

REFINITIV STREETEVENTS

EDITED TRANSCRIPT

Q1 2022 Merit Medical Systems Inc Earnings Call

EVENT DATE/TIME: APRIL 27, 2022 / 9:00PM GMT

CORPORATE PARTICIPANTS

Brian G. Lloyd Merit Medical Systems, Inc. - Chief Legal Officer & Corporate Secretary
Fred P. Lampropoulos Merit Medical Systems, Inc. - Founder, Chairman, CEO & President
Joseph C. Wright Merit Medical Systems, Inc. - President of International Division
Raul Parra Merit Medical Systems, Inc. - CFO & Treasurer

CONFERENCE CALL PARTICIPANTS

Andrew William Stafford Piper Sandler & Co., Research Division - Research Analyst
James Philip Sidoti Sidoti & Company, LLC - Research Analyst
Jayson Tyler Bedford Raymond James & Associates, Inc., Research Division - Senior Medical Supplies and Devices Analyst
Lawrence H. Biegelsen Wells Fargo Securities, LLC, Research Division - Senior Medical Device Equity Research Analyst
Michael Stephen Matson Needham & Company, LLC, Research Division - Senior Analyst
Steven Michael Lichtman Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst
William John Plovanic Canaccord Genuity Corp., Research Division - Analyst

PRESENTATION

Operator

Welcome to the First Quarter of Fiscal Year 2021 Earnings Conference Call for Merit Medical Systems, Inc. (Operator Instructions) Please note that this conference call is being recorded, and that the recording will be available on the company's website for replay shortly.

I will now turn the call over to Mr. Fred Lampropoulos, Merit Medical Systems' Founder, Chairman and Chief Executive Officer. Please go ahead.

Fred P. Lampropoulos Merit Medical Systems, Inc. - Founder, Chairman, CEO & President

Thank you, and welcome, everyone, to Merit Medical Systems' first quarter of fiscal year 2022 earnings conference call. And I'm joined today on the call with Raul Parra, our Chief Financial Officer and Treasurer; and Brian Lloyd, our Chief Legal Officer and Corporate Secretary.

Brian, would you mind taking us through the safe harbor provision, please?

Brian G. Lloyd Merit Medical Systems, Inc. - Chief Legal Officer & Corporate Secretary

Thank you, Fred.

Before we get started, I would like to remind everyone that this presentation contains forward-looking statements that receive safe harbor protection under federal securities laws. Although, we believe these forward-looking statements are based upon reasonable assumptions, they are subject to unknown risks and uncertainties. The realization of any of these risks or uncertainties as well as extraordinary events or transactions impacting our company could cause actual results to differ materially from those currently anticipated.

In addition, any forward-looking statements represent our views only as of today, April 27, 2022, and should not be relied upon as representing our views as of any other date. We specifically disclaim any obligation to update such statements, except as required by applicable law. Please refer to the section entitled Cautionary Statements regarding forward-looking statements in today's presentation for important information regarding such statements.

Please also refer to our most recent filings with the SEC for a discussion of factors that could cause actual results to differ from these forward-looking statements. Our financial statements are prepared in accordance with accounting principles, which are generally accepted in the United States. However, we believe certain non-GAAP financial measures provide investors with information regarding the underlying business trends and performance of our ongoing operations and can be useful for period-over-period comparisons of such operations. This presentation also contains certain non-GAAP financial measures. A reconciliation of non-GAAP financial measures to the most directly comparable U.S. GAAP measures is included in today's press release and presentation furnished to the SEC under Form 8-K. Please refer to the section of our presentation entitled non-GAAP Financial Measures for important information regarding

non-GAAP financial measures discussed on this call. Readers should consider non-GAAP financial measures in addition to, and not as a substitute for financial reporting measures prepared in accordance with GAAP. Please note that these calculations may not be comparable with similarly titled measures of other companies. Both today's press release and our presentation are available on the Investors page of our website.

I will now turn the call back to Fred.

Fred P. Lampropoulos *Merit Medical Systems, Inc. - Founder, Chairman, CEO & President*

Thank you, Brian. And let me start with a brief agenda of what we will cover during our remarks today.

I will start with an overview of our better-than-expected revenue results for the first quarter. After my opening remarks, Raul Parra will provide you with a more in-depth review of our quarterly financial results and the formal financial guidance for 2022 that we have reaffirmed in today's press release as well as a summary of our balance sheet and financial condition. We will then open the call for your questions.

