

Merck
Investment Notes

Please read Disclaimer at bottom of these notes!

“Merck & Co. is a leading worldwide healthcare company. Its principal businesses are pharmaceuticals and animal health products. Its key billion-dollar blockbusters include Singulair, Remicade, Zetia, Vytorin, Januvia/Janumet, Nasonex, and Temodar. The company also has a leading vaccine business and a consumer products business. MRK shares are included in the S&P 500.”

Argus 5/9/11

May 10, 2011 (36.77) Thesis and Analysis

Thesis:

Aging population, need of pharmaceuticals. Large company in a depressed industry. . Risks include failing to integrate massive acquisitions. Another risk would be the failure of Merck to meet its non-GAAP targets (see discussion below). AA credit rating from Standard & Poors, and Moody's. Very difficult for me to value, because of supposed non-recurring costs. These non-recurring costs are mainly from the integration of Schering. We have the same issue with Pfizer and Novartis. Yet, my analysis shows a greater margin of safety with those other names.

The current dividend yield is 4.13%, and a pay-out ratio of 68.90%. Yet, the payout ratio could be deceiving as normalized net income is potentially higher than GAAP. As a matter of fact, I have not seen an analyst report which does not use adjusted earnings, which are much higher.

With that said. I prefer to look at Merck as a frequent re-occurring one time item type company. Going from memory, I think Novartis might also fit in there, and certainly Pfizer. Even using punishing GAAP estimates, with a 5% growth rate, I project an ROI of near 8% annualized for 15 years. Using our intrinsic value spreadsheet, with the same givens, the intrinsic value is substantially below the current market price.

Yet, if I change the spreadsheets, and use F2011 adjusted eps estimate of \$3.60, and F2012E of \$3.80 (both are currently below all estimates I have seen), the immediate intrinsic value goes to \$53 now, and \$65 in 2016. ROI's in our Valuation analysis spreadsheet would also increase to annualize Returns on Investment of 10% to 11% for 10 and 15 years respectively.

All other fundamental metrics are much lower than history. Price to Sales is 2.42X, whereas for the last 5 years the ratio has averaged ~4X, and for 10 years it has averaged About the same.

Merck seems to be generating a great amount of free cash flow. I have projected \$4.20 of Free Operating Cash flow for F2011. If I am correct, the Price to FCF is 8.45X, which is an 11.83% yield.

I will have to monitor this on a quarter to quarter basis. If one uses GAAP, I think Merck could be considered overvalued. Yet, why use GAAP when guidance and cash flow are both indicating strong recurring earnings and cash flow. This is the only company in our portfolio where I need to focus so closely on interim earnings. The difficulty in owning this if cash flow is disguised or earnings quality is low, and hence GAAP earnings turn out to be recurring earnings.

I will certainly make Merck a sales candidate for portfolio reduction when one needs cash generation.

Fundamental Analysis

Company Name	Merck
Symbol	MRK
Date Worked On	10-May-11
Base Year	31-Dec-11
Price	\$36.77
Shares Outstanding	3,104
Market Capitalization	\$114,134
Cash and CE	\$13,029
Long Term Debt	\$15,644
Minority Interests	\$0
Goodwill	\$12,207
Intangibles	\$37,906
Other Intangibles	\$0
Enterprise Value	\$116,749
Short Term Debt	\$2,202

Stockholders Equity	\$54,384
Depreciation and Amortization	\$8,000
CapEx	\$1,800
Revenues	\$47,000
Total Assets	\$105,865
Net Income	\$6,848
Dividend Per Share	\$1.52
Interest Expense	\$750
Net Income Before Taxes	\$11,045
Enterprise Value Per Share	\$37.61
Price To Enterprise Value	97.76%
Total Debt	\$17,846
Total Debt / Net Income	260.60%
Total Debt Per Share	\$5.75
Tangible Book Value	\$4,271
Book Value Per Share	\$17.52
Tangible Book Value Per Share	\$1.38
Price / Book Value	209.87%
Price / Tangible Book Value	2672.30%
Price / Earnings Ratio	16.67
Enterprise Value / Earnings Ratio	17.05
Earnings Yield	6.00%
Earnings / Enterprise Value	5.87%
Price To Sales Ratio	242.84%

Net Income / Total Assets	6.47%
Total Assets / (Revenues/365)	822.14
Enterprise Value / Revenues	248.40%
Goodwill / Total Assets	11.53%
Goodwill / Stockholders Equity	22.45%
Debt / Equity	32.81%
Average P/E Last 10 Years	15.0
Free Operating Cash Flow	\$13,048
Free Operating Cash Flow Per Share	4.20
Free Operating Cash Flow Flow Yield	11.43%
Price / Free Operating Cash Flow	8.75
Revenues Per Share	\$15.14
Net Income Per Share	\$2.21
Return on Equity	12.59%
Bond Rating (S&P)	AA
Growth Rate	5.00%
Dividend Yield	4.13%
Dividend / Net Income	68.90%
Dividend / Cash Flow	36.16%
Interest Coverage Ratio	15.73
Insider Activity	Some Sales
Buy-Backs	\$1.6B in F2010
Dilution	No

Management Compensation	Fair
Price to consider to buy more	\$32.00
Price to sell or consider reducing	\$37.00
Action (Buy, Hold or Sell)	H
Portfolio Allocation Suggestion	3%

Morningstar 4/19/11

Merck & Co, Inc. MRK [NYSE] | ★★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
36.48 USD	46.00 USD	32.20 USD	64.40 USD	Medium	Wide	C	AA	Drug Manufacturers - Major

“Over the longer term, Merck is improving its growth outlook as it faces only one major patent loss in the next five years with Singulair in 2012 and it is poised to launch several key new drugs.”

“Further, the company's deep Phase III pipeline provides strong replenishments to the current product line up in 2012-13.”

