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PRESENTATION

Operator

Welcome to the first quarter of fiscal year 2023 Earnings Conference Call for Merit Medical Systems, Inc. At this time, all participants have been placed in listen-only mode. Please note that the conference call is being recorded and that the recording will be available on the company's website for replay shortly. I would now like to turn the call over to Mr. Fred Lampropoulos, Merit Medical Systems' Founder, Chairman and Chief Executive Officer. Please go ahead, sir.

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 2023 Earnings Conference Call. I am joined on the call today by 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 statements, please?

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

Thank you, Fred. 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 on 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 26, 2023 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 Statement -- 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 useful 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, 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. Let me start with a brief agenda of what we will cover during our prepared remarks. I will start with an overview of our revenue results for the first quarter. After my opening remarks, Raul will provide you with a more in-depth review of our quarterly financial results and the formal financial guidance for 2023 that we updated in today's press release as well as a summary of our balance sheet and financial condition as of March 31, 2023. We'll then open the call for questions.

Now beginning with a review of our first quarter revenue performance. We reported GAAP revenue of \$297.6 million in the first quarter, up 8% year-over-year. Our total GAAP revenue growth was driven by 12% growth in the United States and 3% growth in international sales. Our total revenue increased 9.8% year-over-year in the first quarter on an organic constant currency basis, excluding the headwind to our GAAP revenue growth related to changes in exchange rates compared to the prior year period.

Our first quarter revenue results were notably stronger than the growth expectations that we outlined in our fourth quarter call. Specifically, we shared our expectation for constant currency revenue growth in the range of 3% to 5% year-over-year in quarter 1.

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. Note unless otherwise stated, all growth rates are approximated and are on a year-over-year and constant currency basis. We have included reconciliations from our GAAP reported results to the related non-GAAP item in our press release and presentation available on our website.

First quarter total revenue growth was driven by 10% growth in our Cardiovascular segment and 14% growth in our Endoscopy segment. While constant currency growth exceeded the high end of our expectations in both segments, our Cardiovascular segment drove nearly all of the revenue upside versus the high end of our expectations in quarter 1. Sales of our peripheral intervention products increased 9%, representing the largest driver of total cardiovascular segment growth again this quarter.

Within the PI product category, sales of both our drainage products and our access products increased 13% and together represented roughly 41% of total PI growth year-over-year, and sales of our radar localization biopsy and angiography products increased 10% and together represented roughly 39% of our total PI growth in quarter 1.

Of note, while the portfolio of products in our PI category continues to be the largest driver of growth in our Cardiovascular segment, I believe it is important to appreciate the value of contributions to our total PI growth in recent years that come from our highly differentiated Scout radar localization product line. We have been pleased with the market response to our Scout mini reflector following the commercial launch in the first half of 2022.

Continuing on with the discussion of our quarter 1 revenue growth drivers. Sales of our OEM products increased 24% and we're the second largest contributor to our total Cardiovascular segment growth year-over-year. These results exceeded the high end of our growth expectations, which we attribute to continued improving demand from larger customers in multiple categories, including our EP and CRM hit and intervention products, which together increased more than 50% year-over-year in quarter 1.

Cardiac intervention products sales increased 7% in quarter 1 were the 3 largest contributors to total CI growth coming from a 12% increase in sales and geography products and a 15% growth in sales of both our access products and our EP/CRM products. Angiographic products growth was driven by strong growth in sales of the InQwire diagnostic guidewires. Access products growth was driven by high teens growth in sales of our Prelude Ideal and Prelude Radial Sheath. And EP/CRM products growth was driven by strong demand for our SNAP and our Heartspan sheaths, as well as our focused Safeguard cool compression device, which is receiving positive market response following the commercial launch in August of last year.

Sales of our Custom Procedural Solutions, or CPS products, increased 6%, which was notably better than the mid- to high single-digit declines we expected in quarter 1. This upside was driven primarily by stronger-than-expected demand for our CPS products from customers outside the U.S., specifically in Germany, the Middle East and China, where sales increased in the low double digits year-over-year in quarter 1.