Now beginning with a review of our first quarter revenue performance, we reported total GAAP revenue of \$275.4 million in the first quarter up 10.6% year-over-year. Our total revenue growth was driven by an 8.2% growth in U.S. sales and 13.8% growth in international sales. Our total revenue increased 11.3% year-over-year in the first quarter on an organic constant currency basis, excluding the headwind of our GAAP revenue growth related to changes in exchange rates compared to the prior year period. Our total constant currency growth was driven primarily by a 7.4% increase in U.S. sales and a 16.6% increase in international sales.

Our first quarter revenue exceeded the growth expectations that we discussed in our fourth quarter call, specifically that our constant currency revenue would increase in the range of approximately 6% to 8% year-over-year. The strong revenue results in quarter 1 were driven by solid execution from our team, stronger-than-anticipated demand during the month of March, particularly in the U.S. and more favorable-than-anticipated sales trends in the APAC and Rest of World regions.

Now let me provide you with a more detailed review of our revenue results in the first quarter, beginning with the sales performance in each of our primary reportable product categories. Now note, unless otherwise stated, all growth rates are on a year-over-year and constant currency basis. First quarter total revenue growth was driven by 11.5% growth in sales of cardiovascular products and 7.6% growth in sales of endoscopy products. Sales of our peripheral interventional products increased 14%, representing approximately half of the total Cardiovascular segment growth. Within the peripheral intervention or PI product category, sales of our radar localization products increased 27% and were the largest driver of total PI growth in quarter 1.

Sales of our access and geography and biopsy products, which together represented roughly 1/3 of our total PI business increased 17%. And sales of our drainage products, which were strong again this quarter, increasing 16% year-over-year. Sales of our cardiac intervention products increased 10%, representing the second largest contributor total Cardiovascular segment growth.

Within the Cardiac Intervention or CI product categories, sales of our intervention products were the largest drivers of total product category growth, increasing 18% with sales of our basics and MAP lines continuing to deliver strong contributions to the growth, increasing 24% in quarter 1.

Sales of our angiography products also contributed meaningfully to our total CI product category growth, increasing 17% in quarter 1, driven substantially by continued strong demand for our diagnostic guidewires, manifolds and cardiology diagnostic catheters. Sales of our OEM products were stronger than expected in quarter 1, increasing 20%, driven significantly by improving demand from larger customers replenishing inventory levels in multiple categories, including kits, coatings and angiography products. We are pleased to see that sales of our CPS products returned to growth of 4% in quarter 1, fueled by mid-single-digit growth in sales of kitchen trades.

Finally, sales in our Endoscopy segment increased 8% in quarter 1, driven primarily by a 13% increase in sales of our EndoMAXX line and a 14% increase in the sales of other stents.

Now turning to a brief summary of our sales performance on a geographic basis. As I mentioned, our first quarter sales in the U.S. increased 7.4% year-over-year and our international sales increased 16.6% year-over-year, both on a constant currency basis. Importantly, our first quarter sales results reflect improving growth trends in both the U.S. and OUS markets on both a 2-year and 3-year basis.

In summary, we are encouraged by the improving growth trends and proud of our team's strong execution despite another quarter marked by a challenging operating environment. That strong execution is not limited to driving better-than-expected revenue results. And frankly, we are seeing it across the organization, including our efforts to advance our Foundations for Growth Program.

As discussed on prior calls, we have launched more than 40 initiatives intended to drive value creation for Merit across many areas, including SKU optimization, network consolidation, compensation and benefits and, of course, product line transfers and manufacturing initiatives. Year 2 of the Foundations for Growth Program is off to a strong start, and we are enjoying the early benefits of our work to date, as the program is helping to offset the inflationary cost pressures we're seeing in certain raw materials, shipping and freight expenses.

We are also seeing the early benefits of improving our manufacturing efficiency in the area of product line transfers, continuous improvement in line efficiency and in SKU rationalization. We remain committed to the financial targets that we outlined in the Foundations for Growth Program for the 3-year period ending December 31, 2023, which calls for our constant currency organic revenue to increase at a CAGR of at least 5%, non-GAAP operating margins of at least 18% and cumulative cash flow generated of more than \$300 million.

Now with that said, I'll turn the time over to Raul, who will take you through a more detailed review of our first quarter financial results and over our 2022 financial guidance, which we reaffirmed in today's press release.

Mr. Parra?

Raul Parra *Merit Medical Systems, Inc. - CFO & Treasurer*

Thank you, Fred.

Given Fred's detailed discussion of our revenue results, I will begin with a review of our financial performance across the rest of the P&L. For the avoidance of doubt, unless otherwise noted, my commentary will focus on the company's non-GAAP results during the first quarter of fiscal year 2022. We have included reconciliations from our GAAP reported results to the related non-GAAP items in our press release and presentation available on our website.