Credit Suisse 4/29/11

Financial and valuation metrics

Year	12/10A	12/11E	12/12E	12/13E
EPS (CS adj.) (US\$)	3.42	3.72	4.06	3.84
Prev. EPS (US\$)	—	—	—	—
P/E (x)	10.5	9.6	8.8	9.3
P/E rel. (%)	66.5	70.1	72.6	—
Revenue (US\$ m)	45,987.4	46,653.1	47,919.0	46,588.3
EBITDA (US\$ m)	20,340.3	17,543.3	22,714.3	21,467.0
OCFPS (US\$)	3.48	4.46	6.82	5.45
P/OCF (x)	10.4	8.0	5.2	6.6
EV/EBITDA (current)	5.6	6.2	4.3	4.1
Net debt (US\$ m)	3,803	-1,370	-13,515	-22,584
ROIC (%)	18.33	20.42	22.64	21.88
Number of shares (m)	3,085.36	IC (current, US\$ m)		62,507.42
BV/share (current, US\$)	18.1	EV/IC (x)		1.8
Net debt (current, US\$ m)	3,226.3	Dividend (current, US\$)		1.52
Net debt/tot. cap. (current, %)	3.0	Dividend yield (%)		4.2

Source: Company data, Credit Suisse estimates.

Argus 5/9/11

Key Statistics

Key Statistics pricing data reflects previous trading day's closing price. Other applicable data are trailing 12-months unless otherwise specified

Market Overview

Price	\$36.48
Target Price	\$41.00
52 Week Price Range	\$31.04 to \$37.68
Shares Outstanding	3.09 Billion
Dividend	\$1.52

Sector Overview

Sector	Healthcare
Sector Rating	OVER WEIGHT
Total % of S&P 500 Market Cap.	10.00%

Financial Strength

Financial Strength Rating	MEDIUM
Debt/Capital Ratio	23.9%
Return on Equity	21.0%
Net Margin	3.5%
Payout Ratio	0.41
Current Ratio	1.86
Revenue	\$46.15 Billion
After-Tax Income	\$1.61 Billion

Valuation

Current FY P/E	9.83
Prior FY P/E	10.67
Price/Sales	2.44
Price/Book	2.07
Book Value/Share	\$17.63
Market Capitalization	\$112.55 Billion

Growth & Valuation Analysis

GROWTH ANALYSIS

(\$ in Millions, except per share data)

	2006	2007	2008	2009	2010
Revenue	22,636	24,198	23,850	27,428	45,987
COGS	6,001	6,141	5,583	9,019	18,396
Gross Profit	16,635	18,057	18,268	18,409	27,591
SG&A	8,165	7,557	7,377	8,543	13,245
R&D	4,783	4,883	4,805	5,845	10,991
Operating Income	3,544	5,290	5,053	2,387	2,370
Interest Expense	—	—	-380	250	632
Pretax Income	6,221	3,371	9,932	15,290	1,653
Income Taxes	1,788	95	1,999	2,268	671
Tax Rate (%)	29	3	20	15	41
Net Income	4,434	3,275	7,808	12,899	861
Diluted Shares Outstanding	2,188	2,193	2,143	2,273	3,120
EPS	2.03	-1.04	3.63	5.65	0.28
Dividend	—	—	1.14	1.52	1.52

GROWTH RATES (%)

Revenue	2.8	6.9	-1.4	15.0	67.7
Operating Income	-36.0	49.3	-4.5	-52.8	-0.7
Net Income	-4.3	-26.1	138.4	65.2	-93.3
EPS	-3.3	—	—	55.6	-95.0
Dividend	—	—	—	33.3	—
Sustainable Growth Rate	—	—	29.0	24.2	-6.7

VALUATION ANALYSIS

Price: High	\$36.63	\$42.07	\$41.33	\$26.72	\$29.99
Price: Low	\$25.75	\$32.01	\$17.50	\$16.03	\$24.52
Price/Sales: High-Low	3.5 - 2.5	3.8 - 2.9	3.7 - 1.6	2.2 - 1.3	2.0 - 1.7
P/E: High-Low	18.0 - 12.7	— - —	11.4 - 4.8	4.7 - 2.8	107.1 - 87.6
Price/Cash Flow: High-Low	15.6 - 11.0	19.3 - 14.7	18.8 - 7.9	25.7 - 15.4	11.6 - 9.5

Merrill Lynch 4/29/11

Estimates (Dec)

(US\$)	2009A	2010A	2011E	2012E	2013E
EPS	3.25	3.42	3.71	3.88	3.53
GAAP EPS	5.67	0.28	2.22	2.39	2.05
EPS Change (YoY)	-4.7%	5.2%	8.5%	4.6%	-9.0%
Consensus EPS (Bloomberg)			3.70	3.83	3.78
DPS	1.41	1.52	1.52	1.60	1.64

Valuation (Dec)

	2009A	2010A	2011E	2012E	2013E
P/E	11.1x	10.5x	9.7x	9.3x	10.2x
GAAP P/E	6.3x	128.4x	16.2x	15.0x	17.5x
Dividend Yield	3.9%	4.2%	4.2%	4.5%	4.6%
EV / EBITDA*	14.9x	7.9x	7.3x	7.0x	7.7x
Free Cash Flow Yield*	1.7%	8.2%	11.6%	11.0%	9.9%

* For full definitions of *iQmethod*SM measures, see page 10.

iQprofileSM Merck & Co.