Finally, sales in our Endoscopy segment increased 14%, which was modestly better than the high end of our growth expectations. While we are pleased to see the business return to growth in quarter 1, as expected, endoscopy results continue to experience business disruption as we continue to navigate material shortages and work on qualifications for our new vendor. However, our guidance continues to assume improving trends as we move through the year, which we expect will result in mid-teens growth for our endoscopy business in 2023.

Now turning to a brief summary of our sales performance on a geographic basis. Our first quarter sales in the U.S. increased 11% year-over-year. Sales to U.S. customers came in roughly \$5 million higher than the high end of our growth expectations and represented 62% of our total company constant currency growth this quarter. Our U.S. growth performance reflects continued strong execution and overall improving trends in the U.S. market, particularly in the month of March.

International sales increased 9% year-over-year, which is a strong performance in light of the challenging global macro environment in certain international markets. All 3 of our major regions posted growth above the high end of our expectation and sales in the EMEA, APAC and Rest of World regions increasing 17%, 2% and 7%, respectively, year-over-year.

While we are pleased to deliver international growth ahead of what our guidance has assumed as expected, our international growth was materially impacted by COVID-related headwinds in China, our largest OUS market. Sales in China declined in the high single digits year-over-year in quarter 1, which exceeded our expectations due primarily to material improvements in trends in March.

Excluding China, our total international growth was nearly 17% in quarter 1. Now while we are pleased with all 3 regions, which contribute to the stronger-than-expected growth, we saw the most upside versus expectations in the EMEA region, where the recent year-over-year growth was primarily driven by demand in France, Germany, the Middle East and Spain.

Excluding China, sales in APAC increased 21%, fueled by mid-teens growth in Japan and strong contributions and growth from sales to customers in both Australia and Korea. And lastly, in our Rest of World region, we delivered 7% growth year-over-year, driven by solid growth in Latin America, Brazil and Mexico, partially offset by high single-digit declines in Canada compared to the prior year period.

In summary, we couldn't be happier with the strong start in fiscal year 2023. We are certainly encouraged by the improving growth trends in both the U.S. and international markets, but we recognize that the impressive results we delivered in quarter 1 are a direct result of our team's continued focus on executing our multiyear strategic plan.

In a few moments, Raul will review our financial results for the quarter and the updated guidance, which we announced in our press release this afternoon. I expect you will share my view that our financial performance in Q1 continues to demonstrate that the team's hard work and commitment to our Foundations for Growth program is paying off.

Non-GAAP gross and operating margins of 50.1% and 16.1%, respectively, and more than 20% growth year-over-year in both non-GAAP net income and non-GAAP earnings per share. Clearly, we are very, very proud of significant year-over-year improvements in profitability we delivered in the first quarter. Now that said, we are not losing focus. And we know we have a lot of work yet to do this year. We have updated our 2023 financial guidance to reflect the better-than-expected financial results in the first quarter. Importantly, we remain confident in our team's ability to deliver continued progress in the year -- in year 3 -- excuse me, of our Foundations for Growth program and the related financial targets for the 3-year period ending December 31, 2023, which calls for our constant currency organic revenue growth to increase at a CAGR of at least 5%; non-GAAP operating margins of at least 18% and cumulative free cash flow of more than \$300 million.

Now with that said, let me turn the call over to Raul, who will take you through a detailed review of our first quarter financial results and our 2023 financial guidance, which we updated in today's press release. Raul?

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 2023. 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 13% year-over-year in the first quarter. Our gross margin for the first quarter was 50.1% compared to 47.7% in the prior year period, representing the highest first quarter gross margin in the company's history. The year-over-year increase in gross margin was primarily due to favorable changes in product mix, improved obsolescence expense, freight and distribution as well as other FFG related efficiencies.

As expected, our first quarter gross margins were impacted by the inflationary headwinds we are seeing in freight, logistics, labor and raw materials. The 230 basis point increase in gross margins year-over-year exceeded the high end of the expectations we outlined on our Q4 call, which called for gross margins to increase 90 to 190 basis points year-over-year due primarily to fixed cost leverage on the better-than-expected sales performance in the period.

