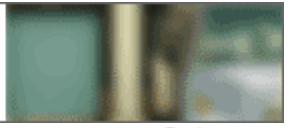


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NEWS ANALYSIS
By David Shook

A Pick-Me-Up in Merck's Medicine Cabinet?

Earnings are down, and expiring patents have some investors seeing a painful tomorrow. But history says now could be the time to buy

On Oct. 18, venerable drugmaker Merck & Co. ([MRK](#)) is expected to announce third-quarter profits of roughly \$2 billion, or 84 cents a share, on sales of more than \$12 billion. That's roughly 8% profit growth compared to a year ago. But considering Merck's long history of double-digit earnings appreciation, the most recent quarter, while in line with expectations, looks downright disappointing.

While companies in many other industries would do almost anything to report 8% profit growth, by drug-industry standards, Merck is having a tough year. The pharmaceutical industry is expected to average profit growth of 15% next year, but Merck anticipates 9% growth. Little wonder the stock has tumbled 26% this year, to \$69 a share.

Worries over Merck's drug pipeline and patent expirations have cast a pall over the near-term earnings picture. New drug revenues are a must for Merck, since four of its top sellers have lost patent protection in the past two years. Time to dump it? Not yet, say some contrarian analysts.

BIG FIVE. Long-time shareholders may remember that Merck has been warning for three years that its current funk was coming. Well, the hard times are here and are no worse than management said they would be. Meanwhile, the company is scrambling to replace lost revenue and in due time will come through, some analysts say.

"Merck's management has never let us down. Analysts have talked for years about Merck's drugs losing patent protection and how that could bury the company. Well, guess what? It hasn't happened, and it won't," says Gruntal & Co.'s Jeffrey Kraws, one of six Wall Street analysts recommending that investors buy Merck.

The company acknowledges its stumble with patent expirations this year, but it says two or three drugs in the pipeline should hit the market in a year to 18 months and bolster sales growth. In the meantime, Merck is comfortable that its five top sellers can carry it through 2002.

"GREAT POTENTIAL." "If you look at the top four of those five key medicines in each of those disease areas, there are 20 million people [in the U.S.] who remain untreated," says Merck spokesman Greg Reaves. The drugs are Zocor for cholesterol,

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Vioxx for arthritis, Singulair for asthma, Cozaar/Hyzaar for hypertension, and Fosamax for osteoporosis. "We believe these drugs still have great potential for growth," Reaves says.



Analysts don't dispute how reliant Merck is on these products in the near term. "When you look at those five key drugs together, they account for 63% of the company's pharmaceutical sales," says Banc of America analyst Leonard Yaffe. But in the near term, revenue growth for those top five may disappoint, according to Yaffe.

The company's five best sellers together had sales growth of 44% last year. This year, they should increase only 25%, Yaffe predicts. He rates the stock "market perform," which is lower than a buy rating at his bank. Indeed, of the Wall Street analysts who cover Merck, only six give it a buy rating, according to Thomson Financial. Sixteen have hold or equivalent ratings on the stock, and one rates it a sell.

COMPETITIVE PRESSURE. Zocor, Merck's best-selling drug, is doing extremely well, having generated \$1.4 billion in second-quarter revenues. However, its second-biggest seller, arthritis painkiller Vioxx, has seen its meteoric sales growth slow -- in part due to safety concerns. Vioxx sales were up about 50% in the second quarter, to \$725 million. When used in place of aspirin, Vioxx can cut down on stomach-ailment side effects. But it also may increase the risk of heart attack, some studies show.

Vioxx is under intense competitive pressure from Pharmacia ([PHA](#)) and Pfizer ([PFE](#)), which together market a very similar drug called Celebrex. Both Merck and Pharmacia are expected to introduce improved versions of their arthritis drugs in 2002, but Pharmacia's most likely will hit the market first -- a big advantage in the prescription-drug business.

Meanwhile, until Merck can produce some new blockbusters, drugs that had accounted for 37% of revenues are growing at a negative 8% pace. The reason is patent expirations. Generic competition for drugs such as Pepsid for treatment of heartburn and Mevacor for high cholesterol has cut deep into Merck's drug franchises. With few new drugs to pick up the slack at this point, Merck has seen its total sales growth slow considerably.

A MATTER OF TRUST. The company is hoping to replace lost revenues in a year or two with an improved form of Vioxx, called Arcoxia, and a new cholesterol-lowering drug being developed with Schering-Plough. That drug, ezetimibe, could be sold in combination with Zocor, for which Merck already has an extensive sales force.

Merck's slow growth should continue through next year, and that's likely to disappoint Wall Street. But investors willing to put a little trust in the company's reputation now have an opportunity to buy the stock cheap. Merck's 26% slide since Jan. 1 is worse than the Dow Jones pharmaceutical index, which fell 15% year-to-date.

Merck now trades at 21.8 times this year's earnings estimates, vs. 27.5 for the drug sector as a whole. And with a stock-market capitalization of \$158 billion, the company still has the ability to buy other companies and their revenue-producing drugs, if necessary.

PROMISES TO KEEP. What's crucial now is that Merck unveils a strategy that restores its status as an industry bellwether and proves its critics wrong. Gruntal's Kraws believes it will come through, albeit without a lot of flash. "This may not be the most promotional of companies, but Merck doesn't disappoint investors over the long term," he says. Clearly, there is precedent for this point of view.

Look back over Merck's history and you'll see that it has consistently delivered on its promises to Wall Street. "Is the company experiencing difficulties this year? Yes. But I can't stress enough that Merck's management is one of the best in the business," says Joseph Zammit-Lucia, president of Cambridge Pharma Consultancy in Cambridge, England.

Have patience with Merck, he says: While it has a reputation for keeping quiet during good times and bad, the company always finds ways to generate new revenues. Given this record, some investors might find Merck worth the risk.

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Edited by Beth Belton

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