iQmethodSM – Bus Performance*

(US\$ Millions)	2009A	2010A	2011E	2012E	2013E
Return on Capital Employed	8.7%	11.6%	12.8%	13.7%	12.9%
Return on Equity	17.9%	18.1%	20.0%	20.8%	19.2%
Operating Margin	25.6%	29.9%	32.2%	33.8%	32.1%
Free Cash Flow	1,931	9,144	12,963	12,263	11,000

iQmethodSM – Quality of Earnings*

(US\$ Millions)	2009A	2010A	2011E	2012E	2013E
Cash Realization Ratio	0.5x	1.0x	1.3x	1.2x	1.2x
Asset Replacement Ratio	0.6x	0.2x	0.3x	0.3x	0.3x
Tax Rate	19.9%	20.0%	21.8%	21.0%	21.0%
Net Debt-to-Equity Ratio	13.3%	12.3%	-0.1%	-10.7%	-19.0%
Interest Cover	15.3x	19.2x	21.8x	23.0x	22.0x

Income Statement Data (Dec)

(US\$ Millions)	2009A	2010A	2011E	2012E	2013E
Sales	27,429	45,988	46,771	46,353	43,909
% Change	15.0%	67.7%	1.7%	-0.9%	-5.3%
Gross Profit	20,811	34,589	35,451	35,076	32,951
% Change	13.2%	66.2%	2.5%	-1.1%	-6.1%
EBITDA	8,680	16,424	17,872	18,457	16,901
% Change	11.5%	89.2%	8.8%	3.3%	-8.4%
Net Interest & Other Income	2,385	(191)	(182)	(512)	(450)
Net Income (Adjusted)	7,392	10,676	11,494	11,815	10,634
% Change	1.0%	44.4%	7.7%	2.8%	-10.0%

Free Cash Flow Data (Dec)

(US\$ Millions)	2009A	2010A	2011E	2012E	2013E
Net Income from Cont Operations (GAAP)	7,411	10,718	11,526	11,847	10,666
Depreciation & Amortization	2,576	7,381	7,550	7,300	7,300
Change in Working Capital	(2,707)	930	127	282	152
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(3,888)	(8,207)	(4,340)	(5,209)	(5,103)
Capital Expenditure	(1,461)	(1,678)	(1,900)	(1,957)	(2,016)
Free Cash Flow	1,931	9,144	12,963	12,263	11,000
% Change	-63.4%	373.4%	41.8%	-5.4%	-10.3%

Balance Sheet Data (Dec)

(US\$ Millions)	2009A	2010A	2011E	2012E	2013E
Cash & Equivalents	9,311	10,900	16,394	22,181	24,793
Trade Receivables	6,603	7,344	7,394	6,985	6,616
Other Current Assets	12,531	10,820	10,747	10,184	9,848
Property, Plant & Equipment	18,279	17,082	16,182	15,339	14,555
Other Non-Current Assets	65,936	59,635	55,332	50,520	45,738
Total Assets	112,660	105,781	106,049	105,209	101,551
Short-Term Debt	1,379	2,400	881	781	681
Other Current Liabilities	14,326	13,241	13,342	16,356	15,862
Long-Term Debt	16,095	15,482	15,482	15,482	13,630
Other Non-Current Liabilities	19,375	17,853	18,155	17,151	16,246
Total Liabilities	51,175	48,976	47,860	49,769	46,420
Total Equity	61,485	56,805	58,189	55,439	55,131
Total Equity & Liabilities	112,660	105,781	106,049	105,209	101,551

* For full definitions of iQmethodSM measures, see page 10.

Deutsche Bank 4/29/11

Fiscal year end 31-Dec	2007	2008	2009	2010	2011E	2012E
Financial Summary						
DB EPS (USD)	3.23	3.42	3.26	3.42	3.73	3.84
Reported EPS (USD)	3.23	3.42	3.27	3.43	3.73	3.84
DPS (USD)	1.51	1.53	1.42	1.52	1.65	1.66
BVPS (USD)	8.66	8.93	28.12	17.69	13.87	16.04
Valuation Metrics						
Price/Sales (x)	4.4	3.3	2.3	2.4	2.4	2.4
P/E (DB) (x)	15.7	10.8	9.1	10.5	9.6	9.3
P/E (Reported) (x)	15.7	10.8	9.1	10.5	9.6	9.3
P/BV (x)	6.7	3.4	1.3	2.0	2.6	2.2
FCF yield (%)	8.2	4.1	nm	9.8	11.7	11.9
Dividend yield (%)	3.0	4.1	4.8	4.2	4.6	4.6
EV/Sales	4.0	3.0	2.5	2.5	2.2	2.2
EV/EBITDA	13.5	9.3	7.5	5.6	6.2	6.0
EV/EBIT	17.1	11.4	9.9	8.3	6.9	6.6
Income Statement (USDm)						
Sales	24,216	23,849	27,429	45,987	46,689	45,068
EBITDA	7,192	7,748	9,256	20,272	16,649	16,445
EBIT	5,665	6,335	7,028	13,740	15,049	14,845
Pre-tax profit	9,268	8,868	9,415	13,540	14,938	15,445
Net income	7,060	7,332	7,417	10,708	11,517	11,715
Cash Flow (USDm)						
Cash flow from operations	9,778	4,481	17	12,478	13,917	14,115
Net Capex	-1,011	-1,298	-1,461	-1,678	-1,050	-1,050
Free cash flow	8,767	3,183	-1,444	10,800	12,867	13,065
Equity raised/(bought back)	0	0	0	0	0	0
Dividends paid	-3,307	-3,279	-3,215	-4,734	-5,111	-5,048
Net inc/(dec) in borrowings	0	0	0	0	0	0
Other investing/financing cash flows	-4,513	541	11,830	2,054	-4,850	-4,850
Net cash flow	947	446	7,171	8,120	2,906	3,167
Change in working capital	1,251	-3,517	-3,034	1,188	500	500
Balance Sheet (USDm)						
Cash and cash equivalents	5,336	4,368	9,311	10,900	12,205	13,772
Property, plant & equipment	12,346	12,000	18,279	17,082	18,130	19,180
Goodwill	1,455	1,439	12,038	12,378	12,070	11,770
Other assets	29,213	29,388	72,686	65,421	42,315	41,810
Total assets	48,350	47,195	112,314	105,781	84,720	86,532
Debt	5,739	6,240	17,474	17,882	13,880	9,880
Other liabilities	24,427	22,197	35,783	33,523	28,218	27,353
Total liabilities	30,166	28,437	53,257	51,405	42,098	37,233
Total shareholders' equity	18,184	18,758	59,057	54,376	42,622	49,299
Net debt	404	1,872	8,163	6,983	1,675	-3,892
Key Company Metrics						
Sales growth (%)	7.0	-1.5	15.0	67.7	1.5	-3.5
DB EPS growth (%)	27.9	6.0	-4.7	4.9	9.0	3.0
Payout ratio (%)	45.0	43.8	40.1	43.6	44.2	43.4
EBITDA Margin (%)	29.7	32.5	33.7	44.1	35.7	36.5
EBIT Margin (%)	23.4	26.6	25.6	29.9	32.2	32.9
ROE (%)	39.5	39.7	19.1	18.9	23.7	25.5
Net debt/equity (%)	2.2	10.0	13.8	12.8	3.9	-7.9
Net interest cover (x)	nm	nm	nm	nm	nm	nm
DuPont Analysis						
EBIT margin (%)	23.4	26.6	25.6	29.9	32.2	32.9
x Asset turnover (x)	0.5	0.5	0.3	0.4	0.5	0.5
x Financial cost ratio (x)	1.0	1.0	1.0	1.0	1.0	1.0
x Tax and other effects (x)	1.2	1.2	1.1	0.8	0.8	0.8
= ROA (post tax) (%)	15.2	15.3	9.3	9.8	12.1	13.7
x Financial leverage (x)	2.6	2.6	2.0	1.9	2.0	1.9
= ROE (%)	39.5	39.7	19.1	18.9	23.7	25.5
annual growth (%)	27.2	0.5	-52.0	-1.0	25.8	7.3
x NTA/share (avg) (x)	8.2	8.6	17.1	18.2	15.7	15.1
= Reported EPS	3.23	3.42	3.27	3.43	3.73	3.84
annual growth (%)	27.9	6.0	-4.5	5.2	8.6	3.0