Operating expenses increased 11% year-over-year in the first quarter. The year-over-year increase in operating expenses was driven by a 10% increase in SG&A expense and a 14% increase in R&D expense compared to the prior year period.

Our operating expense performance in Q1 was better than expected and reflects strong operating leverage due to our continued focus on expense management and prioritization of investments to support our future growth initiatives.

Total operating income in the first quarter increased \$7.7 million or 19% year-over-year to \$48 million. Our operating margin for Q1 was 16.1% compared to 14.6% in the prior year period. The 150 basis point increase in operating margin was driven by a 230 basis point increase in our non-GAAP gross margin, offset partially by an 80 basis point increase in our non-GAAP OpEx margin compared to the prior year period.

First quarter other expense net was \$0.7 million compared to \$0.9 million last year. The change in other expense net was primarily related to decreased expense from realized and unrealized foreign currency losses compared to the prior year period, partially offset by increased interest expense due to higher effective interest rates year-over-year.

Note, our other expense net line was roughly \$1 million lower than what our guidance had assumed as a result of lower noncash expense realized on foreign currency gain loss in the period. First quarter net income was \$37.5 million or \$0.64 per share compared to \$30.4 million or \$0.53 per share in the prior year period. We are pleased with our profitability performance in the first quarter, where we delivered 23% growth year-over-year in non-GAAP net income and 22% growth year-over-year in non-GAAP diluted earnings per share, exceeding the high end of our expectations.

Turning to a review of our balance sheet and financial condition. As of March 31, 2023, we had cash and cash equivalents of \$57.9 million, total debt obligations of \$197.8 million and available borrowing capacity of approximately \$521 million compared to cash, cash equivalents of \$58.4 million, total debt obligations of \$198.2 million and available borrowing capacity of approximately \$523 million as of December 31, 2022.

Our net leverage ratio as of March 31 was 0.6x on an adjusted basis. We generated \$1.8 million of free cash flow in the first quarter. Cash from operations increased 21% year-over-year in the first quarter, driven by the strong improvements in GAAP net income year-over-year, offset partially by an 11% increase year-over-year in the use of cash for working capital.

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. Our free cash flow generation was also impacted by a 34% increase year-over-year in cash invested in capital expenditures.

Turning to a review of our updated fiscal year 2023 financial guidance. We have included a table in our earnings press release, which details the updated ranges for each of our formal financial guidance items and how those ranges compared to both prior guidance and the prior year period. We now expect GAAP net revenues growth of approximately 6% to 7% year-over-year compared to 4% to 5% previously. The updated GAAP net revenue range now assumes a headwind from the changes in foreign currency exchange rates of approximately \$3.5 million to \$4 million, representing a headwind to our forecasted GAAP growth rate of 30 to 40 basis points compared to our prior guidance range, which assumes \$10 million to \$11 million and 90 to 100 basis points, respectively.

The GAAP net revenue guidance range now assumes net revenue growth of approximately 5% to 6% in our Cardiovascular segment and net revenue growth of approximately 15% to 16% in our Endoscopy segment. The increase in the low end of our -- of both these growth ranges reflect the stronger-than-expected revenue results from the first quarter. Note, the midpoint of our 2023 constant currency sales growth expectations now assumes approximate 6% growth year-over-year in the U.S. and approximately 7% growth year-over-year in OUS markets. Both of these expectations are roughly 100 basis points higher than our prior guidance assumptions, which again reflect the stronger-than-expected revenue results from the first quarter.

With respect to profitability guidance for 2023, we now expect GAAP net income in the range of approximately \$100 million to \$105 million, unchanged from prior guidance and GAAP diluted earnings per share of \$1.71 to \$1.79 versus \$1.72 to \$1.80 per diluted share previously. And non-GAAP net income in the range of approximately \$166 million to \$171 million or \$2.83 to \$2.93 per diluted share compared to \$163 million to \$168 million or \$2.80 to \$2.89 per diluted share previously.