Gross profit increased approximately 7% year-over-year in the first quarter. Our gross margin for the first quarter was 47.7% compared to 49.2% in the prior year period. The 151 basis point decrease in gross margins year-over-year was primarily due to increased absenteeism from the COVID-19 pandemic, which drove unfavorable manufacturing variances, higher freight costs and higher obsolescence expense, offset partially by changes in product mix. As expected, our first quarter results reflect the inflationary headwinds we are seeing in logistics, labor and to a lesser extent, in raw materials. Specifically, we estimate that the year-over-year increase in logistics expense represented a headwind to our non-GAAP gross margins of approximately 145 basis points in the first quarter.

First quarter operating expenses increased 9% compared to the first quarter of 2021. The year-over-year increase in operating expenses was driven primarily by a 12% increase in SG&A expense, partially offset by a 3% decrease in R&D expense compared to the prior year period. The increase in SG&A expense was primarily due to higher selling expense, including commissions and bonus expense on the increase in sales year-over-year. The decrease in R&D expense was driven primarily by lower manufacturing and R&D expenses, partially offset by increased clinical expense for certain R&D projects, including clinical trials for our Embosphere Microspheres and WRAPSODY Endoprosthesis projects.

Total operating income in the first quarter increased \$1.4 million or 4% year-over-year to \$40.2 million. Our operating margin for Q1 was 14.6% compared to 15.6% in the prior year period. The year-over-year change in operating margin was driven primarily by the 151 basis

point decline in our non-GAAP gross margin, offset partially by a 50 basis point reduction in our non-GAAP operating expense margin compared to the prior year period.

First quarter other expense net was approximately \$900,000 compared to \$1.3 million last year. The change in other expense net was primarily related to decreased interest expense as a result of lower average debt balance despite a higher effective interest rate.

First quarter net income was \$30.4 million or \$0.53 per share compared to \$29.9 million or \$0.52 per share in the prior year period. We are very pleased with our profitability performance in the first quarter, where we reported year-over-year growth in non-GAAP net income and diluted earnings per share despite the incremental pressure on our gross margin and a higher-than-expected tax rate in the period.

Turning to a review of our balance sheet and financial condition. As of March 31, 2022, we had cash on hand of \$55.8 million, long-term debt obligations of approximately \$253 million and available borrowing capacity of approximately \$475 million. This compares to cash on hand of \$67.8 million, long-term debt obligations of approximately \$243 million and available borrowing capacity of approximately \$490 million as of December 31, 2021. Our net leverage ratio as of March 31 was 1x on an adjusted basis.

With respect to our cash flow generation in the first quarter, as expected, our use of cash for working capital increased compared to the prior year period. In recent quarters, we have discussed our strategy to proactively invest in our inventory balances to build the requisite safety stock and ensure high customer service levels. This strategy represented roughly 1/3 of our total working capital use of cash in the first quarter. Their largest use of cash in working capital this quarter came from items that were essentially timing related, and thus were unique to Q1 and are not expected to impact future quarters. Specifically, cash used in accrued expenses totaled \$23.5 million, consisting of approximately \$18.3 million for the settlement payment related to the consolidated securities class action lawsuit with the balance of accrued expenses, use of cash related to payments of payroll-related bonuses.

We continue to expect strong free cash flow generation this year and our target of approximately \$75 million of free cash flow in 2022 remains unchanged. Of note, this free cash flow target assumes planned investments related to the Foundations for Growth Program that are expected to drive our CapEx investment in the range of \$55 million to \$60 million in 2022.

Turning to a review of our fiscal year 2022 financial guidance, which we reaffirmed in today's press release. For the 12 months ended December 31, 2022, we continue to expect GAAP net revenue growth of approximately 4% to 6% year-over-year. This GAAP net revenue range assumes a headwind from the changes in foreign currency exchange rates in the range of approximately \$3 million to \$3.5 million, representing a headwind of approximately 30 basis points to our forecasted GAAP growth rate this year. The GAAP net revenue guidance range also assumes net revenue from growth of approximately 4% to 6% in the Cardiovascular segment and net revenue from growth of approximately 6% to 8% year-over-year in Endoscopy segment.

With respect to profitability guidance for 2022, we continue to expect GAAP net income in the range of \$75.4 million to \$84 million or \$1.30 to \$1.45 per diluted share. Non-GAAP net income in the range of \$140 million to \$148.7 million or \$2.41 to \$2.56 per diluted share.

For modeling purposes, our fiscal year 2022 financial guidance continues to assume non-GAAP gross margins in the range of approximately 50.1% to 50.6% compared to 49.3% in fiscal year 2021. Non-GAAP operating margins in the range of approximately 16.6% to 17.3% compared to 16% in fiscal year 2021. Non-GAAP other expense of approximately \$6 million and diluted shares outstanding of approximately 58 million.