Source: Company data, Deutsche Bank estimates

Company guidance

Figure 1: 2011 Company guidance

	MRK 2011 guidance of 4/29/11	DB Estimate
EPS	\$3.66 -\$3.76	\$3.73
Total Revenue	Low to mid single digit growth	1.5%
Tax rate	20% - 22%	22.2%
R&D expenses	\$8.0- \$8.4B	\$8,161

Source: Deutsche Bank and company information

Earnings Release Notes 4/29/11 1Q11

\$ in millions, except EPS amounts	First Quarter 2011	First Quarter 2010
Sales	\$11,580	\$11,422
GAAP EPS	0.34	0.09
Non-GAAP EPS that excludes items listed below ¹	0.92	0.83
GAAP Net Income ²	1,043	299
Non-GAAP Net Income that excludes items listed below ^{1,2}	2,861	2,608

¹ Merck is providing certain 2011 and 2010 non-GAAP information that excludes certain items because of the nature of these items and the impact they have on the analysis of underlying business performance and trends. Management believes that providing this information enhances investors' understanding of the company's performance. This information should be considered in addition to, but not in lieu of, information prepared in accordance with GAAP. For a description of the items, see Table 2a, including the related footnotes, attached to this release.

² Net income attributable to Merck & Co., Inc.

A reconciliation of GAAP to non-GAAP net income and EPS is provided in the tables that follow.

\$ in millions, except EPS amounts	First Quarter 2011		First Quarter 2010	
	Net Income ²	EPS	Net Income ²	EPS
GAAP	\$1,043	\$0.34	\$ 299	\$0.09
Difference	1,818	0.58 ³	2,309	0.74 ³
Non-GAAP that excludes items listed below	\$2,861	\$0.92	\$2,608	\$0.83

\$ in millions	First Quarter	First Quarter
	2011	2010
Purchase accounting adjustments ⁴	\$1,580	\$2,374
Costs related to restructuring programs	126	351
Merger-related costs	77	87
Arbitration settlement charge	500	—
Other ⁵	(134)	—
Net decrease (increase) in income before taxes	2,149	2,812
Estimated income tax (benefit) expense ⁶	(331)	(503)
Decrease (increase) in net income	\$1,818	\$2,309

The table below reflects sales of the company's top Pharmaceutical products, as well as total sales of Animal Health and Consumer Care products.

\$ in millions	First Quarter 2011	First Quarter 2010	Change
Total Sales	\$11,580	\$11,422	1%
Pharmaceutical ⁸	9,820	9,665	2%
SINGULAIR	1,328	1,165	14%
REMICADE	753	674	12%
JANUVIA	739	511	45%
ZETIA	582	534	9%
VYTORIN	480	477	1%
COZAAR/HYZAAR	426	782	-46%
NASONEX	373	320	17%
JANUMET	305	201	52%
ISENTRESS	292	232	26%
TEMODAR	248	274	-10%
GARDASIL	214	233	-8%
Animal Health	758	709	7%
Consumer Care ⁸	517	489	6%
Other Revenues ⁹	486	559	-13%

Financial Targets

The company updated its 2011 non-GAAP EPS target range to \$3.66 to \$3.76 from the previous target range of \$3.64 to \$3.76. The target range excludes purchase accounting adjustments, restructuring costs, merger-related expenses, the \$500 million charge related to the resolution of the arbitration proceeding with Johnson & Johnson, and certain other items. The 2011 GAAP EPS target range is \$2.04 to \$2.39.

In addition, the company lowered its non-GAAP R&D expense target to a range of \$8.0 billion to \$8.4 billion for the full year of 2011. This target excludes restructuring costs and in-process R&D impairment charges.