For modeling purposes, our fiscal year 2023 financial guidance assumes non-GAAP gross margins in the range of approximately 50.7% to 51%, reflecting a 30 basis point increase at the low end versus prior guidance assumptions. Non-GAAP operating margins in the range of approximately 18% to 18.2%. GAAP and non-GAAP other expense of approximately \$6.6 million and \$6 million, respectively, both of which reflect a \$1 million lower expense versus guidance, which benefited our first quarter results that I discussed earlier.

Non-GAAP tax rate in the range of 21.5% to 22.5% versus approximately 21% previously and diluted shares outstanding of approximately \$58 million. We continue to expect CapEx in the range of \$55 million to \$60 million and free cash flow of approximately \$115 million.

Lastly, we would like to provide additional transparency related to our growth and profitability expectations for the second quarter of 2023. Specifically, we expect our total revenue to increase in the range of approximately 4% to 6% year-over-year on a GAAP basis and up approximately 5% to 7% year-over-year on a constant currency basis.

Note that the midpoint of our second quarter constant currency sales growth expectations assumes approximately 6% growth year-over-year in the U.S. and approximately 7% growth year-over-year in OUS markets. With respect to our profitability expectations for the second quarter, we expect to see non-GAAP gross margins to increase in the range of 70 to 130 basis points year-over-year. We also expect to see non-GAAP operating margin in a range of down 20 basis points to down 60 basis points year-over-year.

These margin expectations, combined with higher interest expense year-over-year are expected to drive a year-over-year change in non-GAAP EPS in the range of flat year-over-year on the low end to up mid-single digits year-over-year on the high end of the range.

That wraps up our prepared remarks. Operator, we would now like to open up the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question will come from the line of Steve Lichtman from Oppenheimer.

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

So really balanced strength here on the top line in the first quarter. I guess just for my question and my follow-up upfront here, just touching on a couple of different areas. One, OEM, very solid again. Can you talk about the drivers there and what do you think is sort of

the sustainable growth looking ahead for that segment? And then secondly, just in China, as I think geographically, given the strength in March, how are you feeling overall about the outlook for your business in China?

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

Yes, Steve, thank you very much. Listen, I think the OEM issue really comes down to increased procedural growth rate and to be very candid with you, reliability. I mean people buy the product because we can deliver the product. So I think you take those 2 factors and those really spell out what the OEM opportunity is.

In terms of sustainability, we're just going to stay within our forecast for the year. And if we see other things, we'll discuss that in further calls. But as you can see, the business is doing well there, and we're very, very pleased with the OEM. Raul, do you want to pick up the China question?

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

Yes. Look, I think I'll start off with just saying our international sales grew up 9% on a constant currency basis, essentially all 3 of our major regions posted above the high end of our expectations, which I think we were really excited about. And as expected, our OUS growth was impacted by the COVID-related headwinds in China, which we expected. I will call out that excluding China, our international sales were up nearly 17% on a constant currency basis. So I think we're excited how China came back in March, and we'll see how the rest of the year pans out. But excited about how our international sales did excluding that impact.

Operator

Our next question comes from the line of Jayson Bedford from Raymond James.

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

Congrats on the success here. So just a couple. On your comments on the strength in March, particularly in the U.S., Fred, you've been doing this for a few years. I'm just curious, why do you think March was so strong? And kind of what are you seeing out there either from a procedure standpoint or even a company-specific standpoint that maybe perhaps you're gaining a bit more share than others?

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

Yes. Listen, I think, Jason, as I mentioned in my previous comments on OEM, a lot of it's reliability and Merit's ability to deliver while others are maybe still trying to catch up and the procedure growth rate. So if you -- I mean, you take those things, it's kind of consistent across the board globally is our ability to do that, the vertical integration. Other things that we do as a business, I think, are playing well, or have in the past and we think will play well in the future as well.

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

I'm wondering, do you think there's kind of a catch-up of procedures out there? Is it an access situation here where hospital staffing has come down to allow hospitals to perform these more procedures? I'm just kind of curious from a macro perspective what's going on.

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

It's the question of the day. We get this all the time. I was talking to another senior executive of a medical -- a large medical device company. And they were still talking about the issues of staffing. We see some trends in staffing. On the other side of the coin, I think that you are seeing -- there's some pent-up demand out there, clearly, I think it's going to be out there for a while. So I think all of the factors, all of the macro factors, in my view, our view as a company, I think, are paying in Merit's favor.

