer a total annual return of 9.4% through 2026, down from our prior estimate of 13.5%. This projected return stems from annual expected EPS growth of 5%, a starting yield of 3.4% and a low single-digit contribution from multiple expansion. Growth for *Keytruda* remains robust and *Gardasil* had a rebound quarter. The spinoff of the company's women's health and biosimilar businesses should also provide additional tailwinds for growth. We have lowered our 2026 price target $20 to $106 due to reduced earnings guidance as a result off the spinoff, but maintain our buy rating on shares of the company.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Revenue	48047	47267	44033	42237	39498	39807	40122	42294	46840	47994
Gross Profit	31176	30821	27079	25469	24564	25777	27210	28785	32728	32509
Gross Margin	64.9%	65.2%	61.5%	60.3%	62.2%	64.8%	67.8%	68.1%	69.9%	67.7%
SG&A Exp.	13733	12776	11911	11606	10313	10017	10074	10102	10615	10468
D&A Exp.	7427	6978	6988	6691	6375	5471	4676	4519	3652	3625
Operating Profit	8976	9877	7665	6683	7547	5499	6797	8931	12241	8483
Op. Margin	18.7%	20.9%	17.4%	15.8%	19.1%	13.8%	16.9%	21.1%	26.1%	17.7%
Net Profit	6272	6168	4404	11920	4442	3920	2394	6220	9843	7067
Net Margin	13.1%	13.0%	10.0%	28.2%	11.2%	9.8%	6.0%	14.7%	21.0%	14.7%
Free Cash Flow	10660	8068	10106	5672	11255	8762	4563	8307	9967	5569
Income Tax	942	2440	1028	5349	942	718	4103	2508	1687	1709

Balance Sheet Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Total Assets ($B)	105128	106132	105645	98167	101677	95377	87872	82637	84397	91588
Cash & Equivalents	13531	13451	15621	7441	8524	6515	6092	7965	9676	8062
Acc. Receivable	8261	7672	7184	6626	6484	7018	6873	7071	6778	7851
Inventories	6254	6535	6226	5571	4700	4866	5096	5440	5978	6310
Goodwill & Int.	46457	41217	36102	33378	40325	35467	32467	31357	33621	34842
Total Liabilities	48185	50669	53319	49376	56910	55069	53303	55755	58396	66184
Accounts Payable	2023	1753	2274	2625	2533	2807	3102	3318	3738	4594
Long-Term Debt	17515	20569	25060	21403	26412	24842	24410	25114	26346	31791
Total Equity	54517	53020	49765	48647	44676	40088	34336	26701	25907	25317
D/E Ratio	0.32	0.39	0.50	0.44	0.59	0.62	0.71	0.94	1.02	1.26

Profitability & Per Share Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Return on Assets	5.9%	5.8%	4.2%	11.7%	4.4%	4.0%	2.6%	7.3%	11.8%	8.0%
Return on Equity	11.5%	11.5%	8.6%	24.2%	9.5%	9.2%	6.4%	20.4%	37.4%	27.6%
ROIC	8.4%	8.2%	5.7%	16.2%	6.3%	5.8%	3.9%	11.2%	18.9%	12.9%
Shares Out.	3041	3027	2928	2838	2781	2749	2697	2650	2603	2536
Revenue/Share	15.53	15.37	14.70	14.43	13.90	14.28	14.60	15.79	18.16	18.89
FCF/Share	3.45	2.62	3.37	1.94	3.96	3.14	1.66	3.10	3.86	2.19

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

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