Merck continues to expect full year 2011 revenue to grow in the low- to mid-single digit percent range from a base of \$46.0 billion in 2010.

Merck continues to estimate that its consolidated non-GAAP 2011 tax rate will be approximately 20 percent to 22 percent.

A reconciliation of anticipated 2011 EPS as reported in accordance with GAAP to non-GAAP EPS that excludes certain items is provided in the table below.

\$ in millions, except EPS amounts	Full Year 2011
GAAP EPS	\$2.04 to \$2.39
EPS difference ³	1.62 to 1.37
Non-GAAP EPS that excludes items listed below	\$3.66 to \$3.76
Purchase accounting adjustments ⁴	\$5,400 to \$5,100
Costs related to restructuring programs	900 to 700
Merger-related costs	200 to 100
Arbitration settlement charge	500
Other ⁵	(134)
Net decrease (increase) in income before taxes	6,866 to 6,266
Estimated income tax (benefit) expense ¹⁰	(1,840) to (2,000)
Decrease (increase) in net income	\$5,026 to \$4,266

Total Employees

As of March 31, 2011, Merck had approximately 93,000 employees worldwide.

April 18, 2011 (34.00) Review of VL 4/15/11

1. Sales per share projected at \$15.85 for F2011. On 7/15/10 VL wrote, Sales per share was increased to \$15.00 and \$15.40, from \$14.60 and \$14.90 for F2010 and F2011.
2. Cash Flow per share projected at \$6.35 for F2011. On 7/15/10 VL wrote, Cash Flow per was increased to \$5.80 and \$6.35, from \$5.45 and \$5.90 for F2010 and F2011.

3. Earnings \$3.70 for F2011.
4. Capex was \$0.60 for F2011.
5. Projected Return on Total Capital 17.0% and ROE 21.0%.
6. 24% of Sales are dedicated to R&D.
7. Current dividend 4.47%.

October 29, 2010 (36.07) J

Shares are down \$0.87, or 2.36%, after 3rd quarter results were issued this morning. Adjusted eps for the quarter was \$0.85, a penny better than the consensus estimate but revenue was “disappointing” at \$11.13B versus a consensus estimate of \$11.24B. Credit Suisse categorized it as a “low quality beat”, but raised their price target to \$44 from \$42.

GAAP earnings for the quarter were \$0.11 per share. The adjustments from GAAP to “adjusted” included purchase accounting adjustments, merger and restructuring costs, and legal reserve costs associated with Vioxx.

For the full year 2010, Merck issued guidance for GAAP eps ranging from \$0.66 to \$0.97 and adjusted eps from \$3.31 to \$3.39. YTD through Sept. 30, GAAP earnings were \$0.44/share and adjusted earnings were \$2.54.

YTD Wtd average shares o/s were 3123.3M

There is no balance sheet or cash flow statement so I will have to wait for the Q to see book value changes.

From the conference call:

Bought back \$300M of shares in the quarter (\$1.3B ytd)

Some quick notes from Credit Suisse report from this morning:

Rated outperform with price target of \$44

Investors were nervous about revenue miss and results are “good enough”

Importantly, the company kept the \$3.5B cost synergies target by 2011 and the high single digit non GAAP eps 2009-2013 growth.

Consumer division was a surprising beat.

10/11/10 (36.82) Review of Value Line 7/16/10

8. Sales per share was increased to \$15.00 and \$15.40, from \$14.60 and \$14.90 for F2010 and F2011.
9. Cash Flow per was increased to \$5.80 and \$6.35, from \$5.45 and \$5.90 for F2010 and F2011.

10. Earnings were unchanged at \$3.35 and \$3.80 for F2010 and F2011.
11. Capex was unchanged at \$0.50 and \$0.60 for F2010 and F2011.
12. Cash Flow per was decreased to \$20.15 and \$20.65, from \$21.65 and \$21.95 for F2010 and F2011.
13. Shares outstanding was decreased to 3050 and 3050, from 3119 and 3120 for F2010 and F2011.
14. Return on Total Capital and ROE were slightly increased.
15. "Integration of Schering Plough progressing nicely."

October 5, 2010 (36.34) J

Update of Intrinsic value and valuation analysis with results and assumptions:

Intrinsic value

30 year bond rate	5.25%
Growth rate	6.50%
2010 est. eps	\$3.35
2011 est. eps	\$3.80
Intrinsic value	\$60.36

The 6.50% growth rate is the Value Line estimate as well as Reuters consensus growth rate and the 2010 and 2011 eps estimates are VL and consensus estimates.

Valuation results

2010 est. eps	\$3.27
Growth rate (10 & 15 yr)	5%
Tangible book multiple	3
10 yr ROI at tangible book multiple	12.71%
15 yr ROI at tangible book multiple	13.32%
15 yr ROI assuming PE=15	6.73%
15 yr ROI using Meyer rule of thumb	10%

In November 2009, the Company announced a \$3B share buyback. As of June 30, 2010, there was \$1.7B remaining. During the 2nd quarter, the company bought \$1.3B of stock at an average price of \$34.03.

6/30/10 Total equity	\$57,665.6
Less: Minority interest	2,434.0
Merck common equity	\$55,231.7
6/30/10 avg o/s shares	3,125.5

Book value/share	\$17.67
6/30/10 Goodwill	\$12,225.5
Intangible assets	43,281.4
Tangible book/share	(\$0.08)

The negative tangible book is driven by the November 2009 purchase of Schering-Plough. The transaction increased goodwill by \$216.9M and intangible assets by \$122.5M

Free cash flow – 6 months ending June 30, 2010 vs. June 30, 2009

	June 30, 2010	June 30, 2009
Net income	\$1,110.4	\$3,044.1
Depreciation & amort	3,635.1	932.6
Cap ex	(679.8)	(600.3)
Free cash flow	\$4,065.7	\$3,376.4

The increase in depreciation and amortization is related to the November 2009 purchase of Schering-Plough.