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

Just on gross margin, it was clearly quite strong in the first quarter. You lifted the gross margin guide, but the operating margin assumption didn't really change for the year. So I'm just curious as to where the incremental reinvestment is going? Yes. I'm going to pick up the front end and let Raul talk on the back.

Listen, we talked about in previous calls about sales meetings. We talked about trade shows and those things. And we talked about making those investments in our previous phone calls saying they were coming as this COVID situation unwrapped. And in fact, that's exactly -- we have a couple of trade shows this week. So it really is trade shows and sales meetings.

And just briefly on the sales meetings, I attended them, and it's just nothing like getting the team together, talking about their successes, their opportunities and the camaraderie that comes with all of that is important in any type of organization. I've seen it through my military career and my business career. Raul, do you want to pick up the gross margin part?

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

Yes. Look, I think on the gross margin, clearly, the strong sales allowed us to better cover our fixed coverage. So that helped the gross margin kind of exceed where we thought we'd end. Additionally, on the operating margin targets. Look, I think one of the things that I'll call out, it's kind of foundations for growth, right? There is a level of investment that we're making in the business, specifically as this gross margin comes in. We've been -- we've continued to talk about that prudent investment in growth initiatives.

And so I think it's really just about balancing, Jayson, the growth that we're seeing, the profitability in our gross margin that we're seeing and then just making sure that we find the right balance between delivering increased profitability and just making sure that we have continued success on the growth side.

Operator

And our next question will come from the line of Mike Matson from Needham.

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

I guess I'll start with the gross margin was obviously really strong, and you called out product mix. I was wondering if you could maybe just talk about what you're seeing there, kind of the categories that are higher margin and maybe growing faster or some ones that are lower margin, maybe growing slower driving that mix benefit?

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

Yes. Well, I'll call out a couple of things first, right? We saw improved obsolescence expense. Obviously, the freight and distribution as we shift from ocean -- sorry, from air to ocean is helping. We also have some related FFG initiatives that are flowing through that are helping it.

On the product mix side, we continue to see growth in our Cianna product line, in our peripheral intervention mark areas. OEM was a strong player, too, which has increased gross margins. So just kind of a mix of different things, Mike.

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

Can I add something, Raul, if I could just. I think with our Chief Commercial Officer and aligning all of our global initiatives and support is also something that just overall plays well for the business. That's Phil Wright and his team. And I think it's a much more cohesive and effective unit in the commercial side that drives.

Because remember, we're all tied -- everybody in this company is tied to margins and results. And when you line all that up, it's just really interesting to see what happens.

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

Yes. Okay. So it's more of a -- this is more of a kind of a deliberate effort on your part as opposed to just kind of something that happened. You're deliberately powering this product.

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

Yes, let me just tell you everything out here is (inaudible). They've got somebody in their office that got them in mind. I mean there's -- it's very deliberate. Yes.

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

And just lastly, Mike, I mean, I think our guidance kind of previewed the gross margin that we were expecting, right? So slightly ahead of where we thought, just from a fixed cost leverage in Q1, but generally within the guidance that we've given.

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

And then kind of a related question, I guess, just I feel like when you started the Foundations for Growth program, I think one of the things you talked about was some SKU rationalization, product rationalization, some lower margin categories and things like that. And I just wanted to get an update there. Has that sort of been accomplished? Or has that had an effect on gross margins?

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

So yes, look, SKU rationalization is a program. It's quite frankly, a multiyear program. And if we're successful, you shouldn't notice other than gross margin accretion. We've gotten rid of some pack businesses in Australia, some pack business in Ireland. In Europe also, that will be kind of fully gone here by midyear. So generally, it is one of the initiatives that we continue to work on. And again, it's a multiyear approach. Most of it is kind of we've got better, higher quality, higher gross margin products that we want to replace it with.

