Merck & Company (MRK)

Updated July 30th, 2022 by Nathan Parsh

Key Metrics

Current Price:	$89	**5 Year CAGR Estimate:**	11.8%	**Market Cap:**	$226 billion
Fair Value Price:	$110	**5 Year Growth Estimate:**	5.0%	**Ex-Dividend Date:**	09/14/22
% Fair Value:	81%	**5 Year Valuation Multiple Estimate:**	4.2%	**Dividend Payment Date:**	10/07/22
Dividend Yield:	3.1%	**5 Year Price Target**	$140	**Years Of Dividend Growth:**	11
Dividend Risk Score:	B	**Retirement Suitability Score:**	B	**Rating:**	Buy

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 67,000 people around the world and generates annual revenues of ~$58 billion.

On June 2nd, 2021, Merck completed its previously announced spinoff of its women's health and biosimilar portfolio into Organon & Co (OGN).

On October 1st, 2021, Merck announced that its antiviral drug, *Lagevrio* (molnupiravir), was effective in reducing the risk of hospitalizations and deaths by 50% for patients with COVID-19. The company expects to deliver as many 20 million doses in total by the end of 2022. The drug is currently available in 30 markets, including the U.S., U.K., and Japan.

On July 28th, 2022, Merck reported second quarter results for the period ending June 30th, 2022. Revenue improved 28.1% to $14.6 billion, easily topping estimates by $750 million. Adjusted net income of $4.7 billion, or $1.87 per share, compared very favorably to adjusted net income of $1.6 billion, or $0.61 per share, in the prior year and was $0.16 above expectations.

Pharmaceutical revenue increased 28% to $14.6 billion for the quarter, with *Lagevrio* sales adding $1.2 billion, down from $3.2 billion in the fourth quarter of 2021. *Keytruda*, which treats cancers such as melanoma that cannot be removed by surgery and non-small cell lung cancer, remains the key driver of growth for the company, with sales higher by 26% to $5.3 billion for the quarter. The product eclipsed the $17 billion mark for revenue in 2021, a 20% improvement from the previous year, and could reach $20 billion this year. *Keytruda* continues to see gains in market share across a number of indications. Sales for Merck's HPV vaccine *Gardasil* grew 36% to $1.67 billion due to particularly strong demand in China. *Januvia/Janumet*, which treats diabetes, fell 2% to $1.2 billion. This product will lose market exclusivity in the E.U. and China in the third quarter. Animal Health revenue of $1.47 billion was essentially unchanged from the prior year, mostly due to unfavorable currency exchange. Demand remains high for livestock products and parasiticides for companion animals.

Merck provided an updated outlook for 2022 as well. The company narrowed adjusted earnings-per-share guidance to a range of $7.25 to $7.35, compared to$7.24 to $7.36 per share previously. Revenue is projected in a range of $57.5 billion to $58.5 billion, up from $56.9 billion to $58.1 billion and $56.1 billion to $57.6 billion previously.

Growth on a Per-Share Basis

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2027
EPS	$3.82	$3.49	$3.49	$3.59	$3.78	$3.98	$4.34	$5.19	$5.94	$6.02	***$7.30***	***$9.32***
DPS	$1.68	$1.72	$1.76	$1.80	$1.84	$1.88	$1.99	$2.20	$2.48	$2.64	***$2.76***	***$3.52***
Shares[1]	3027	2928	2838	2781	2749	2697	2650	2603	2536	2535	***2531***	***2475***

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 just over 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

[1] In millions of shares

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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 years. Merck paused its dividend from 2005 through 2011, but has increased its dividend for 11 consecutive years, including a 6.2% raise for the June 7th, 2022 payment date.

Valuation Analysis

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Now	2027
Avg. P/E	10.8	13.3	16.4	15.8	15.2	15.6	14.8	15.9	13.6	12.7	***12.2***	***15.0***
Avg. Yld.	4.1%	3.7%	3.1%	3.2%	3.2%	3.0%	3.0%	2.7%	3.0%	3.4%	***3.1%***	***2.5%***

Shares of Merck have increased $1, or 1.1%, since our May 2nd, 2022 update. Based off of guidance for the current year, the stock has a forward price to earnings multiple of 12.2. Merck's long-term average price-to-earnings ratio is 14.4. Due to growth rates of key products, particularly *Keytruda*, we believe shares could trade with a price-to-earnings ratio of 15 by 2027. If shares were to revert to this target by 2027, then valuation would be a 4.2% tailwind to total annual returns.