Of note, we have updated our assumptions for full year 2022 tax rate to a range of 22% to 23% versus 22% previously discussed.

Lastly, given the continued uncertainty in the global macro environment, we would like to provide additional transparency related to our growth and profitability expectations for the second quarter of 2022. Specifically, we expect our total revenue to be in the range of approximately a 1% decrease to an approximate 1% increase year-over-year on a GAAP basis and approximately flat to up to 2% increase year-over-year on a constant currency basis in the second quarter of 2022.

Our growth expectations for the second quarter of 2022 reflects 2 items of note. First, our revenue increased 28% year-over-year in the

second quarter of 2021, driven by 34% increase in the U.S. and 21% increase or growth in international markets. Second, we expect sales of endoscopy devices to decrease approximately 20% to 22% year-over-year in the second quarter as we are managing through some business disruption related to issues with a third-party contract manufacturer. We view this disruption as transitory and expect to return to normalized growth trends in the second half of 2022. With respect to our profitability expectations for the second quarter, we expect to see improving non-GAAP gross margin trends, offset by low- to mid-single-digit growth in non-GAAP operating expenses compared to the prior year period. The modest decline in non-GAAP operating margin combined with a higher tax rate, is expected to drive an approximate 5% to 10% decline in our non-GAAP net income and EPS.

With that, I'll turn the call back to Fred.

Fred P. Lampropoulos *Merit Medical Systems, Inc. - Founder, Chairman, CEO & President*

Well, thank you.

In closing, despite the challenging operating environment in quarter 1, we are proud that we were able to deliver revenue results that exceeded our guidance. We are confident in our 2022 guidance, which calls for total revenue growth on a constant currency basis of 4% to 6% year-over-year. We expect to see progressive improvement in our operating environment, specifically access to patients and elective procedures over the first half of 2022. We also continue to expect to report improving non-GAAP gross and operating margins and strong free cash flow in 2022, driven by strong execution and contributions from our multiyear strategic initiatives related to the Foundations for Growth Program. The benefits from this program are helping us to navigate the inflationary environment well. And while we have avoided material business impacts related to global supply chain disruptions to date, this is something we are watching closely as more and more companies are struggling in this area. Our team continues to execute well and remains focused on our strategic initiatives while standing ready to adapt quickly to changes in our markets. We would like to thank all of the team members around the world that made our performance in the first quarter possible.

Now that wraps up our prepared remarks, and we'll turn the time back over to our administrator, and open up the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question will come from Jayson Bedford with Raymond James.

Jayson Tyler Bedford *Raymond James & Associates, Inc., Research Division - Senior Medical Supplies and Devices Analyst*

I've 2 fundamental questions. So first on gross margin. I appreciate some of the year-over-year dynamics. But can you just walk us through some of the sequential dynamics, meaning fourth quarter revenue similar actually to first quarter here, but carry a higher gross margin. I'm just wondering if you could walk through kind of the difference there between the gross margin in 4Q and 1Q.

Raul Parra *Merit Medical Systems, Inc. - CFO & Treasurer*

Yes. I think first of all, Jayson, there's a level of seasonality from Q4 to Q1 that you have to kind of account for just as we do the shutdown in December; we ramp up production in January. One of the primary things there maybe that exaggerated that was the absenteeism that we saw from Omicron in January, which drove unfavorable manufacturing variances. Obviously, the higher freight costs and higher obsolescence expense as it relates to the prior year too had an impact, but on the plus side, it was offset -- partially offset by good product mix. So again, I think it was as expected, the Omicron, obviously, maybe was a little bit more exaggerated than we had hoped. But nevertheless, I think we saw sequential improvement with January being the worst, and then it just got better from there with a strong March.

Jayson Tyler Bedford *Raymond James & Associates, Inc., Research Division - Senior Medical Supplies and Devices Analyst*

Okay. That's helpful. And then just wanted to ask kind of a broad question on the pipeline and new product flow. It seems like there's been a few more releases out there for Merit on new product flow. Can you walk through some of the new products that you'd highlight either that have recently been launched or that are upcoming?

Fred P. Lampropoulos Merit Medical Systems, Inc. - Founder, Chairman, CEO & President

Yes, Jayson, thank you. We introduced a thoracostomy tray that has about 80% of the products in there are Merit-made. And there's a participant in the marketplace that has not been able to deliver, and Merit had the products. We developed a valve for pneumothorax. That was all done internally, and we're able to turn that project around relatively quickly. And then we saw that the opportunity just opened up. So we did a press release on that, and it served 2 purposes. It of course, let the community know. But more importantly, is that the industry know and a lot of these things get picked up by hospitals and different administrators. And so that actually helped to drive sales. So that would be one of them and one that we're spending a lot of time on ramping up because we think it has a big opportunity.