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

And Mike, some of it comes in efficiency, too, where we might be -- we have a catheter that we're selling hundreds of a month, and it might be 5 centimeters longer or shorter. And then we have something that we sell tens of thousands a month, and we move them over. So that SKU rationalization comes not only just in low products, but also in margins there. But in the efficiency of manufacturing.

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

Low runners.

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

Yes, low runners. I think we keep our customers happy. They're thrilled that we talked with them and work this out and have this transition. So that's why you have to do this in a sequence, and it has to be well disciplined. You want to keep your customers happy instead of someone -- and I've seen this happen with other players. They just go out and just knock something off with no input this or that and they upset their customers. It's just not a smart way to do business. That's what we've tried to do.

Operator

Our next question comes from the line of James Sidoti from Sidoti.

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

It's been a couple of years, I looked back, where Q1 exceeded Q4, but it isn't very common, especially when you have a slowdown in China due to COVID. So it's especially impressive this year. Were there any onetime things in the quarter? Or is it just the procedures that are starting to come back?

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

Listen, I think it's execution. I think it's the coordination of selling organizations throughout the world and messaging. And I think part of it is increased procedure growth rates that we talked about, particularly later in the first quarter. We're seeing those kinds of things, Jim, but nothing that I'm aware of, Raul. I'm not aware of any onetime anything.

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

No. I mean our guidance is built on things kind of opening up over the year. So we'll see. March is 1 month and the quarter is 1 month. We'll see how the rest of the stuff. But we're excited of how things have trended so far.

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

And has pricing been a factor? I know you have thousands of products. So it's hard to say what your average price increase is. But how much of the growth would you estimate came from pricing?

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

That's a great question, Jim. But we're not going to discuss that on the call. We just don't -- we actually don't disclose that publicly. But I will say that most of our growth continues to be volume and pricing is a benefit that we're getting and continue to expect to get.

James Philip Sidoti Sidoti & Company, LLC - Research Analyst

And then on the expense line, R&D up \$3 million or \$4 million in the quarter. What -- is that due to trials or what's going into that?

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

Yes, trials and just making sure that we invest -- continue to invest in the business. Again, I think what we're trying to do is make sure that we're prudent about the way we deliver profits but also continue to invest in the business.

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

And then last one for me. inventory. You noted how that increased year -- from the beginning of the year. Is that all safety stock? Is there an anticipation of continued strong growth in the rest of the year? And what can we read out of that?

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

Yes. Look, a large part of it is really kind of our strategy just to make sure that we can maintain the customer service levels that we -- that our customers expect of us. We've been in a good position that we've been able to deliver product, and we want to continue to be able to do that.

Secondarily, we've got the shift from air to ocean, which does require a little bit more inventory and the lag. And then also just some of the site consolidations and product line transfers that we have. So it's a combination of a few things. But mostly, it's really just about making sure that we can meet our customers' needs.

James Philip Sidoti Sidoti & Company, LLC - Research Analyst

Do you think you'll see a similar increase in the second quarter? Or do you think you're -- you've already built it up to the point where it's going to be more of a slower increase?

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

We don't give intra-quarter or intra-month guidance on free cash flow just because of the timing of things. We haven't changed our free cash flow target of \$115 million. So I'm going to leave it at that, Jim, if you're okay with that.

Operator

Our next question will come from the line of Jason Bednar from Piper Sandler.

Jason M. Bednar Piper Sandler & Co., Research Division - Director & Senior Research Analyst

Congrats on a really nice start to the year guys. Apologies in advance. This may have been covered. Been hopping between a couple calls here. Raul, just to start with you, really maybe just trying to understand the components of the full year guide at the revenue line. As we've got 1 in the books. We have kind of the 2Q formal or informal guidance, however you want to think about it, that's out there now. I think when I put this together, and again I still need to work through some of the elements of the model, but I think this implies a slight decel in the growth in the second half of the year.

I think the comps are actually a bit easier though in the second half. Pricing probably is getting a little bit better. China is probably better in the second half than the first half. So maybe just help with the sequencing as we think through the factors influencing like that, the cadence of that organic growth.