Difficult to compare operational results on a YoY basis due to the merger but I look at free cash flow increasing 20% as a significant positive. The company noted in the second quarter Q that merger synergies were still being executed and would be in place by the end of 2012. “Merger synergies” is a business school term for cost savings, generally due to employee reduction.

Debt

Based on Finra search, the bonds are not showing any stress. S&P rating is AA- and has been at that level since October 2004. Fitch rates as A+ and Moodys is Aa3. Bonds maturing in 5 years are yielding 1.5%, at 9 years the yield is 2.8% and 15 years is 4.5%.

Revenue

The Schering acquisition has allowed the revenue to be more diversified. As an example, Singulair is Merck’s largest (in terms of sales) drug and represented 12.4% of pharmaceutical revenue (10.6% of total revenue) for the six months ending June 30, 2010. For the first six months of 2009, Singulair represented 22.1% of pharmaceutical revenue and 20.5% of total revenue.

Notes from other analysts:

S&P (8/4/10, price \$35.01) rates as 4 star buy with a price target of \$42 based on an assumed 11.1 PE on 2011 earnings of \$3.80. The dividend, currently 4% may be raised in the next 12 months. The acquisition of Schering was a major transforming event. It has expanded and diversified the revenue base and has beefed up the pipeline. Risks to the investment include the failure to integrate Schering and litigation uncertainty.

Morningstar (7/30/10, price \$34.73) rates as 4 stars with a fair value of \$46. They have a buy price of \$32 and a sell at \$64. They project mid-single digit eps growth through 2013. Year over year comparisons are difficult but Merck seems to be integrating the Schering acquisition well. Anticipate margin improvement as operations are streamlined. The Schering acquisition puts Merck in a stronger strategic position.

Credit Suisse (8/27/10, price \$34.48) rates as outperform with a target price of \$42. EPS estimate (adjusted) of \$3.37 in 2010, \$3.90 in 2011 and \$4.08 in 2012. Projected 6.5% growth results in eps in

2015 of \$5.26. Revenue is projected to grow from \$45,602 in 2010 to \$52,988 in 2015, with gross margins increasing from 76.1% in 2010 to 78.1% in 2015. CS is projecting revenue from the current pipeline of \$8.675B in 2015 (vs. PFE pipeline revenue of \$4B in 2015).

Conclusion:

At the current price and using 2010 estimated eps (albeit “adjusted” earnings), we are holding a stock trading at a PE of around 10 and yielding 4.2%. These shares probably offer some protection on the downside and seem undervalued at this time. Even assuming an 11 PE on 2011 eps of \$3.8, the price would be close to \$42 (+15% from current price) and if we use a PE of 15 on next year’s earnings, we arrive at a price of \$57 (+57% from current price). The 5 year average PE is 16 according to Value Line.

7/14/10 (36.07) Review of Value Line 7/16/10

Basically all metrics are the same as 4/16/10 report. Nothing new to report.

5/19/10 Merck (MRK) (32.75) J

Current year eps estimate of 3.38, PE of 9.7; next year estimate of 3.89, PE of 8.4. The annual dividend is 1.52 (4.6%). Less patent issues than PFE. I think Schering did more for MRK than Wyeth did for PFE. I would not reduce.

April 14, 2010 (36.10) R Review of Value Line 4/16/10

1. Projects CF growth of 10.5% to 13-15, earnings of 6.5% growth.
2. Various Metrics

	2010	2011
Sales per share	14.60	14.90
Cash Flow per share	5.45	5.90
Earnings per share	3.35	3.80
Dividends per share	1.52	1.52
Capex per share	0.60	0.65
TBV	21.65	21.95

3. “merger with Schering ought to bear fruit in the coming years.”
4. “Balance sheet is strong.”
5. Dividend payout ratio projected in mid to low 40’s. Consistent or lower than past.
6. Patent losses coming. Yet, to the best of my knowledge this is totally industry specific.
7. Company financial strength is A.

July 21, 2009 (29.44) (John)

Quick update:

Merck released its 2Q09 results this morning. No balance sheet yet. Revenues were above expectations but were down 3% vs. 2Q08. However, excluding foreign currency adjustments, the revenues were up 3%. EPS (GAAP .74) results were also above expectations. Restucturing charges and other one-time charges amounted to .09/share. The company re-affirmed previous revenue and eps

guidance. 2009 revenue is expected to be \$23.2B - \$23.7B and GAAP eps is projected to be \$2.84 - \$3.09 and excluding certain items is expected to be \$3.15 - \$3.30.

The merger with Schering-Plough is on scheduled for the 4th qtr 2009. The estimates above exclude any SGP results. Merck is paying \$10.50 cash per share plus .5767 of a MRK share.

Bonds are rated AA- and showing no stress at all. 2015's yielding 3.36% and 2037's are 5.34%. The dividend yield is 5.5%.

10 yr avg PE is slightly over 20 and applying that to 2009 guidance results in share price of \$57. Even at 15 PE, share price computes to \$43.

We have not followed SGP too closely and there is some uncertainty about projected cost savings from merger so that may account for some of the price discount.

Value Line (7/17/09) – weak start in 2009, even as stand-alone company it is trading at an attractive valuation. Sales growth will be slow but the bottom line will fare better. Good recovery potential 2012-2014.

Morningstar (7/21/09) – 2Q results in line with their estimates. Januvia and Singulair helped offset slowing revenue from other mature drugs. With SGP's "powerful" pipeline, the combined company will be well-positioned for long-term growth. They rate it at 5 stars with a fair value of \$46/share.