Safety, Quality, Competitive Advantage, & Recession Resiliency

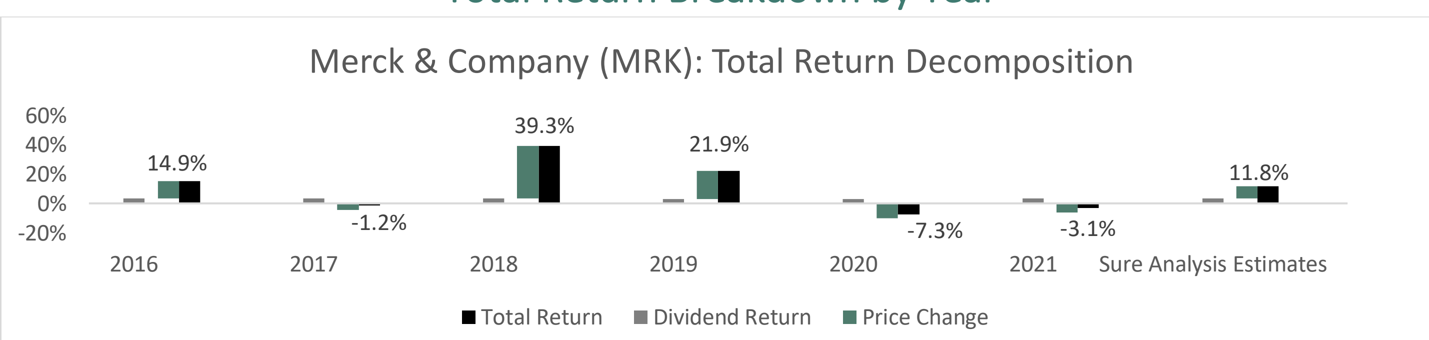
Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2027
Payout	44%	49%	50%	50%	49%	47%	46%	42%	42%	44%	***38%***	***38%***

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 suffered a subsequently 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 11.8% through 2027, down from our prior estimate of 12.1%. This projected return stems from annual expected EPS growth of 5%, a starting yield of 3.1%, and a mid-single-digit contribution from multiple expansion. Once again, *Keytruda* provided strong growth rates that should last for years given its patent protection. Most other top products also showed year-over-year growth as well. Merck continues to earn a buy recommendation due to projected returns.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Revenue	47267	44033	42237	39498	39807	40122	42294	46840	47994	48704
Gross Profit	30821	27079	25469	24564	25777	27210	28785	32728	32509	35078
Gross Margin	65.2%	61.5%	60.3%	62.2%	64.8%	67.8%	68.1%	69.9%	67.7%	72.0%
SG&A Exp.	12776	11911	11606	10313	10017	10074	10102	10615	10468	9634
D&A Exp.	6978	6988	6691	6375	5471	4676	4519	3652	3625	3214
Operating Profit	9877	7665	6683	7547	5499	6797	8931	12241	8483	13199
Op. Margin	20.9%	17.4%	15.8%	19.1%	13.8%	16.9%	21.1%	26.1%	17.7%	27.1%
Net Profit	6168	4404	11920	4442	3920	2394	6220	9843	7067	13049
Net Margin	13.0%	10.0%	28.2%	11.2%	9.8%	6.0%	14.7%	21.0%	14.7%	26.8%
Free Cash Flow	8068	10106	5672	11255	8762	4563	8307	9967	5569	9661
Income Tax	2440	1028	5349	942	718	4103	2508	1687	1709	1521

Balance Sheet Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Total Assets	106132	105645	98167	101677	95377	87872	82637	84397	91588	105694
Cash & Equivalents	13451	15621	7441	8524	6515	6092	7965	9676	8062	8096
Acc. Receivable	7672	7184	6626	6484	7018	6873	7071	6778	7851	9230
Inventories	6535	6226	5571	4700	4866	5096	5440	5978	6310	5953
Goodwill & Int.	41217	36102	33378	40325	35467	32467	31357	33621	34842	44197
Total Liabilities	50669	53319	49376	56910	55069	53303	55755	58396	66184	67437
Accounts Payable	1753	2274	2625	2533	2807	3102	3318	3738	4594	4609
Long-Term Debt	20569	25060	21403	26412	24842	24410	25114	26346	31791	33102
Total Equity	53020	49765	48647	44676	40088	34336	26701	25907	25317	38184
LTD/E Ratio	0.39	0.50	0.44	0.59	0.62	0.71	0.94	1.02	1.26	0.87

Profitability & Per Share Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Return on Assets	5.8%	4.2%	11.7%	4.4%	4.0%	2.6%	7.3%	11.8%	8.0%	13.2%
Return on Equity	11.5%	8.6%	24.2%	9.5%	9.2%	6.4%	20.4%	37.4%	27.6%	41.1%
ROIC	8.2%	5.7%	16.2%	6.3%	5.8%	3.9%	11.2%	18.9%	12.9%	20.3%
Shares Out.	3027	2928	2838	2781	2749	2697	2650	2603	2536	2535
Revenue/Share	15.37	14.70	14.43	13.90	14.28	14.60	15.79	18.16	18.89	19.19
FCF/Share	2.62	3.37	1.94	3.96	3.14	1.66	3.10	3.86	2.19	3.81

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