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

Yes. We really didn't change any of the assumptions from Q2 to Q4. It's really what you're seeing from a guidance perspective or the updated guidance is a strong Q1. Again, what we saw is January, February in line with our expectations and then a very strong March. And we don't want to go out and get ahead of ourselves, Jason. I think what we want to see is let's see if this 1 month turns into 3 months and then 6 months and then a full year. So I think that's where we're at. Again, nothing -- not much has changed in the back half.

Jason M. Bednar Piper Sandler & Co., Research Division - Director & Senior Research Analyst

Fair enough. And then on the free cash flow outlook, maybe building on a little bit of Jim's question there previously. But how do we think about that -- the cadence of that \$115 million coming through working towards moving all the way back to ocean versus air freight? And then how should we think about the capital allocation here this year? Is it still the working assumption you just continue to pay down debt?

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

Yes. We'll continue to pay down debt. And again, I think \$150 million is still our target for the year. We did talk about some timing-based items in our Q4 call just a couple of months ago related to Q1. But we don't give intra-quarter information on free cash flow just because it's so tricky on a timing base. But look, we haven't changed our target yet. So I think, hopefully, that gives you the confidence that we see in here.

Jason M. Bednar Piper Sandler & Co., Research Division - Director & Senior Research Analyst

Definitely. Okay. And then Fred or Raul, it seems like you're clearly picking up share here in the market, have been for multiple years now. But maybe talk about the competitive landscape as it stands today as we look out across your key geographies, the U.S., Europe and China, any shifts or changes that are worth calling out?

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

I think, Jason, that the real factor is our ability to provide product and the reliability. That's where this comes from. And that goes back to vertical integration and all the things we've talked about for a very long time. It's really the core of Merit's business is the opportunity -- you heard Raul say several times on this call is getting the product to customers and the reliability.

Everybody's out there fighting for the same health care dollar. And the question is, who does it better. And our goal is to just continually improve to meet that need. And also, as was pointed out to invest in the business for new products that make it easier for physicians and technicians to be able to do their job. So it's kind of the same thing we've been doing for a long time, but with maybe a little bit more of a sharpened focus.

Operator

Our next question comes from the line of Michael Petusky from Barrington Research.

Michael John Petusky Barrington Research Associates, Inc., Research Division - MD & Senior Investment Analyst

I guess, slightly beating a dead horse. But I just want to ask, the free cash flow generation in the first quarter, and I understand certainly Q1 is always going to be the lowest. But I mean, did that come in a little soft even relative to internal? Or was that actually relatively in line?

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

Again, Mike, I think we talked about it being soft in Q1. As a matter of fact, I believe you asked the question, right, hey, how -- what's the cadence of free cash flow. And again, I always call out Q1 because it is lighter than what we expect. And so I'll just leave it at that. Again, we haven't changed our free cash flow target for the year. So hopefully, that gives you some confidence of where we're at.

Michael John Petusky Barrington Research Associates, Inc., Research Division - MD & Senior Investment Analyst

Fair enough. And I didn't catch the commentary about China and March, it sounded like you said it got better, but did you quantify that or just essentially say, hey, China got better in March?

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

Yes, no quantification. Just China got better, right? It exceeded our expectations. And so hopefully, that will continue.

Michael John Petusky Barrington Research Associates, Inc., Research Division - MD & Senior Investment Analyst

And I guess, Fred, in terms of what you guys are seeing out there in terms of assets? I mean, are you seeing more? What kind of valuations are you seeing with interest rates where they are? I mean, how has that changed the landscape? I mean -- and I guess you're thinking about assets, if you could just talk about that.

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

Yes. Listen, I think it's changed substantially, not enough necessarily to what we'd like to see. I think there are a lot of very high expectations out there. We see a lot of things coming across our desk. We look at them. But again, the best way we put it, Mike, is that we are looking for things that fit our sales channels, things that are complementary to our foundations for growth and our -- the profitability, all the things that we talked about.

We are seeing things though, loosen up, as you know, and we've said before on previous calls, things were just simply too expensive. And I think that's -- I mean without getting too prophetic here, I mean we talked about that is that it just didn't make sense to us to be -- on these prices.