There are other products, and we have a full pipeline for this year. Some of the products very candidly, that were introduced in -- during the beginning of COVID, never really got a fair shot. So things like our valve fountain catheter are now out there, and that's picking up interest and particularly in treating pulmonary embolism, which are a function of a number of patients. Let me see what else I know that we have quite a roll...

Raul Parra Merit Medical Systems, Inc. - CFO & Treasurer

Well, I would just say that generally, we're trying to do a better job of letting people know that we've launched new products. And it's just part of our FFG initiative as part of communications, and we're going to try and be more active in that from that standpoint.

Fred P. Lampropoulos Merit Medical Systems, Inc. - Founder, Chairman, CEO & President

We'll keep doing it. So, there you go.

Operator

Our next question comes from Jason Bednar with Piper Sandler.

Andrew William Stafford Piper Sandler & Co., Research Division - Research Analyst

This is Drew on for Jason. And congrats on a nice quarter here. Do you want to start off on the guidance here, you posted a nice beat on the top and the bottom, even offsetting a pretty sizable impact to the gross margin. So maybe you could just walk us through the decision not to raise either component today? And maybe what I'm kind of curious about getting at here is, if you strip out some of the smaller pressures maybe the lockdown in China in currency. Do you think you would have raised the guidance this afternoon? Or are the pressures on supply chain likely to be sticky enough for that probably not the case?

Raul Parra Merit Medical Systems, Inc. - CFO & Treasurer

I think for us, if you remember last year, we got off to a hot start in Q1, and we decided to wait till after Q2 to really revisit our guidance. I think the same applies this year. One quarter, one quarter. We'd like to get at least the second quarter out of the way and then see where we're at and see what else is brewing out there and then revise guidance, if needed. But I think we feel optimistic about the business. Things are going well, and that's really -- I think from my standpoint, patience is our best friend right now, especially in this environment.

Andrew William Stafford Piper Sandler & Co., Research Division - Research Analyst

Okay. That's very helpful. And then there's been a couple of public reports about private market interest in Merit and some more specifics identified regarding prices and announcement dates and that kind of thing. I'm sure you can't comment specifically on those reports, but just wondering if you can speak to how you and the board balance opportunities of both near- and long-term shareholder value creation?

Fred P. Lampropoulos Merit Medical Systems, Inc. - Founder, Chairman, CEO & President

Yes. I think the biggest program for Merit right now to enhance shareholder value is our Foundations for Growth. That's where we spend our time on. That's where very candidly, where the compensation is aligned with the objectives and so that's where we spend our time and where we think the greatest -- and we've seen that. The evidence -- empirical evidence of that has been the performance of the company over the last few years. In terms of rumors, we simply do not comment on them. We are publicly held. And so as -- we have a fiduciary responsibility. But other than that, that's the same thing that I've been saying for 30 years. So that's, I think, the best way to answer that question.

Operator

Our next question comes from Larry Biegelsen with Wells Fargo.

Lawrence H. Biegelsen Wells Fargo Securities, LLC, Research Division - Senior Medical Device Equity Research Analyst

I'll echo the earlier, congratulations on a nice quarter here, Fred and Raul. Just a few for me here. On -- Fred, I'm surprised we haven't gotten to China yet, given that it's a pretty big part of your business. What are you seeing on the ground there? How much are procedures down in your view right now given the lockdown. We've heard other companies say maybe down 20% right now? And what are your expectations for the second quarter?

Fred P. Lampropoulos Merit Medical Systems, Inc. - Founder, Chairman, CEO & President

Yes. Larry, we don't comment on them. I will say that we grew at, I think, 27% in the first quarter. We know the issues are out there. We haven't seen direct situations in Beijing. And Joe Wright, who has -- is our Chief Commercial Officer. Joe, do you want to quickly comment?

Joseph C. Wright Merit Medical Systems, Inc. - President of International Division

Yes. We've seen, of course, the lockdowns in Shanghai, and that's impacted the business, but we haven't yet seen that spread. So we're confident that our forecast is included in the budget.

Fred P. Lampropoulos Merit Medical Systems, Inc. - Founder, Chairman, CEO & President

Okay. And Raul, do you want to quickly comment on it?

Raul Parra Merit Medical Systems, Inc. - CFO & Treasurer

Yes. I mean, as you look at -- our guidance it obviously assumes a material -- is a material driver to our mid-to-high single-digit growth in the APAC region. But we're not going to provide country-specific growth assumptions specifically to that. Other than to say, we provided Q2 total revenue growth expectations today, which includes our near-term expectations in the APAC region, China included. And previously, we thought volume-based purchasing tenders would begin in April. That's what we said in our Q4 call, now expected to begin probably May or June. We remain committed in China long term, introducing new products, expanding our reach and deeper into the Midland territories, and we remain pretty confident in our long-term growth in China.