Credit Suisse (7/21/09) – Beating consensus by .06 should be viewed as meaningful. 2Q results should please shareholders given revenue and expense gains in quarter. SGP performance and outlook remains intact. They have a target price of \$32 based on a PE of just under 9 on 2009 earnings.

I continue to be very comfortable with this position and would buy for any new accounts.

June 10, 2008 (36.20)

Share price hit a 52-week low this morning of 36.12. The 52 week high of 61.62 was in January 2008. Current price is about 42% lower than that high.

Current PE 16.33

Dividend 1.52/sh (3.9%)

Book value/share 9.09 (a/o 3/31/08 Q)

Tangible book/share 8.11 (a/o 3/31/08 Q)

Price/Book 3.98

Price/Tangible book 4.45

The current price/book of 3.98 is at the low point in the valuations of the past 5 years. From 2003 through 2007, the price/book ranged from 4 to 7 times book.

Revised valuation analysis today and the ROI is very attractive. The 10 year return is 18% and 15 year is 16.5%. In arriving at the current year estimate, we reduced the amount of income received from the Schering joint venture to reflect lower sales of Vytorin and Zettia by 50%. Our eps (normalized) is 3.06 versus 3.20 in value line and the company's estimate is 3.28-3.38. In computing the ROI, I used 3 times tangible book, which is 25%+ lower than today's price/book. The earnings growth rates were

8% in years 1-10 and 5% after that. Value line earnings growth through 2013 is 11.5% and the company has a goal of double digit growth.

Bonds are rated AA- by S&P and Fitch and Aa3 by Moodys.

MRK.GU / CUSIP 589331AK3; maturity 3/1/2015

Coupon is 4.75% with a current yield to maturity of 4.703%. The last sale date was 6/9/08 at a price of \$100.261. This price is up from the mid-90's last summer (2007).

MRK.GV / CUSIP 589331AM9; maturity 11/15/2036

Coupon is 5.75% with a current yield to maturity of 6.112%. The last sale date was 6/10/08 at a price of \$95.13. The last trade is down from \$105 in Jan 2008. The issue was trading in the low 90s last year.

Merck bought back 29M shares during 1st qtr at avg price of 47.32. At the end of the qtr, there was \$3,719.9M remaining under a \$10B buy-back plan announced in July 2002.

Updated our intrinsic valuation worksheet using growth rates of 8% and 4%. At 8%, the intrinsic value is \$72/share and at 4%, it is \$49/share. The stock appears to under-valued even at a harsh 4% growth assumption.

The company has been the subject of several headlines since the beginning of the year, with much of the news seemingly negative. In addition to the company specific news, the entire pharma industry is under stress as increased emphasis is put on patent expirations and legal issues that arise once drugs are introduced to the public. In addition, the upcoming presidential election leads to some industry uncertainty as healthcare reforms may be discussed by the candidates. In addition, several recent articles have said that pharma is not seen as a safe investment and that may be the reason for some of the selling. People mention Pfizer and its continuous share price decline and all companies in the industry are affected.

Merck's patent issues include: Fosomax (occurred in 1st qtr 2008, yet sales increased 1% vs. prior year), Cozaar/Hyzaar in 2010 and Singulair in 2012.

A couple of the major headlines since January:

Merck's joint venture with Schering and the Vytorin and Zetia confusion. These cholesterol drugs did not show increased effectiveness in slowing heart disease versus a less effective drug. The stock was punished when these results were discussed at a conference. While prescriptions have slowed, I read that they are still being filled. This was confirmed by a pharmacist client. During the first qtr 2008, Merck's share of the JV income was \$394.6M. This amounted to 8.9% of Merck's first qtr income before taxes, yet the stock price dropped about 20%. He also noted that Merck's diabetes drug, Januvia, which was introduced to the market late in 2007 is "flying off the shelves."

Merck also received a "not approvable" letter for the cholesterol drug "Cordaptive". Cordaptive was approved for use in Europe. It may still be resubmitted with additional data to the FDA for future approval in the U.S.

On the bright side, it appears that the company has its arms around the Vioxx liability issue. In addition to the \$5B settlement offer, the company's appeals of several early losses in the Vioxx litigation were overturned in Texas and NJ.

As noted at the annual meeting, Merck does not disclose details of their pipeline until they reach stage 3 testing. This is done partly out of conservatism and to keep competitors from knowing what they are

working on. In a report on drug company pipelines, Goldman (6/5/08 report) notes that “Merck has the largest number of entries with no forecasts due to disclosure, but incremental disclosure could drive upside in our view.”

Other analyst info:

Morningstar rates it 5 stars with a \$50 fair value. Notes that FDA is becoming more risk-averse and therefore more cautious in approving new drugs.

Bear Stearns rates Merck “overweight” with a price target of \$69. Risks include product liability charges, competition on new products, inability to contain expenses and pipeline delays.

Lehman Brothers rates mrk as “overweight” with a \$53 price target.

S&P rates as hold with 12 mo. Price of \$45. S&P estimates for eps are 3.30 in 2008 and 3.60 in 2009. Risks as noted before are pipeline delays are lower revenue from Schering joint venture.

At 0% growth and 3 times tangible book, returns are still extraordinary at 13% and 11% over 10 and 15 years.

April 22, 2008 (38.49)

Attended the annual meeting yesterday. Peter Kim, the head of research, spoke about the pipeline and seemed optimistic about developments. Several drugs in “stage 3” testing that are showing promising results—including obesity, type 2 diabetes, cholesterol, migraines and osteoporosis. There was also a bone and soft tissue cancer drug that has been fast-tracked by the fda. A couple of people asked about a Parkinsons treatment—it does not yet have a name, only referred to as a compound description. Another asked when it would be tested. They might have been employees or relatives of employees since this seemed to catch Peter by surprise. He indicated that it was in Stage 1 testing and Mrk does not comment on pipeline drugs until they reach stage 3, partly out of conservatism since they really don't know what they have but mostly because they don't want competitors knowing what they are working on.