So things are loosening. There's more availability. A lot of them are still those start-ups, so those companies that are not making money. That's not of much interest. But at the same time, there are assets starting to show up, and we'll look at them and see if they meet our criteria.

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

Yes, I'll just add that. I mean, I think if you look at our growth, we continue to display pretty strong growth. And so I think we can continue to exercise patience and we don't have to do anything because we don't -- we're not suffering from a growth--

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

It's a really good point, Raul. We don't have to do anything, but we can be opportunistic.

Michael John Petusky Barrington Research Associates, Inc., Research Division - MD & Senior Investment Analyst

Just real quick, let me sneak one more in. One question that I've gotten increasingly over the last few months regarding Merit, and I think this is truly a compliment to you guys and how you've executed 2/3 of the way, or a little more than 2/3 of the way on Foundations for Growth. I've had multiple questions from investors about, do I think that Merit will do some other multiyear sort of target plan after '23 is over? I understand you're super focused, hyper-focused on executing what you've put out there. But do you have any comment on whether it's likely you'll do something similar going forward?

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

Yes. I can tell you that Raul and I would do a duet on this and some exactly like that. So given your part of the duet here, Raul. Because I have the same answer.

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

Yes. I mean I think the way to look at it is -- the way we look at it internally is we don't want to be that wide open receiver that drops the ball at the 1 yard line. So we want to -- I understand everybody's focused past '23, but we are just hyper-focused on making sure we cross that finish line, we score that touch down, and that's where we're at.

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

And Mike, we are all aligned to that goal. Every single person in this company is aligned on that goal -- compensation goals, company, individual departments and so on and so forth. That's eye on the ball until -- and they talk about football, I'm a baseball guy. I mean, we got to get the last out in the ninth inning, and then you win the World Series. You don't win it in the sixth inning.

So I guess it would be if you had -- if it's the 11th inning we're playing extra innings. So we just want to finish it up. And that's what you'll hear us say. It's very consistent. And then we'll talk about where we go from there.

Michael John Petusky *Barrington Research Associates, Inc., Research Division - MD & Senior Investment Analyst*

Fred. The only comment I have on that is, given the state of the Red Sox, I'm surprised you're still a baseball fan, but good luck.

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

That's a cheap shot -- and not only that, I've got an Orioles guy sitting in the room here with me and they won 6 to 2 today. I'm really hurt. I'm very, very hurt over that comment.

Michael John Petusky *Barrington Research Associates, Inc., Research Division - MD & Senior Investment Analyst*

Sorry, Fred.

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

Especially a guy from Chicago. Come on.

Operator

Our next question comes from the line of William Plovanic from Canaccord.

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

Great. I just have 2. One is looking at the business today and understanding everything you've done, what do you think peak operating margins could be for this business eventually? And then my second question, I'll give it and then I'll go on mute, is one of the questions that I get from investors is, Fred, you've built this company since the '80s, -- you've done a phenomenal job. How should we think about -- is there some point which you step down? Is there a succession planning? Or how do we think about that?

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

Yes, you're welcome. Let me hit the last one there. Listen, we have a formal program. We will have an announcement by this year in the second half of the year that lays it out in a public release to everybody. You shouldn't read into that, but that's the end. So I want to make sure that's clear, but it will spell out the succession program that's being run by our ESG and our comp committee. So that will come out formally and that will answer your question.

In terms of peak performance, we just don't talk about that. Remember that goal line, Bill, it's the home plate, the goal line, the net. That's it. Touch down. Yes, we'll cross that bridge when it's time to cross. It's not at this point, and we want to stay consistent.

Operator

All right. Thank you. And I'm not showing any further questions in the queue. I'd like to turn the call back over to Fred for any closing remarks.

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

Ladies and gentlemen, thank you very much for your time. There's a lot of calls out there. I know you're busy. So we'll do this again. Thank you once again. We appreciate it. We'll sign off now from Salt Lake City. Raul and I will be available for the next few hours to answer questions. And we'll talk to you then. Thank you very much, and good evening.

Operator

And that does conclude our conference call for today. Thank you for your participation. Everyone, have a great day.

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