Lawrence H. Biegelsen Wells Fargo Securities, LLC, Research Division - Senior Medical Device Equity Research Analyst

That's helpful. Just for my follow-up here, just on inflation, how much incremental inflation do you think you're absorbing this year versus, say, the last time you guided, how are you offsetting that? And I'm just trying to understand how we get from the 47.7, I think, percent, gross margin in the first quarter to, I think, relative to the guidance you gave of 50.1% to 50.6% kind of -- how do you -- what gets better from here?

Raul Parra Merit Medical Systems, Inc. - CFO & Treasurer

Yes. Well, look, I think when we guided our -- we did call out a headwind of approximately 120 basis points of inflationary costs in our guidance, Larry. As you can see, our gross margin on the low end was 90 basis points. So we tempered that too. But we've got a lot of Foundations for Growth initiatives that I think continue to help our gross margin, not only currently, but in the future, I mean there's just a lot of work. We called out in our opening remarks over 40 initiatives. A big portion of those are in the cost of goods sold line. So despite the inflationary headwinds that we're seeing, and despite the 120 basis points we baked in, we're still on the low end, looking to expand gross margins by 90 basis points. And so I think it will just get better from here. And that's the way we've planned for it.

Fred, do you want to say...

Fred P. Lampropoulos Merit Medical Systems, Inc. - Founder, Chairman, CEO & President

Yes. And just on the other side, I think our pricing initiatives are really, really important for as part of our Foundations for Growth. We brought out a fellow that worked for a major company. And Larry, I think that ability to really look at pricing, where we sit in the

marketplace, where we think there are the opportunities. I think I've said it before. So -- and that is we see probably a better chance to look at increased prices over our inflationary pressures. And I think the pricing part of it is a big part, we'll talk about that sometime in the future.

Operator

Our next question comes from Mike Matson with Needham.

Michael Stephen Matson *Needham & Company, LLC, Research Division - Senior Analyst*

I guess I wanted to start with the currency headwind that you're expecting. It seems a little smaller than what we've heard from some of your -- some of the larger med tech companies with similar international exposure. Is that maybe because you're doing more of your international business in U.S. dollars, or are you hedged somehow, maybe you can just talk to the 30 basis points, I mean, like Boston Scientific today, I think it was guiding to like a 200 basis point headwind this year, for example.

Raul Parra *Merit Medical Systems, Inc. - CFO & Treasurer*

Yes. I mean, look, I'm sitting across here from Travis, and I'm letting him get warmed up here because I'm going to let him answer his first question ever, but just to call out, Travis does an excellent job with our hedging policies and the work that he does. And there is some dynamics, obviously, that help us just because of where we do business, that help offset things. But Travis, do you want to give him a little bit of color and flavor for what you're looking at?

Unidentified Company Representative

So you're absolutely right. It's a currency mix. It's a geographical issue of where we sell product and where we're seeing headwinds and where we're necessarily seeing tailwinds relative to the prior period.

Raul Parra *Merit Medical Systems, Inc. - CFO & Treasurer*

So we have some offset.

Unidentified Company Representative

As well as, obviously, the derivative program that we have in place.

Michael Stephen Matson *Needham & Company, LLC, Research Division - Senior Analyst*

Okay. Got it. And then I think you made a comment about procedure growth in March being particularly strong. So what I'm wondering, is there something going on where we're actually starting to see some sort of backlog benefit here in March and April, particularly in, I guess, the U.S. and Europe?

Fred P. Lampropoulos *Merit Medical Systems, Inc. - Founder, Chairman, CEO & President*

Yes, Mike, this is Fred. Listen, I saw a report recently that talked about procedures being at 106% or something. I mean we are seeing more access from our salespeople all the time, and it's improving, particularly in the U.S. and to a lesser extent, Europe. But we are seeing that. And whether it's a backlog, whether it's -- that, I don't know, but just strictly from a procedure, our salespeople get more access and there's the need out there. So I think it's -- that's the essence of what we see.

Raul Parra *Merit Medical Systems, Inc. - CFO & Treasurer*

Yes, I would just say, overall, the environment has just improved. U.S. was very strong this last quarter. So...

Operator

Our next question comes from Jim Sidoti with Sidoti.

James Philip Sidoti *Sidoti & Company, LLC - Research Analyst*

I just wanted to push a little bit on your pricing power. I mean when do you typically raise prices? And you've done a good job on the gross margin, you're seeing some SG&A costs go up. Are you thinking you'll be able to offset that in the second half of this year with the price increase?