Even with a reduction in the Schering joint venture, mrk is still sticking by its earnings guidance. Dick Clark made reference to his 2010 plan of cagr eps growth of double digits and 4-6% revenue growth between 2006-2010 which is still on target. Steps to increase gross margins to pre-Zocor levels targeted for 2009 will be met in 2008.

A shareholder asked about share price and referenced the fact that mrk was worst performer in Dow ytd. Dick Clark—“I feel your pain.” He said that in 2006 and 2007, mrk was the best performer in the dow.

Merck & Co., Inc. reaffirmed its fiscal 2008 non-GAAP earnings per share (EPS) range of \$3.28 to \$3.38 that adjusts for certain items and GAAP EPS range of \$3.84 to \$4.00. The Company expects a generally even distribution of non-GAAP EPS across the remaining quarters in fiscal 2008. Both the non-GAAP and GAAP EPS ranges include a \$700 million reduction in equity income guidance,

attributable to the lower-than-anticipated contribution from the Merck/Schering-Plough joint venture, as well as updates to other guidance elements to reflect current business trends. The 2008 GAAP guidance includes a pretax charge of approximately \$100 million to \$300 million associated with the Company's global restructuring program, the \$2.2 billion gain from a distribution from the AstraZeneca limited partnership. According to Reuters Estimates, analysts on an average were expecting the Company to report non-GAAP EPS of \$3.28 for the same period.

March 31, 2008 (37.19)

Down today over \$7 (16%) at this point based on news over the weekend that Vytarin is not as effective as thought. Vytarin is a joint venture with Schering which combines Merck's Zocor and Schering's Zetia. A panel of cardiologists found that it was not any more effective than Zocor (the Merck drug). Any changes in actual prescriptions will take several weeks or months to see. The head of the panel was just on CNBC and said the conclusion was that Vytoring would no longer be the first drug prescribed but would still be prescribed when other drugs are not effective.

Quick check on the bonds and they are still performing very well. At this point Merck shares are down about 38% ytd. I think the market overreaction is based on headlines and provides a buying opportunity for the stock.

Merck's share of the Joint Venture income in 2007 was \$1,832.5M before taxes. Not taking into account the Vioxx settlement expense, this was approx. 22% of Merck's income from continuing ops, in 2006 it was 27%. According to CNBC, the "panel" discussion was a one man tirade against the drug. Goldman Sachs cut back the drug usage based on the panel discussion and left its price target at \$53.

August 2, 2007 John (51.50)

Reviewed the 2Q07 8K and the 2006 10K. Merck is currently trading at a PE of about 18. Pre-Vioxx PE levels (01-03) ranged from 18 to 23. Our intrinsic worksheet places a current value of 42/share; using a conservative earnings increase of 6%--8K indicated that company was on target for double digit increases through 2010. If we use 10% growth, intrinsic value increases to 58/share.

2Q07 revenue increased 6% v. 2Q06. Income before taxes increased 6% in 07; 07 also included an addtl reserve of \$210M for Vioxx costs.

Enterprise value of 52.18/share – not out of line with current price. Revenue prospects appear to be improving and the company has increased earnings guidance for 2007.

The Vioxx situation is certainly a big question mark for the company. Merck has a reserve of about \$800M for litigation costs and also has \$630M cap on its product liability insurance. The total costs are unknown at this point.

November 9, 2004

1. Merrill mentioned that they expect Vioxx liability to be \$4 to \$18b, with guess at \$11B. Notice our note below, where Larkresearch mentioned "billions of dollars". Like Larkresearch Merrill has indicated that it is impossible for them to determine the financial implications of the DOJ and SEC investigation.
2. Merrill explains that if MRK were found guilty of criminal charges by DOJ, they could be banned from future government reimbursement.
3. The news today of SEC and DOJ investigation, according to Merrill, was mentioned in the 10Q.

4. We read a note today by CIBC. Here are some things they discussed:
 - a. 2005e eps 2.61, 2006e 2.53 (this could be reduced to 2.33 to 2.41 for financing of any settlement.
 - b. expects financing of eventual settlement to be paid with existing cash and raised funds.
 - c. Estimates that \$10b in litigation could lower eps by \$0.50 pre tax.
 - d. Worst case estimated at 50,000 individuals getting \$250k each.
 - e. Every billion in reserve would result in 0.45 pretax impact to eps.
 - f. Eps to decline in 2007 because of Zocor coming off patent in 2006.

November 8, 2004

Today's price is \$26.26.

1. Income Builder www.larkresearch.com (subscription required) discussed in issue 1232. Interesting notes include author describing that an outsider can not predict the Vioxx situation in regards to legal costs. Author assumes that it reasonable to assume it will be billions of dollars. Explains that Wyeth spent around \$18bil on fen-phen. Explains that MRK has lost over \$40bil in market cap, which could be likened to a \$60B pre tax write-off.
2. Looking at Value Line 10/22/04 issue when price was \$30 per share, we see the following:
 - a. Dividend yield of 5.1%. Now that the price is 26.26 the dividend yield is 5.67%. this assumes a \$1.49 annual dividend. Dividend yield has been as low as 1.9% in 1991 and as high as 3.4% in 1994. We are at historical highs for yields since 1988. Of course that is based on dividend not being cut.
 - b. Sales per share are expected to be 10.00 in f2005. Hence price to sales is 2.63X. This is the low range of P/S over recent years.
 - c. Cash flow per share expected to be 3.30 in F2005, with capex being 0.75 per share. Hence free cash flow would be 2.55 per share.
 - d. Eps expected to be 2.60 in f2005. P/E based on 2.60 is near 10X. The lowest average annual p/e since 1988 was 14.0 in 1994 and the highest was 30.0 in 1998.

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