Fred P. Lampropoulos Merit Medical Systems, Inc. - Founder, Chairman, CEO & President

Yes, Jim, we generally don't talk about timing and this -- and I will say that many things we're looking at our time with some of the national accounts we have and when they come off and this that and the other is complex. And that's something that Brandon that fellow that came in as our pricing guy. So it's a long-term program, but nevertheless, the point is not that there's some magical thing that happens in the second half. It's a program that we have that's going to be going on in all of our products in the future, both in terms of introduction prices, where we sit in the marketplace. How much market and how pricing affects all of it. So it's an ongoing program that will be very consistent and something that will help our marketing and sales people going forward. But I think it's very important to our Foundations for Growth, and that's where it comes from, and that's another really important point.

James Philip Sidoti Sidoti & Company, LLC - Research Analyst

And then your guidance for free cash flow, it sounds like it will be another strong year. Do you anticipate continuing to start to pay down debt? Or would you consider other options for the use of cash?

Fred P. Lampropoulos Merit Medical Systems, Inc. - Founder, Chairman, CEO & President

Well, I'll answer it. But whenever I look at Raul, he loves cash. And the first use is to go ahead and to keep and pay off our debt is the first deal is where we look first and it gives us plenty of power. We see the markets. We see decreases and we saw it today, we saw yesterday. So I think it's the first time we've seen that there starts to be a little bit of light in terms of opportunities. So I think Merit's in a very good place in looking at those for the future. So to pay off debt has been consistent with what we've done for the last couple of years.

Raul Parra Merit Medical Systems, Inc. - CFO & Treasurer

Yes. And I think one of the things we're going to do this year, Jim, is, again, I think we have room on the working capital side, so we're taking advantage of that, making sure we have the right inventory levels. Again, I think we've been very lucky and been able to manage through the kind of the logistics and supply chain issues. But nevertheless, we want to make sure that our operations group has a little bit of rope to purchase additional inventory so we can kind of continue to meet the customer demand that we're seeing out there. So we'll use some of that for working capital and the rest we'll pay down debt unless something comes our way.

James Philip Sidoti Sidoti & Company, LLC - Research Analyst

And you talked about an increase in CapEx spending. Is that primarily for a facility in the U.S. or outside the U.S?

Raul Parra Merit Medical Systems, Inc. - CFO & Treasurer

We typically say that roughly \$35 million of it is typical maintenance and R&D projects. And then the rest would be related to the Foundations for Growth. And we do have an expansion going on in Mexico for additional clean room space for some of the product line transfers that we're doing. We're also adding capacity in Venlo for some of our...

Fred P. Lampropoulos Merit Medical Systems, Inc. - Founder, Chairman, CEO & President

It's our Coatings project.

Raul Parra Merit Medical Systems, Inc. - CFO & Treasurer

Yes, Coatings project. Thank you, Fred. So there is a little bit of building going on. But again, I think we've done the big things historically, you guys know that. So it's just incremental investments that we're making at this point.

Operator

Our next question comes from Steven Lichtman with Oppenheimer.

Steven Michael Lichtman Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst

On China, I think you mentioned for value-based purchasing, you're expecting a slightly later timing of that. But is that confirmed? And if it is confirmed, is the expected impact about in line with what you had thought going into the year?

Fred P. Lampropoulos Merit Medical Systems, Inc. - Founder, Chairman, CEO & President

Yes. Listen, anything that we talk about comes from our field sales force, and they're the ones that feed us the information based on what they see on the ground. So that's always where the information comes from. And it's been, I think, very reliable over the years. So that's where...

Raul Parra Merit Medical Systems, Inc. - CFO & Treasurer

Yes, I mean it's based on what information we have today.

Fred P. Lampropoulos Merit Medical Systems, Inc. - Founder, Chairman, CEO & President

But as you know, China is not the easiest place. So we rely on those guys, and they've guided us I think, properly, for a number of years.

Steven Michael Lichtman Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst

Okay. All right. Got it. And then just on tax rate, obviously, I assume that these slightly higher rates due to mix, Raul, geographic mix. And I know I've asked you this a number of times over the years, but what are the latest thoughts in terms of potential to get some leverage there?

Raul Parra Merit Medical Systems, Inc. - CFO & Treasurer

Yes. We baked in some stock option exercises this year. As you know, we typically guide to a higher rate, typically 24% to 25%. This year, we baked in a little bit of stock option benefit just because given historically, we've had more exercises and our tax rate is pretty low. I think last year it was around 18%. So this year, we did bake in a little bit more of those exercises. And we just didn't have as many as we had thought in the first quarter. And it's all timing-related, and so I think we just took it up a little bit just to account for some of those exercises that we were expecting that just didn't come through.

Fred P. Lampropoulos Merit Medical Systems, Inc. - Founder, Chairman, CEO & President

At least in the first quarter. Yes, who knows where -- the markets by the volatility, we look at it every day like...

Steven Michael Lichtman Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst

And just big picture, Raul, in terms of leverage of that line, nothing really changes. And just some updated thoughts on opportunities there.

Raul Parra Merit Medical Systems, Inc. - CFO & Treasurer

I think I missed that first part of the question. I heard...

Steven Michael Lichtman Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst

Leverage of the tax -- on the tax rate line leverage opportunities to bring that down?

Raul Parra Merit Medical Systems, Inc. - CFO & Treasurer

Yes. We keep having conversations with our tax advisers, and it's just hard in the current environment because there is no stability in Congress. And it's hard to plan for something that might change in 3 years, 2 years. I mean, 6 months, maybe even, right? So it's -- we've had the initial discussions. I know Mike Waller Chief of Accounting has had discussions with our tax advisers on things that we can do. But honestly, it's me right now kind of hesitant to do anything given the environment that we're in.

Operator

(Operator Instructions) Our next question comes from Will Plovanic with Canaccord.

William John Plovanic Canaccord Genuity Corp., Research Division - Analyst

My first is just on the Endo unit. The third-party manufacturing issues you spoke of looks to be about a \$2 million impact in the quarter. What gives you confidence that this won't lead into the third quarter or fourth quarter?

Fred P. Lampropoulos *Merit Medical Systems, Inc. - Founder, Chairman, CEO & President*

Yes. The -- we've transferred half of that business on one of the segments already. So we have confidence in our new provider, which is a U.S. company. And they are the same folks that are bringing up the second half and replacing a European vendor. So we have confidence in them. That's why we had a good relatively first quarter because we were able to pick up the stuff in the past. So we're confident in their ability. They've delivered on everything they said they were going to do. And so that's why we're confident on the latter half of the year. We're engaged in it. We're transferring it as we speak. And unfortunately, we were disappointed by one of our other vendors, but we've solved that at least we have identified it, and we're working on it, and we should be back in the market by the (inaudible) solution. Yes.

William John Plovanic *Canaccord Genuity Corp., Research Division - Analyst*

Okay. Great. And then how much was, Raul, the impact to obsolescence in the quarter?

Raul Parra *Merit Medical Systems, Inc. - CFO & Treasurer*

Let me just pull that up here.

William John Plovanic *Canaccord Genuity Corp., Research Division - Analyst*

And why you're looking for that, just as I think, I'm going to go back to the FX question. I think you're saying the guide is \$3 million to \$3.5 million in the year based on the 1% hit to the second quarter, you're at \$3.5 million through the first 6 months. Do you expect to benefit as we exit in the fourth quarter because I would expect another negative hit in the third quarter, you would have to have a positive to offset it in the fourth quarter. I'm trying to do the math on this.

Raul Parra *Merit Medical Systems, Inc. - CFO & Treasurer*

Yes. I guess I missed the...

Unidentified Company Representative

Do you want me to answer that?

Raul Parra *Merit Medical Systems, Inc. - CFO & Treasurer*

Yes, Travis. I missed the first part of the question.

Unidentified Company Representative

Yes. No, that's correct. Again, you have to take into context where certain currencies were at the end of last year. But yes, that is correct.

Raul Parra *Merit Medical Systems, Inc. - CFO & Treasurer*

So the obsolescence is about 100 basis points.

Operator

Thank you. And that concludes our Q&A session. I would now like to turn the call over to Mr. Fred Lampropoulos for any closing remarks.

Fred P. Lampropoulos *Merit Medical Systems, Inc. - Founder, Chairman, CEO & President*

Yes. Thank you very much. Ladies and gentlemen, thank you for your time today. We look forward to reporting back on our results and our progress. We'll be available over the next several hours. I have to travel to another meeting. And so just for those who will go on that call, I'll be calling it as well and Raul will be holding down the ship, but (inaudible) on those calls, and we look forward to clarifying. Again, thank you very much for your interest in the company, and we look forward to talking to you again soon.

Signing off from Salt Lake City. Good evening.

Operator

Thank you. That does conclude our conference call for today. Thank you for your participation.

DISCLAIMER

Refinitiv reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Briefs are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT BRIEFS REFLECTS REFINITIV'S SUBJECTIVE CONDENSED PARAPHRASE OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES REFINITIV OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT BRIEF. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2022 Refinitiv. All Rights Reserved.